



“Facts do not cease to exist because they are ignored”

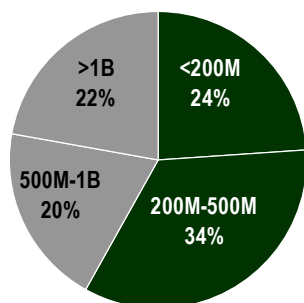
Aldous Huxley (1894 – 1963) – British writer

Introduction

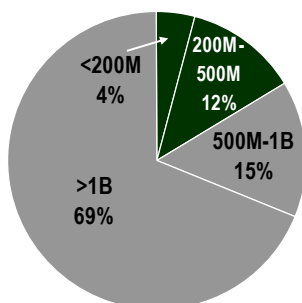
The small cap segment of the high yield market is rarely mentioned by the most prominent high yield investors—most likely because large asset levels preclude them from investing in this space. As of March 31, 2010, 58% of issuers in the high yield market had less than \$500 million in total issuance; 78% had less than \$1 billion in total issuance. We believe the small cap portion of the high yield market presents opportunities that are too important to ignore. This piece will explore the merits and issues of investing in the small cap credit market.

Chart 1: High Yield Market Breakdown 3/31/10

By Number of Issuers



By Total Par Value



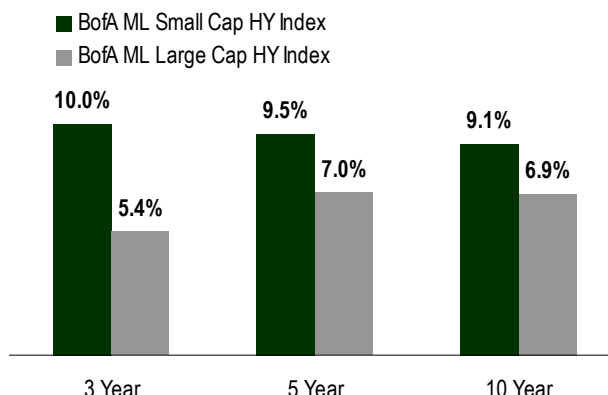
Historical Backdrop

Opportunities in the high yield credit market were originally limited to fallen angels. Investors' goal was to identify credits with high likelihoods of returning to investment grade. This changed during the Milken-era high yield market revolution, which introduced new forms of credit structures and distribution. Consequently, high yield investors' opportunity set expanded to include both leveraged buyouts and small cap issuers. Today, many small cap issuers now rely on high yield market financing to support their business, making this an integral market segment.

Performance

As depicted in Chart 2, the small cap high yield market has outperformed its large cap brethren by a considerable margin. Over the last three years small caps have outperformed by 460 basis points annualized. Over the last ten years small caps have outperformed by a smaller, but still meaningful margin of 220 basis points annualized.

Chart 2: Annualized Performance 3/31/10



Risks

Critics of the small cap credit market contend that it performs well simply due to additional risk embedded in this market segment. The three most common critiques are that small cap credits 1) have less research coverage, 2) are less liquid and, 3) have greater volatility. We agree with the first two points but partially disagree with the third.

1) Less Research Coverage

We acknowledge that small cap credits have less sell-side research coverage compared with large cap credits. Rating agencies and investment banks alike have economic interests that sway their focus in favor of large issuers; incentives to cover small issuers are often modest at best. This does not mean that small issuers offer less attractive investment opportunities. For the right manager, it means the opposite. It does, however, require proprietary research and adept judgment without the benefit of consensus opinion.

2) Less Liquid

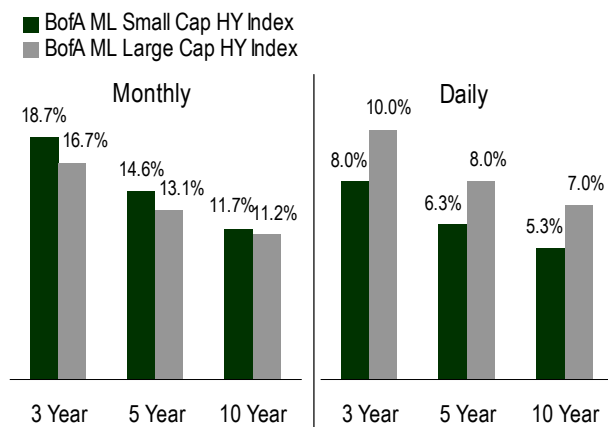
We agree that small cap issuers tend to be less liquid compared to large cap issuers. Liquidity in the high yield market, however, is a double-edged sword. Valuation of large cap credits is often influenced by externalities rather than by fundamentals. These technical conditions (e.g. credit default swaps, indexing activity) rarely affect small cap issuers in a meaningful way.



