



“You can’t always see things for what it is if you just stare at it, sometimes you have to step back, look at things from a different perspective and ask questions”

- Leonardo Ruiz

Introduction

Since bottoming on March 9, 2009, the high yield market is up nearly 85% through October 31, 2010. That equates to a +3.2% monthly compounded return, or a doubling of your investment every 1.9 years—performance few investors would protest.

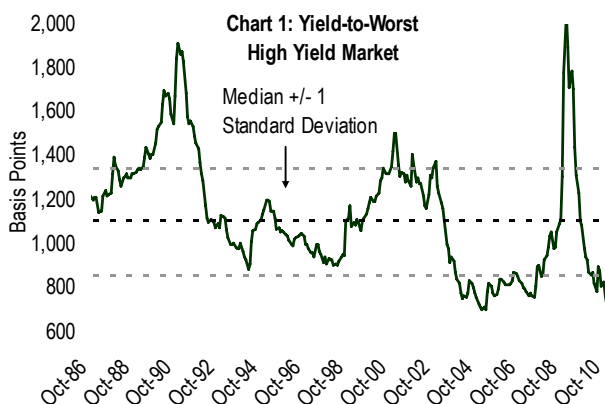
Given the strong returns, we are focusing our November newsletter on the subject of valuation. To start, we describe several common methods that high yield investors use to evaluate whether the market is over or undervalued. Next, we will discuss the pros and cons of each method. Finally, we will describe a concept we refer to as the high yield **liquidity premium (“LP”)**. We believe this is a worthwhile complement to more traditional appraisal metrics and adds valuable perspective.

Yield-to-Worst

First, let’s define some terms:

- **Yield-to-maturity:** the rate of return an investor would realize if he held the bond until expiration, assuming the bond does not default.
- **Yield-to-call:** the rate of return an investor would realize if the bond is called by the issuer at the call date.
- **Yield-to-worst:** the lower of yield-to-maturity or yield-to-call.

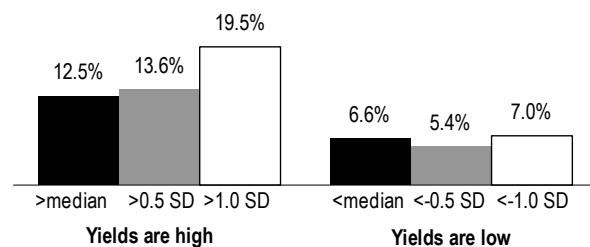
Of the three yield metrics, yield-to-worst (“YTW”) is preferred in the high yield market because most below investment grade bonds are issued with embedded call options. YTW considers the multiple call scenarios associated with the bond, and identifies which scenario has the lowest yield. Rationally, the YTW metric assumes the bond issuer will act in its own best interests. The chart below shows the YTW for the high yield market historically.



The yield-to-worst for the high yield market as of October 31st was 726 basis points, which is 378 basis points (~1.4 standard deviations) below the historical median. On first blush, this suggests today’s high yield market is not particularly attractive relative to other periods.

The chart below shows the 1-year returns of the market in various yield environments. Historically, when the market’s yield-to-worst was more than 1 standard deviation below the median, as it is today, the market returned +7.0% over the following twelve months—this is below the high yield market’s average historical return of +9.2% per annum (1/1/86-10/31/10).

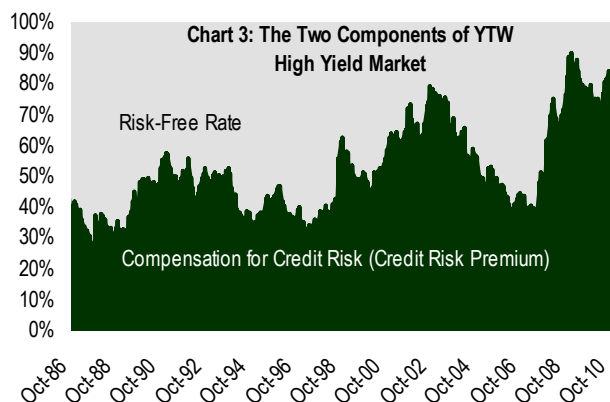
Chart 2: High Yield Market Avg Return Over Following 12 Months Based on Various Levels of YTW



While using yield-to-worst as a proxy for high yield market attractiveness is a reasonable top-level consideration, it contains important shortcomings. Most notably, YTW ignores the current interest rate environment. The YTW on a bond has two broad components: the risk-free rate and the credit risk premium. YTW does not distinguish between the two, thus, it fails to quantify the credit risk premium.



