Hotchkis & Wiley High Yield Strategy Conference Call

January 12, 2012

Moderator: Mary Papamarkou

Operator: Thank you for participating in the Hotchkis & Wiley 4Q High Yield Strategy conference call. My name is Nene and I will be your conference operator today. All lines have been placed on mute to prevent any background noise. After the speaker's remarks, there will be a question and answer session. If you would like to ask a question during this time, simply press star then the number one on your telephone keypad. If you would like to withdraw your question, press the pound key. Ms. Papamarkou, you may begin your conference.

Mary Papamarkou: Thank you, Nene. Good afternoon and welcome to the Hotchkis & Wiley High Yield Strategy conference call for investment professionals. My name is Mary Papamarkou. I'm a Managing Director at Hotchkis & Wiley. On behalf of everyone at Hotchkis & Wiley, thank you for joining us today. With me is Ray Kennedy, Portfolio Manager. Today, we will be conducting an overview of the Hotchkis & Wiley High Yield Strategy and the general High Yield market. After Ray speaks, we will open the call up to questions.

Please be aware that you can find helpful information on the High Yield Strategy, as well as all of our strategies, on our website hwcm.com, or by contacting us at 800-796-5606. For our mutual fund products, you should read the prospectus carefully before investing or sending money. The opinions expressed here today are subject to change and are not guaranteed and should not be considered recommendations to buy or sell any security. Strategy holdings and sector allocations are also subject to change at any time and are not recommendations. Fixed income securities are subject to interest rate risks and as such their value may fall as interest rates rise. Investing in high yield securities may carry a greater risk of non-payment of interest or principal than higher rated bonds. Discussion of individual securities mentioned in this call is intended to provide background on the portfolio construction. This discussion should be viewed solely within the context of the strategy.

I would like to take just a minute to talk about our firm and the High Yield Strategy. As of December 31st, 2011 our firm's assets total approximately $16.1 billion. The High Yield Strategy has approximately $670 million in total assets of which $406 million are in the fund and the remainder in separate institutional accounts.

Ray, why don't we get started today with the review of the Hotchkis & Wiley High Yield Strategy, maybe a brief recap of the team, the process and portfolio construction?

Ray Kennedy: OK, well first of all thank you all for joining us and Happy New Year. For those of you who aren't familiar with the strategy, we started about three years ago; in fact, come April we will be in business officially for three years. We have a strategy that focuses on a balance between small caps and fallen angels with an emphasis on trying to find value in those sectors. Our goal as a business is to keep this relatively small, meaning that we don't plan to run a very large institutional or public base of funds, but we do plan to take advantage of this great research platform that we have at Hotchkis that focuses largely on value in small caps. It blends very well with the strategy we employ in the High Yield strategy. Myself and Mark Hudoff run the strategy and we also have two dedicated analysts, as well as the entire team of industry/credit analysts at Hotchkis that totals about 26. With that I think we will go ahead and start Q&A.

Mary Papamarkou: Let's start with a recap of 2011. It was a rough year for value managers in particular. Can you give us a perspective on how you were positioned going into the year versus what actually occurred in the markets?

Ray Kennedy: Those of you who know me know I'll be brutally honest. In terms of what we expected and how we positioned the portfolio, at the beginning of 2011, if you can remember the backdrop, the economy was strong, most of us were concerned about rising rates; Europe was a little bit of a sidebar discussion. If we look at the year and how it transpired, clearly treasuries had probably one of their best performing years; cyclicals had a very difficult year. For example, the autos - even though they had very strong seasonally adjusted sales - tended to underperform largely over concerns of expectations for 2012 and raw material cost, and financials were clearly challenged because of the issues in Europe.

As a portfolio, we positioned ourselves at the beginning of the year to be underweight (BBs), be overweight cyclicals, and to basically own financials that we thought were attractive and wide to the market. In short, we were long beta and lower quality. Clearly that was a tough trade. By the end of the year much of it recovered and that helped our performance toward the end of the year, but it made for what I would consider one of the more disappointing years that we have had. That being said, our two year and since inception results have still been very strong.