3) Greater Volatility

Small caps generally trade at wider spreads than large caps, and have exhibited larger moves in the market over extended periods. Large caps, however, exhibit greater short-term volatility largely due to external influences (described in point 2). Small caps exhibit *more* volatility than large caps using monthly returns, but exhibit *less* volatility than large caps using daily returns (Chart 3).

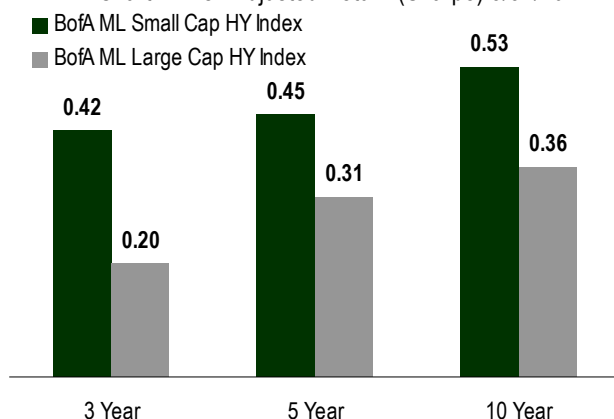
Chart 3: Annualized Standard Deviation 3/31/10



Risk-Adjusted Performance

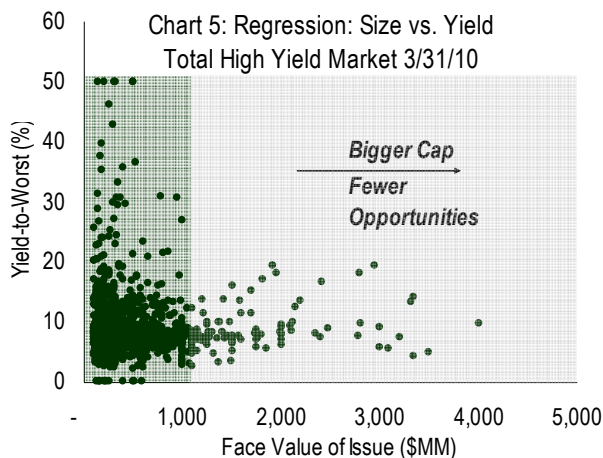
Using the more conservative monthly assumptions in Chart 3 (“pro-large cap”), small cap credits still exhibit a better risk/return profile than large cap credits. After compensating for volatility, small cap credits have produced a definite return advantage over large cap credits (Chart 4).

Chart 4: Risk-Adjusted Return (Sharpe) 3/31/10



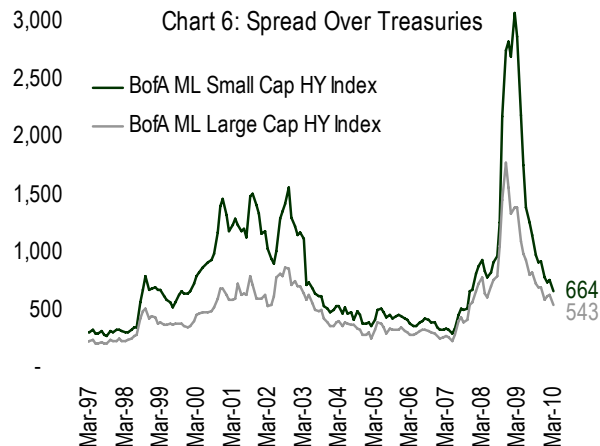
Opportunity Set

The distribution of yields in the small cap market is much less symmetric than in the large cap market. As shown in Chart 5, small caps boast a disproportionate share of the very-high-yielding opportunities.



Current Spreads

Over the past year the high yield market has tightened at a torrid pace—both large and small caps. Despite the robust performance, large and small caps both trade at slightly wider spreads than their historical medians. As shown in Chart 6, small caps trade at a spread of 664 basis points, which compares to the historical median of 661 basis points. Large caps trade at a spread of 543 basis points, which compares to the historical median of 416 basis points. Thus, large caps trade at a deeper discount than small caps relative to their respective historical medians. Nonetheless, we continue to find compelling opportunities in small caps today, albeit selectively. As we saw in Chart 5, the small cap market continues to offer a wide range of opportunities.





Taking Advantage of the Small Cap Credit Market

Effective high yield asset management entails credit market experience, resource breadth, and stability. Taking advantage of the small cap segment of the high yield market requires additional attributes, two being of paramount importance: 1) flexibility and, 2) research depth.