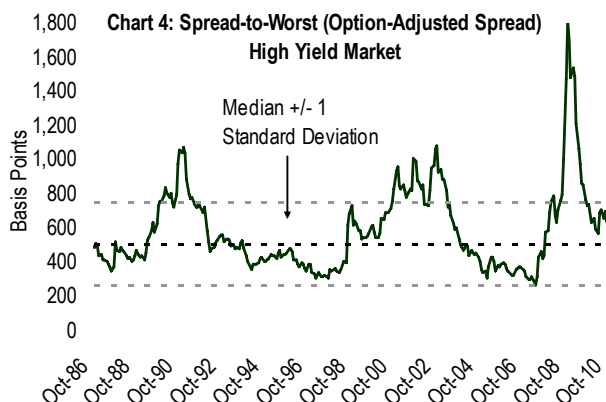
To help illustrate this point, let's consider the current environment. We've already established that the high yield market's YTW is 1.4 standard deviations below its long-term median; however, the risk-free rate (YTW on the 5-Year Treasury) is 2.2 standard deviations below its long-term median. This is important because as high yield investors, we want to capture how much we are being compensated for assuming credit risk. The chart below shows the two components of YTW over time—note that today, compensation for credit risk comprises the majority of the market's YTW.



This leads us to the next measure of high yield valuation: spread-to-worst.

Spread-to-Worst

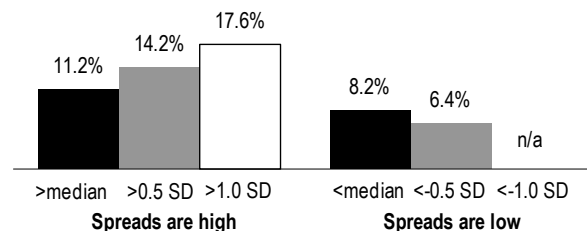
Put simply, a bond's spread-to-worst ("STW") is its yield-to-worst minus the YTW on a similar duration Treasury (which is represented by the green area in the previous chart). As of October 31st, the high yield market's duration is 3.6 and its YTW is 726 basis points. The yield on a similar-duration Treasury is 113 bps. Therefore, the STW for the high yield market is 613 bps (726 - 113). The chart below shows the spread-to-worst for the high yield market historically (note that we use the terms STW and option-adjusted spread "OAS" interchangeably).



Spread-to-worst results in a different valuation conclusion than yield-to-worst. On October 31st, the STW of the high yield market was 613 bps. This compares with the long run median STW of 509 bps. This is approximately 0.5 standard deviations above the long run median.

The following chart shows the 1-year returns of the market in various *spread* environments—similar to the chart on page one showing these returns in various *yield* environments. Historically, when the spread-to-worst on the market was about 0.5 standard deviations above the median, as it is today, the market returned +14.2% over the following twelve months—this is above the high yield market's average historical return of +9.2% per annum.

Chart 5: High Yield Market Average Return Over Following 12 Months Based on Various Levels of STW



There are two core factors that we need to consider in tandem with STW: default rates^a and recovery rates^a. These two thieves erode credit investors' returns.

Our experience has revealed that default trends are closely correlated to the business cycle. Other factors like underwriting standards and access to credit is important, but the driving-force of default trends is the state of the business cycle. Defaults tend to exist in one of two states: very high and very low. Currently, the default run rate is about 50 basis points compared to the long-term average default rate of 432 basis points. The default rate we focus on is based on the number of issuers rather than par value (the latter is lower). Because our strategy is benchmark-agnostic and emphasizes small cap issuers, this is the more prudent technique. We are interested in the number of defaults rather than the size of a single default.

