

# Top 10 Reasons to Invest in High Yield in 2012



January 2012

## “Maturity of mind is the capacity to endure uncertainty”

- John Huston Finley (1863 – 1940)

### Introduction

From the Eurozone’s sovereign debt crisis to the United States’ uncooperative Congress, raging geopolitical uncertainty continues to give investors pause. In addition to precipitating undue stress, uncertainty can also precipitate opportunity. The combination of high yields and low defaults is quite uncommon, and in our opinion, presents an unusual opportunity for the astute investor.

Fundamentals in the high yield market are strong, valuations are compelling, and technicals reasonable. This is a tasty recipe for high yield investors and we are optimistic about the market’s prospects—this newsletter will highlight our top 10 reasons to invest in high yield in 2012.

### #1 Risk/Reward Profile

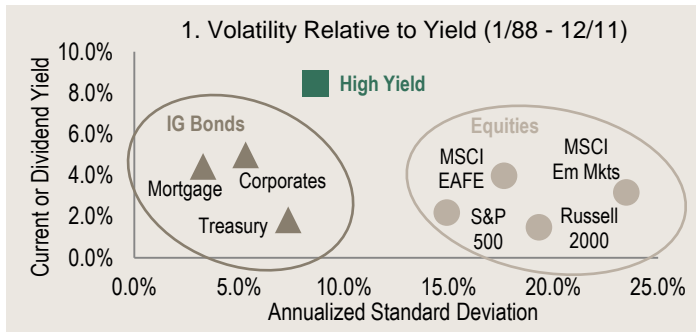
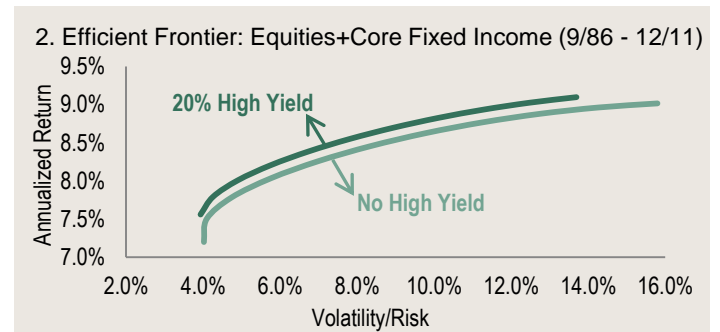


Chart 1 shows a variation of a risk/return profile using historical volatility on the X-axis and yield on the Y-axis. Volatility can vary over time so using historical standard deviation is not perfect, but it helps provide some context about how various asset classes have behaved in the past. The Y-axis plots the current yield for fixed income asset classes and dividend yield for equity asset classes. This is also imperfect because coupon and dividend payments are not assured, but again it helps provide some perspective. As depicted in the chart, high yield has exhibited more volatility than investment grade fixed income and less volatility than equities; it exhibits a higher yield than any of the other major asset classes shown.

### #2 Effective Complement



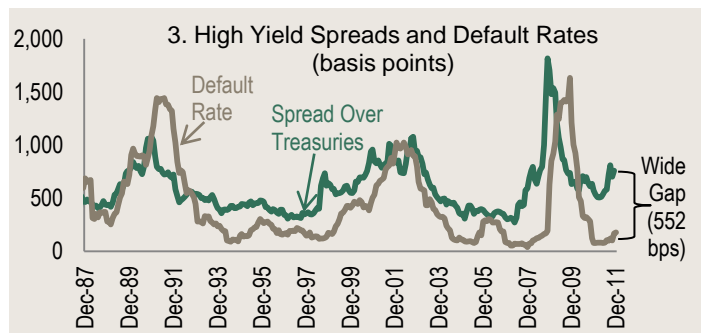
Hypothetical illustration. Past performance is no guarantee of future results.

Because high yield exhibits limited correlation with other major asset classes, it tends to improve the risk/return profile of typical portfolios. On Chart 2, the light green line represents the efficient frontier of a portfolio composed of two basic asset classes: equities and core fixed income<sup>1</sup>. The lowermost/leftmost point on this line represents 100% core fixed income and 0% equity. As you move to the right, the percentage of equity increases until the uppermost/rightmost point on the line, which represents 0% core fixed income and 100% equity.

The dark green line shows the same portfolio but adds a 20% allocation to high yield bonds<sup>2</sup>. The leftmost/lowermost point on the dark green line represents 20% high yield and 80% core fixed income. As you move to the right, the percentage of equity increases and the percentage of core fixed income decreases, but the percentage of high yield remains 20% throughout. The rightmost/uppermost point on the dark green line represents 20% high yield and 80% equity.