1) Flexibility

In order to take a truly active position in a small cap credit, a responsible high yield manager should commit to controlling assets under management. Ballooning assets unavoidably translate into trading difficulties, diluted research, and process changes—or a combination thereof. The following table depicts the amount of an issue (as a percentage) that a manager would need to own to initiate a 1% portfolio position. For example, if a manager had \$10 billion in assets and wanted to take a 1% position in a \$500 million issue, it would require the manager to purchase 20% of the total issue (shaded below). Presumably, this would be an illiquid position. Large asset levels necessitate one of two things: 1) illiquid positions or 2) avoidance of smaller issues altogether. We believe both of these are detrimental to investors.

Chart 7: Liquidity Constraints at Various Asset Levels

Total AUM (\$MM)	2,500	5,000	10,000	20,000
1% Position (\$B)	25	50	100	200
% of \$250MM Issue:	10%	20%	40%	80%
% of \$500MM Issue:	5%	10%	20%	40%
% of \$1B Issue:	3%	5%	10%	20%

2) Research Depth

Many of the issues in the small cap credit market with exceedingly high yields are priced properly (e.g. the green shaded box on Chart 5, page 2). They may be distressed issues with substantial embedded risk that carry deservedly wide spreads. Consequently, naïve purchasing of small cap credits can be a dangerous trade. Structuring a team with extensive experience in corporate research is a prerequisite to taking advantage of these select opportunities. Meticulous due diligence is the only repeatable method for avoiding the pitfalls of high defaults and low recoveries from poor investment decisions in the high yield market—especially in small cap credits.

Wrap-Up

The small cap portion of the high yield market has offered, and continues to offer compelling opportunities for the astute investor; the astute investor being one with responsible management and unique research expertise. We believe the high yield marketplace is structured in a manner that precludes its biggest players from investing in a vital market segment. We have designed our strategy to take advantage of this phenomenon because as Mr. Huxley implies in his quote, ignored opportunities are still opportunities.

Mark Hudoff and Ray Kennedy
Hotchkis and Wiley High Yield Portfolio Managers



HOTCHKIS AND WILEY CAPITAL MANAGEMENT

Small Cap Credits = Big Opportunities

High Yield Newsletter May 2010

Period ended June 30, 2010

Portfolio Characteristics

	HY Portfolio	BofA ML BB/B Constrained	BofA ML Master
Years to Maturity	8.6 years	7.1 years	6.9 years
Yield to Maturity	9.3%	8.3%	9.2%
Yield to Worst	9.0%	8.1%	9.0%
Current Yield	8.6%	8.3%	8.8%
Modified Duration	4.4	4.3	4.2
Spread over Treasuries	683bps	614bps	713bps
Average Coupon Rate	8.9%	8.3%	8.5%
# of Issuers	93	770	952

Allocation by Credit Quality

	HY Portfolio	BofA ML BB/B Constrained	BofA ML Master
Investment Grade	7.4%	9.2%	7.4%
BB	33.5	53.2	43.0
B	47.8	37.7	38.3
CCC or lower	5.5	0.0	11.3
Nonrated	5.8	0.0	0.0

Allocation by Issuer Size

>\$1 billion	57.2%	68.3%	70.0%
\$500 million - \$1 billion	17.2	15.8	14.4
\$200 million - \$500 million	22.5	13.4	12.6
<\$200 million	3.1	2.5	3.0

Allocation by Sector

	HY Portfolio	BofA ML BB/B Constrained	BofA ML Master
Automotive	7.3%	3.2%	4.1%
Banking	9.6	7.8	7.6
Basic Industry	8.4	13.5	11.8
Capital Goods	5.0	4.9	4.8
Consumer Cyclical	7.8	5.8	6.2
Consumer Non-Cyclical	2.7	3.3	3.0
Energy	10.4	12.3	10.5
Financial Services	4.6	2.8	3.8
Healthcare	7.3	7.3	7.2
Insurance	1.9	1.5	1.7
Media	8.8	6.7	6.8
Real Estate	0.0	1.3	1.6
Services	9.1	11.9	12.3
Technology & Electronics	4.8	2.7	4.0
Telecommunications	7.0	9.8	9.3
Utility	4.5	5.2	5.2
Cash	1.0	0.0	0.0

Sources: Charts 1 through 7 - Bloomberg and/or Hotchkis and Wiley.

Representative High Yield portfolio. Client portfolio holdings may vary due to different restrictions, cash flows, and other relevant considerations. Past performance is no guarantee of future results. Investments in debt securities typically decrease in value when interest rates rise. This risk is usually greater for longer-term debt securities. Investment in lower-rated and non-rated securities presents a greater risk of loss to principal and interest than higher-rated securities. Credit Quality weights are derived from the highest bond rating as determined by S&P, Moody's and Fitch. The BofA ML Large Cap HY Index and BofA ML Small Cap HY Index track securities by market cap of the BofA Merrill Lynch US Cash Pay High Yield Index which represents below investment grade US dollar denominated bonds making coupon payments in cash and that have at least \$100 million in outstanding issuance.

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