

High Yield 2011 Commentary



December 31, 2011

MARKET COMMENTARY

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 over the course of the year. As a consequence, high yield investors endured a rather volatile year. In the end, the BofA Merrill Lynch US High Yield Master II Index returned +4.4% as coupon income overcompensated for spread widening. Investors' macroeconomic and geopolitical 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 and Wiley, we share the market's apprehension regarding the geopolitical landscape, but we believe current macroeconomic anxiety is overly discounting high yield bond prices. Our experience has been that compelling valuations and strong fundamentals are likely to prevail in the long run, 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 credit pickers—particularly those of us focused on valuation.

Spreads over treasuries widened by about 200 basis points for the broad high yield market in 2011—roughly half of this was due to an increase in yields and half was due to the rally in treasuries. High yield spreads over BBB-rated corporates also widened by about 100 basis points. At the close of the year, the yield-to-worst on the high yield market was 8.4%. We believe this presents a compelling valuation opportunity given the low default rate, improved fundamentals, and low interest rate environment. As of year-end, the nominal "risk free" yield on 10-year Treasury bonds was less than 2%, which is considerably lower than both the historical and current run rate of inflation (3.7% and 3.4%, respectively). By comparison, the HWCM High Yield portfolio has a yield-to-worst over 9%, and based on the portfolio's current yield repays 4.7 times more cash to shareholders than treasuries¹.

ATTRIBUTION: 2011

The Hotchkis & Wiley High Yield portfolio (gross and net of management fees) underperformed the BofA Merrill Lynch BB/B Index for the year. Three broad themes detracted from relative performance 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.

¹ High yield bonds and U.S. Treasuries have different risk profiles. U.S. Treasuries are generally considered "risk free" securities. 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 current yield and the 10-Year Treasury yield were 8.84% and 1.88%, respectively. Yield measures quoted are not guaranteed or indicative of future yields.

OUTLOOK (SCORING SCALE: 1=VERY NEGATIVE...5=VERY POSITIVE)

- I. **Fundamentals (5):** While we believe the high yield default rate could increase from its abnormally-low current level (<2%), we believe it will subsist below normal levels in the near/medium term. The upgrade/downgrade ratio is near an all-time high at 1.68. Over half of newly issued credits in 2011 were for refinancing, which has transformed the maturity wall into a speed bump—this should support a continuation of low defaults. Profitability remains high and financial leverage has been reduced.

- II. **Valuation (4):** Yields are 8.4% and spreads are 737 basis points. Today's spread implies an excessive default rate, which we view as highly pessimistic and unlikely suggesting an attractive entry point at these levels. Yields relative to investment grade bonds are very attractive, even considering the different risk profiles. The distribution of yields is also wide—a dynamic that we prefer given our bottom-up research process and focus on small caps/fallen angels.

- III. **Technicals (3):** Net flows have been volatile but modestly positive. The market absorbed \$246 billion in new issuance this year with modest inflows because most of these deals were for refinancing. We expect a smaller, but still robust new issue market going forward because companies have reduced refinancing needs; this can create widening pressure on spreads. Countering these pressures are low dealer inventories, which reduces the need for forced selling.

The portfolio attribution in this commentary is based on a representative High Yield 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.

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