As shown in the chart, adding a 20% allocation to high yield would have enabled an investor in a basic core fixed income/equity portfolio to either increase their return for the same level of risk, or decrease their risk for the same level of return over this 25 year period.

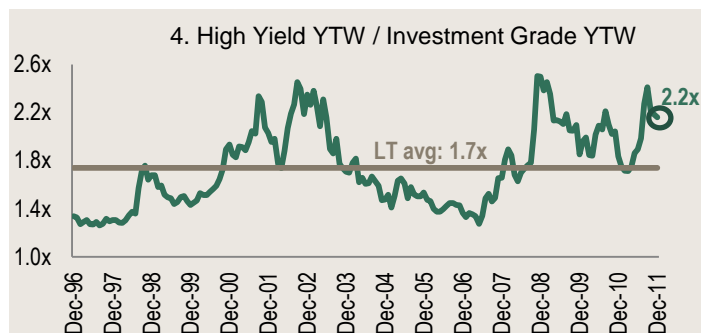
### #3 Spreads Relative to the Default Rate



As the number of defaults in the market increases, intuition tells us that investors should demand a higher yield to compensate them for increased risk. Empirical evidence supports this claim, as the correlation between high yield spreads and the high yield default rate is positive 0.56 over the past 25 years. The reason that the correlation is not closer to 1.0 is because the default rate is a backward-looking metric focused on actual defaults and the spread over Treasuries is a forward-looking metric reflecting the market's sentiment about the future. When spreads exceed the default rate by a wide margin, as shown in Chart 3, the implication is that the market believes the default rate is likely to increase going forward. If the default rate does not increase, or increases marginally, then the implication is that spreads are likely to contract—a positive development for high yield investors.

Because default rates are near all-time lows, we believe the default rate is likely to rise/revert to more “normal” levels. Current spreads, however, imply a default rate close to 10%—a level that we view as exceedingly pessimistic.

### #4 Incremental Yield Pickup



High yield spreads over Treasuries are wide for two reasons: 1) the yield-to-worst (YTW) for the high yield market is high and 2) Treasury rates are low. From an investor's perspective, paltry Treasury rates might make alternative investments more

appealing relative to Treasuries, but it says nothing about the attractiveness of investment alternatives in absolute terms. In other words, wide high yield spreads could simply indicate that high yield is the better of two bad options. Therefore, rather than show the yield difference between high yield bonds and Treasury bonds (i.e. “spreads”), Chart 4 shows the relationship between high yield bonds and investment grade corporate bonds<sup>3</sup>.

As highlighted in Chart 4, the YTW for high yield corporate bonds is normally 1.7x higher than the YTW for investment grade corporate bonds. As shown in Chart 4, however, it is 2.2x higher—nearly 30% higher than average.

### #5 Wide Spread Distribution

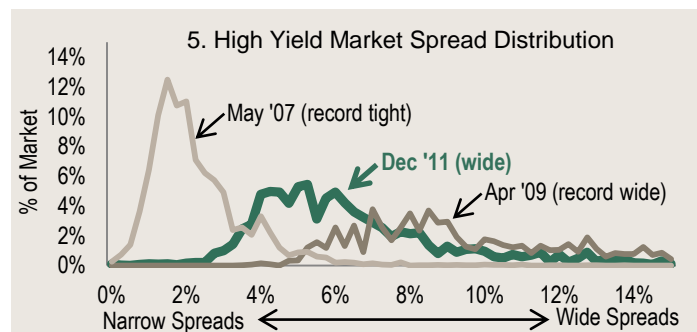
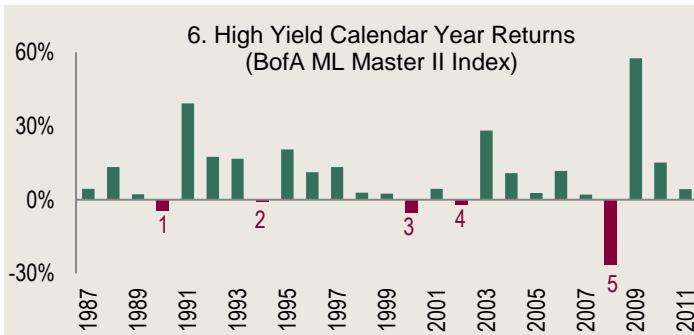


Chart 5 highlights the distribution of spreads in the high yield market (spreads over treasuries). In May of 2007 (pre-financial crisis), spreads were not only narrow but were highly concentrated between 1-3%. In April of 2009 (the heart of the financial crisis), spreads were not only wide but were widely dispersed. We prefer markets composed of bonds offering a wide range of yields as opposed to a tight/clustered market. The former bestows vast opportunities for managers with distinct research advantages.