What have we learned from all this? One is to basically prepare yourself for volatility. I think if there is one thing that was probably the most interesting thing to observe as a portfolio manager last year was the absolute bouts of illiquidity and volatility in the High Yield market, punctuated by some changes from a regulatory standpoint and the dealer community where we saw bids dry up sometimes literally within hours. That was basically what happened last year and I know we are going to talk a little bit about how we are positioned this year, but why don't we go ahead to the next question.

Mary Papamarkou: You and Mark typically like to frame the outlook discussion in fundamentals, technicals and valuation. As we move into 2012, what are your thoughts on each?

Ray Kennedy: The way I look at the overall High Yield market is it is still very attractive. We see it as being a place in which investors can get excess returns, above most fixed income, and will probably be very competitive with equities. But, it will be punctuated again with bouts of volatility and investors should look at it from that standpoint. In terms of the way in which we look at the market, fundamentally most credits are in very good shape. In fact, some of the

Past performance is no guarantee of future results

numbers being kicked around by analysts on the street suggest that leverage really has fallen down to levels below 2005, which was considered a very benign low risk credit environment. The good thing also about leverage is that the names in which you had the most risk - i.e. the CCCs - we've seen a considerable decrease in leverage.

Fundamentally, things did very strong from a leverage standpoint. We have seen cash balances continue to grow and management teams are being extremely conservative; of course, that relates both to capital investments and hiring. The negative is that's kind of reflected a bit in GDP in terms of employment growth and CapEx.

The last thing I'd point out is most of the companies have addressed their refinancing needs. If you look at the overall High Yield market which is about a $1 trillion market, about 50% of it has been refinanced in the last two and a half years. That's pretty remarkable. We don't really have any maturity pressures on our companies. Technically we continue to see good flows, but the flows have been volatile and that's been one of the liquidity challenges that we have seen in the asset class. The new issue calendar last year was about $250 billion. The previous year was about $300 billion. This year our expectation is probably closer to the $200 billion range. You have about $150 billion of the $1 trillion High Yield market that is callable at this point. Probably half of which will be called and refinanced out.

You may also see a significant number of pay downs through cash from operations as well as refinancing in the loan market. Technically, there shouldn't be much pressure on the High Yield market. Our general view is that pressure from a technical standpoint isn't necessarily a bad thing for investors. It can keep the income and the yields very wide for a period of time. The good thing about valuations are that not only are the spreads wide, but the yields are still staying wide. We started the year at about 8.5 %. We are tightening a little bit obviously because of the rally in High Yield.

What's most comforting to me is the breadth of yields out there is not concentrated . For example, if you look at a distribution chart of spreads across anywhere from 200 basis points to, in some instances 1,500 basis points, it's a pretty broad distribution. That gives investment managers like ourselves that are actively looking for value, a lot of opportunities and a lot of ways to make money for investors.

Mary Papamarkou: You alluded earlier to some of the portfolio positioning and what the portfolio looks like today. Can you talk a little bit more about how you are positioned and how you feel about the existing portfolio?

Ray Kennedy: Sure. Our expectation and it's obviously not a science, but we believe the High Yield market will have a pretty good shot at getting low double-digit returns. If we are wrong about Europe and we see much more volatility or the economy does slow down, I think low single-digit returns are probably the range of outcome from that scenario. I look at it from an investor standpoint, the high yield market probably can outperform treasuries pretty easily and probably outperform investment grade.

Past performance is no guarantee of future results

We still look at the High Yield market from the standpoint of fundamentally being strong and the economy still being strong. Asia will probably have somewhat of a soft landing or not as much growth as they have seen in the past. Europe will obviously be the challenge and we will monitor that closely. The way to basically position your portfolio in that scenario is to have a lot of carry. We do have what I characterize as a cyclical view still, but less so.

