

# Capital Income 2011 Commentary



**December 31, 2011**

## MARKET COMMENTARY

The S&P 500 started and ended 2011 at the identical price level (1,258); its +2.1% return can be attributed to dividends paid. The average high yield bond price declined over the course of the year; its +4.4% return can be attributed to coupons paid. Despite the insipid returns, the year was anything but uneventful as investors endured several bouts of extreme volatility. Concerns related to the sovereign debt crisis in Europe, the combative political landscape in the US, and the potential economic slowdown in China rattled investors. These concerns have been exacerbated by the lack of confidence in policymakers, world political leaders, and central bankers. Poor (or no) decisions by policymakers could have lasting consequences (particularly in Europe) and undermine the resounding progress made by businesses over the past three years. Since the financial crisis, we have witnessed unprecedented corporate deleveraging which has been accomplished by improved productivity and restricted spending. This has facilitated strong free cash flows and enabled companies to reduce debt levels, thereby lowering financial risk. Earnings have also been impressive despite the absence of robust economic growth.

At Hotchkis & Wiley, we share the market's apprehension regarding the geopolitical landscape, but we believe current macroeconomic anxiety is overly discounting equity and high yield bond prices. Our experience has told us that in the long run compelling valuations and strong fundamentals are likely to prevail, and thus we welcome 2012 with open arms. Admittedly, we were not sad to see 2011 come to an end as it was a frustrating year for fundamental stock and bond pickers—particularly those of us focused on valuation.

As of year-end, the nominal "risk free" yield on 10-year Treasury bonds is less than 2%, which is considerably lower than both the historical and current run rate of inflation (3.7% and 3.4%, respectively). Assuming inflation continues on its current path, or increases, treasury investors appear willing to lock in a negative real return. By comparison, the HWCM Capital Income portfolio repays 3.2 times more cash to shareholders than treasuries based on its combination of dividend and coupon income<sup>1</sup>, in addition to the potential for capital appreciation.

Efforts aimed at reducing volatility have triggered outflows from equities in favor of bonds and cash (high yield experienced very modest inflows in 2011). Countless studies have demonstrated that herd-like behavior is counterproductive more often than not. We are innately skeptical that the migration away from stocks will ultimately benefit investors that have chosen this path. While elevated volatility and market downturns go hand in hand, so do elevated volatility and market rallies. For disciplined long-term investors, volatility can create opportunity, particularly if those investors are supported with diligent research.

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<sup>1</sup> Equities, high yield bonds, and U.S. Treasuries have different risk profiles. U.S. Treasuries are generally considered "risk free" securities. Equity securities have greater risks and price volatility than U.S. Treasuries, where the price of these securities may decline due to various company, industry and market factors. High yield securities have greater price volatility and credit and liquidity risks (presenting a greater risk of loss to principal and interest) than U.S. Treasuries. As of 12/31/11, the portfolio's yield and the 10-Year Treasury yield were 5.93% and 1.88%, respectively. Yield measures quoted are not guaranteed or indicative of future yields.

**ATTRIBUTION: 2011**

*Asset Allocation:* The Hotchkis & Wiley Capital Income composite returned +6.9% and +6.2% (gross and net of management fees) in 2011 versus the S&P 500 return of +2.1% and the BofA Merrill Lynch U.S. Corporate, Government & Mortgage Index return of +7.9%. Disproportionately attractive equity valuations led us to overweight equities throughout the year. While the long term target is 50/50 equities/high yield, the average allocation to equities throughout the year was 58%. This overweight should have hurt performance as equities lagged high yield bonds, but positive security selection in the equity portion of the strategy overcompensated for the allocation effect.

*Equities:* Growth stocks outperformed value stocks for the year. Despite the value bias, the equity portion of the portfolio outperformed the S&P 500; it has now outperformed in all four quarters since the strategy's inception. Positive stock selection in 8 of the 10 S&P GICS sectors was the primary contributor to the outperformance. An overweight to the high dividend-yielding utilities sector and stock selection in the industrial sector were the most significant performance contributors. An underweight in the consumer discretionary sector and stock selection in technology were performance detractors during the year.

*Fixed Income:* The high yield portion of the portfolio underperformed the broad benchmark (BofA Merrill Lynch U.S. Corporate, Government & Mortgage Index) and the high yield benchmark (BofA Merrill Lynch U.S. High Yield Master II Index) for the year. Investment grade bonds outperformed high yield bonds by a considerable margin. Three broad themes detracted from performance relative to the high yield benchmark for the year. First, the portfolio is overweight B-rated credits and underweight BB-rated credits; BBs outperformed considerably during the year. Second, the portfolio was underweight energy, which was the best-performing (and largest) sector in the index. Finally, credit selection in autos detracted from performance. On the positive side, credit selection in financial services, capital goods, and healthcare contributed to performance for the year.

The portfolio attribution in this commentary is based on a representative Capital Income portfolio. Certain client portfolio(s) may or may not contain the securities discussed in this commentary due to the account's guideline restrictions, cash flow, tax and other relevant considerations. The commentary is for information purposes only and is not intended to be, and should not be, relied on for investment advice. The opinions expressed are those of the portfolio managers as of 12/31/11 and may not be accurate reflections of their opinions after that date. There is no guarantee that any forecasts made will come to pass. Accounts may not continue to hold the securities mentioned and H&W has no obligation to disclose purchases or sales of these securities.

Past performance is no guarantee of future results.