As illustrated in Chart 5, the market is more contracted than the extraordinary April 2009 market, but we believe it remains attractive for bottom-up credit researchers—opportunities abound.

Past performance is no guarantee of future results.

#6 Annual Returns



See conclusion of commentary for index performance.

Chart 6 depicts the calendar year returns for the BofA Merrill Lynch High Yield Master II Index since its inception—1987 was its first full calendar year. Only 5 of these 25 calendar year periods were negative. Until the -26% return in 2008, the worst calendar return had been -5% in 2000. Of course, past performance is no guarantee of future results. We have shown this to numerous investors, however, and most have been surprised that there have been so few negative years.

#7 Long-Term Returns

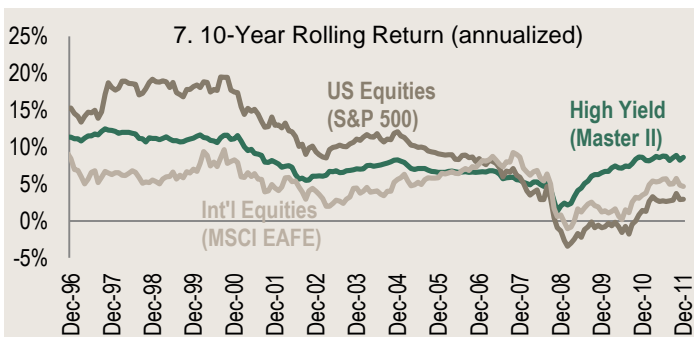
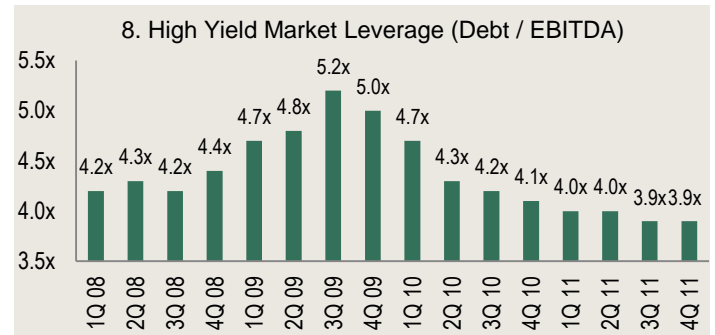


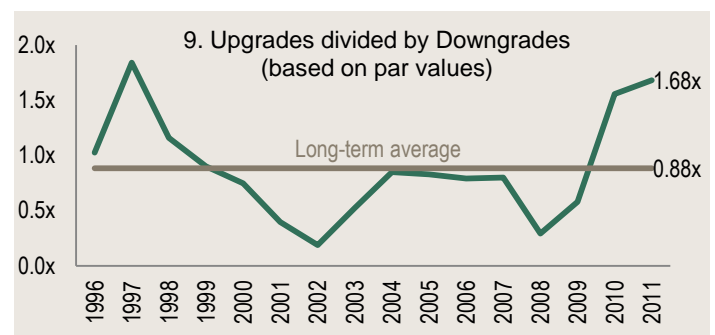
Chart 7 takes a longer-term view by highlighting the 10-year rolling returns for high yield, US equities, and international equities<sup>4</sup>. We do not claim that high yield is a stable asset class, but it has certainly been less volatile than equities. As depicted in Chart 7, high yield has never had a negative return over a ten year period—a claim that equities cannot make.

#8 Decrease in Leverage



Since the financial crisis, the market has undergone one of the largest and fastest financial deleveraging efforts in history. Managements have implemented aggressive cost-cutting programs, which has improved margins and created tremendous operating leverage. When these companies' revenues recovered, earnings and cash flows reached record levels. Many companies have used this cash to improve their balance sheets by paying down debt. Chart 8 shows the leverage for companies in the high yield market as defined by total debt to earnings before interest taxes depreciation and amortization ("EBITDA"). Leverage has declined considerably from the 2009 peak—companies appear to be in much better financial condition.

#9 Upgrade/Downgrade Ratio



Plummeting default rates and improved balance sheets has provided the rating agencies with reason for optimism. As shown in Chart 9, upgrades across the entire high yield market have far exceeded downgrades recently, moving the upgrade/downgrade ratio near an all-time high. While this reflects the opinion of rating agencies, which have a less-than-stellar track record and whom we give little credence, it does further improve corporate health by reducing borrowing costs.