We do have financials in the portfolio but less so. We have also reduced the amount of the underweight in BBs not because we are bullish on treasuries as much as just trying to dampen the volatility that we could still see in the High Yield market. Cash is king at times and we will be actively managing our cash positions to take advantage of these gaps; these air pockets tend to form in the High Yield market for periods of time. From that standpoint, we are very confident about the portfolio. We like it. The names that really underperformed last year didn't do it from a default or a fundamental standpoint; it was more from a volatility and mark-to-market standpoint. We see a lot of potential upside in those names and in some instances we've actually added a little more.

Mary Papamarkou: You believe in the attractiveness long-term of the High Yield market. Can you give some examples about what you like about the asset class?

Ray Kennedy: The great thing about High Yield is every year that we have good returns, especially relative to an equity-like asset class, our risk reward numbers look even more attractive to investors. I think as an asset class we've become more and more established for investors much like investment grade did 15+ years ago. From the standpoint of the attractiveness of High Yield, in our view, you've really got tailwinds in the form of decreasing leverage, improving fundamentals, you are not seeing much LBO activity which can be negative. You are seeing a very attractive valuation both in the short-term as well as in the long-term. And you are also seeing an asset class that can dampen the risks of a rising treasury rate environment and the impact on a portfolio because from a statistical standpoint it actually has a negative correlation that we all know varies by credit quality tier.

In our opinion, not only are we looking at a strong fundamentally-based asset class, it's a very established asset class in the institutional community and is growing in stature in what I characterize as the high net worth community. We're seeing it more and more actively used in there. The risk reward profile continues to improve. And then we talk about the impact of treasuries and how that can actually be beneficial to a portfolio given the short calls that tend to occur in High Yield and the high coupon and how that balances out the risk associated with the rising treasury environment.

Now, one should point out that we don't unnecessarily see a big spike in treasuries, but I think if one were to look at where we are today and where we may end up, we would expect treasuries to be somewhat higher. If they are somewhat lower, we'd probably have bigger issues in the economy.

Mary Papamarkou: We have one question that came in, so it's part of the call before we open up to the audience. Why should someone take a look at the Hotchkis & Wiley High Yield Strategy versus let's say a closed-end bank loan strategy or bank loans in general?

Past performance is no guarantee of future results

Ray Kennedy: It's a great question. For those of you who have known me for a long time, I started the bank loan business at PIMCO. I like the asset class; I think it has a role in a portfolio, especially a portfolio that is looking for interest rate risk management. The tough thing about loans as we saw last year and we will probably see over the next few years is we have a Fed that's going to keep the front end of the curve very low which is going to make loans as an asset class have very low carry.

Investors are going to be challenged from the standpoint of trying to keep that in a portfolio and yet keep their yield up. Also, I would like to point out that typically you want to look at loans in the later part of a credit cycle; we are still early in this credit cycle. We are about three years into this credit cycle and most credit cycles peak about five to six years in terms of where we see a significant deterioration in the fundamentals; we are not there yet.

The last thing I'd point out is there have been a lot of fundamental changes in the loan market since I started that business at PIMCO as well as just seeing the changes in the mix of investors. In the 2000 era many of the loan demands were driven by the CLO market. That has changed substantially. I think you are going to see the usage of loans change considerably. More and more companies are issuing secured debts and being less dependent on the loan market.

Fundamentally, the demand for loans and the issuance of loans is going to change. A lot of these dynamics are going to play into the valuation of loans. For example, they are pre-payable at par for the most part, maybe 101 call for one, maybe two years. It's tough to get total return and when you are talking about a low carry environment, you add that together, it's going to make for a challenging next few years for loans. It's one of the things that changed really in the last six months in the loan market - especially since we clearly are going to have a Fed that keeps rates on hold for a while.

Past performance is not a guarantee or reliable indicator of future returns. Investing in high yield securities is subject to certain risks, including market, credit, liquidity, issuer, interest-rate, and inflation risk. Lower-rated and non-rated securities involve greater risk than higher-rated securities.

U.S. Treasuries, equities, high yield bonds, and other asset classes 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 and other higher-rated securities.

Past performance is no guarantee of future results