Past performance is no guarantee of future results.

## #10 Rising Interest Rate Environments

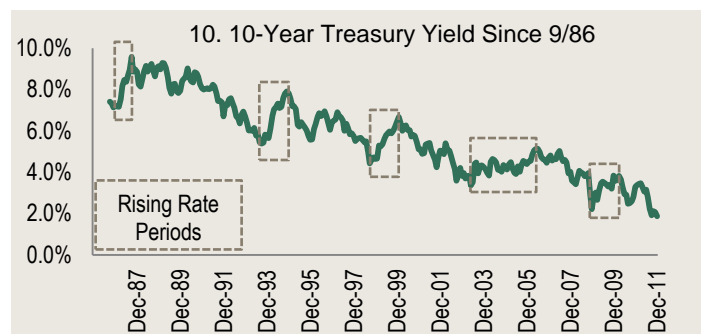


Chart 10 highlights five previous periods of rising interest rates since the inception of the BofA Merrill Lynch Master II High Yield Index. An increase in Treasury rates means a decrease in Treasury bond prices, but it does not necessarily mean a decrease in high yield bond prices. In fact, during each of these five previous rising rate periods the high yield market posted positive returns, ranging from +2% to +69%. To the surprise of many, the high yield market has actually performed better during periods of rising rates than it has during periods of falling rates. The table below shows the average annualized return of high yield bonds, investment grade bonds, and Treasuries in both rising (boxed in the Chart 10) and falling interest environments (non-boxed areas in Chart 10).

### Performance During Rising and Falling Rate Environments<sup>5</sup> Average Annualized Returns: 9/1/86 – 12/31/11

	High Yield	Investment Grade	Treasuries
Rising Rates	12.8%	1.7%	-3.4%
Falling Rates	6.9%	9.8%	11.8%

Contrary to investment grade bonds, high yield performance is primarily influenced by changes in the credit environment and economic growth rather than changes in interest rates. Most of the time, rising rates have coincided with economic growth—an environment normally conducive to high yield.

This is important because many prominent economists and investors believe an interest rate rise is inescapable. As depicted in the previous chart, interest rates have been in a secular decline for the past two and a half decades—a trend that many believe is likely to reverse.

## Summary

Macroeconomic concerns in the marketplace are unnerving to say the least, but we believe these concerns have produced a compelling valuation opportunity for high yield investors. Spreads have blown out despite considerable improvement in fundamentals—most notable has been the strengthening of balance sheets. We believe defaults may pick up from record lows but should remain well below levels implied by current spreads. The ramifications of a disorderly European sovereign debt default and tighter liquidity in the high yield market remain threats, but we believe the attractive yields and strong fundamentals more-than-compensate for the risks at hand—and present a compelling case for investing in high yield in 2012.

Ray Kennedy and Mark Hudoff  
Portfolio Managers

**Past performance is not a guarantee or reliable indicator of future results. Index performance is not indicative of fund performance. An investment cannot be made directly in an index. To obtain fund performance please visit [www.hwcm.com](http://www.hwcm.com).**

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All investments contain risk and may lose value. Investments in debt securities typically decrease in value when interest rates rise. This risk is usually greater for longer-term debt securities. Investment by the fund in lower-rated and non-rated securities presents a greater risk of loss to principal and interest than higher-rated securities. The Fund may invest in derivative securities, which derive their performance from the performance of an underlying asset, index, interest rate or currency exchange rate. Derivatives can be volatile and involve various types and degrees of risks. Depending on the characteristics of the particular derivative, it could become illiquid. Investment in Asset Backed and Mortgage Backed Securities include additional risks that investors should be aware of such as credit risk, prepayment risk, possible illiquidity and default, as well as increased susceptibility to adverse economic developments. The Fund may invest in foreign as well as emerging markets which involve greater volatility and political, economic and currency risks and differences in accounting methods.

Diversification does not assure a profit or protect against loss in a declining market. Credit cycles vary in both length and volatility. Past credit cycles will differ from current or future cycles. Sector allocations are subject to change and should not be considered a recommendation to buy or sell any security.

All references to high yield based on BofA Merrill Lynch US High Yield Master II Index.

Investment grade bonds—Mortgage: BofAML US Mortgage Master Index. Corporate: BofAML US Corporate Master Index. Treasury: Barclays Capital US 10-Year Treasury Bellwether.

Data source(s): Chart 1: Morgan Stanley, Bloomberg, H&W. Charts 2-3, 5-7; Bloomberg, H&W. Chart 4: CreditSights, Bloomberg, H&W. Chart 8: JPMorgan, Capital IQ, H&W. Chart 9: JPMorgan, H&W. Chart 10: Barclays, Bloomberg, H&W.

- <sup>1</sup> S&P 500® Index and BofAML US Corporate, Government & Mortgage Index.
- <sup>2</sup> BofAML US High Yield Master II Index.
- <sup>3</sup> BofAML Master II Index and BofAML US Corporate Master Index.
- <sup>4</sup> BofAML Master II Index, S&P Index and MSCI EAFE Index.
- <sup>5</sup> High Yield: BofAML Master II Index. Investment Grade: BofAML Corp., Gov't & Mtg Index. Treasuries: Barclays 10-Year Treasury.

Average Annual Returns as of March 31, 2012

Chart 2	1 year	3 year	5 year	10 year	15 year
S&P 500 (Equity)	8.54%	23.42%	2.01%	4.12%	6.10%
BofAML Corp/Govt/Mtg (Core FI)	7.77	6.58	6.33	5.88	6.43
BofAML HY Master II (High Yield)	5.64	23.78	7.84	8.95	7.15

Chart 6: BofAML HY Master II calendar year returns

1987	1988	1989	1990	1991	1992	1993	1994	1995
4.47%	13.36%	2.31%	-4.36%	39.17%	17.44%	16.69%	-1.03%	20.46%
1996	1997	1998	1999	2000	2001	2002	2003	2004
11.27	13.27	2.95	2.51	-5.12	4.48	-1.89	28.15	10.87
2005	2006	2007	2008	2009	2010	2011		
2.74	11.77	2.19	-26.39	57.51	15.20	4.38		

Average Annual Returns as of March 31, 2012

Chart 7	1 year	3 year	5 year	10 year	15 year
S&P 500	8.54%	23.42%	2.01%	4.12%	6.10%
BofAML HY Master II	5.64	23.78	7.84	8.95	7.15
MSCI EAFE	-5.31	17.68	-3.04	6.16	4.62

Chart 10: Rising Rate Periods

	9/86-9/87	9/93-11/94	9/98-1/00	5/03-5/06	12/08-12/09
10-Year Treasury	-9.6%	-9.4%	-5.6%	2.8%	-4.1%
BofAML HY Master II	7.5	1.8	5.2	33.2	69.3

BofA Merrill Lynch U.S. High Yield Master II Index tracks the performance of below investment grade, but not in default, U.S. dollar-denominated corporate bonds publicly issued in the U.S. domestic market, and includes issues with a credit rating of BBB or below, as rated by Moody's and S&P. BofA Merrill Lynch U.S. Mortgage Master Index tracks the performance of U.S. dollar denominated fixed rate and hybrid residential mortgage pass-through securities publicly issued by U.S. agencies in the US domestic market. BofA Merrill Lynch U.S. Corporate Master Index tracks the performance of U.S. dollar denominated investment grade corporate debt publicly issued in the U.S. domestic

market. BofA Merrill Lynch U.S. Corporate, Government & Mortgage Index is a broad-based measure of the total rate of return performance of the US investment grade bond markets. Barclays Capital U.S. 10-Year Treasury Bellwether represents an investment in 10-Year on-the-run Treasury bonds. S&P 500® Index is a broad based unmanaged index of 500 stocks, which is widely recognized as representative of the equity market in general. The Russell 2000 Index is comprised of the 2,000 smallest companies in the Russell 3000 Index. MSCI EAFE (Europe, Australasia, Far East) Index is a free float-adjusted market capitalization index that is designed to measure the equity market performance of developed markets, excluding the U.S. & Canada. MSCI Emerging Markets Index is a free float-adjusted market capitalization index that is designed to measure equity market performance of 21 emerging market country indices. The indices do not reflect the payment of transaction costs, fees and expenses associated with an investment in the Fund. It is not possible to invest directly in an index. The Fund's returns may not correlate with the returns of its benchmark indices.

Correlation: Statistical measure of the degree to which the movements of two variables (stock/option/convertible prices or returns) are related. Credit Risk: Risk associated with corporate bonds' possibility of default. Standard deviation: Statistical measure of the historical volatility of a mutual fund or portfolio, usually computed using 36 monthly returns. Basis point: Unit that is equal to 1/100th of 1% and is used to denote the change in a financial instrument. Default Rate: number of defaulted issuers divided by total number of issuers. Yield-to-worst (YTW): calculated by making worst-case scenario assumptions on the issue by calculating the returns that would be received if provisions, including prepayment, call or sinking fund, are used by the issuer.

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