The recovery rate—the amount that the investor *recovers* in defaults—is also an important assessment. Currently, the recovery rate is 37%, just below the long-term median of 39%.

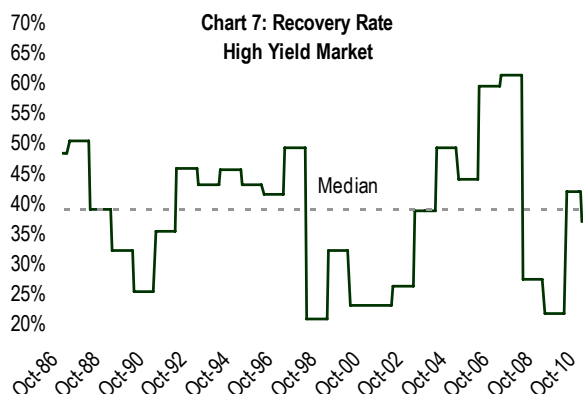
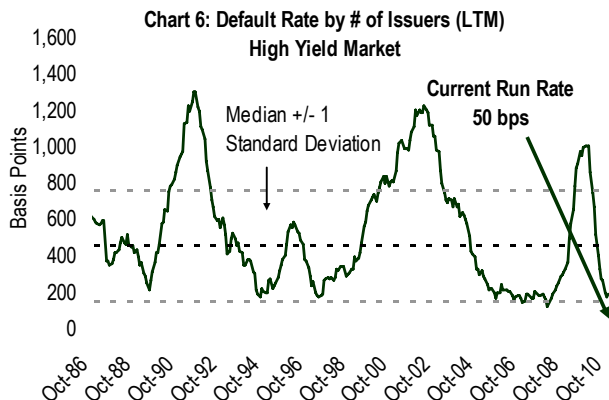


The High Yield Liquidity Premium

HOTCHKIS AND WILEY CAPITAL MANAGEMENT

High Yield Newsletter November 2010

The following charts show the historical default rates and historical recovery rates for the high yield market.



This leads us to a measure of high yield valuation that we view as a useful and complementary valuation metric: liquidity premium.

High Yield Liquidity Premium

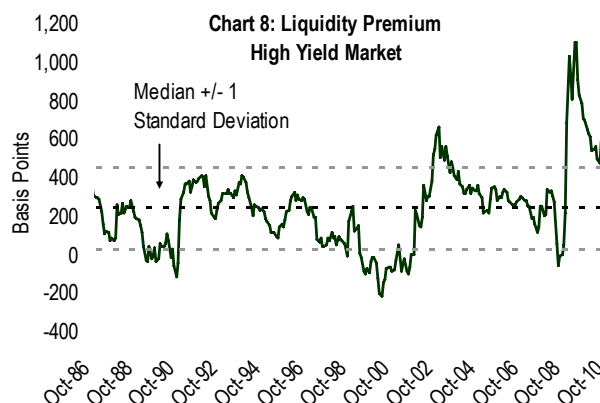
The liquidity premium (“LP”) identifies the excess premium after compensating for default conditions. Precisely, it represents the spread-to-worst minus expected losses; this equates to the amount of the spread that an investor would realize after accounting for defaults and post-default recovery rates.

$$STW = \underbrace{\text{Default Rate} * (1 - \text{Recovery Rate})}_{\text{Credit Loss}} + LP$$

Rearranging the math gives you the formula for the LP:

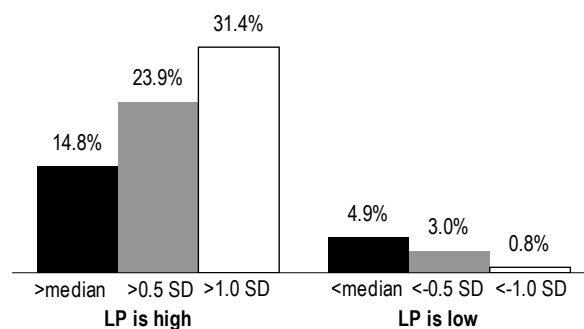
$$LP = STW - \underbrace{[\text{Default Rate} * (1 - \text{Recovery Rate})]}_{\text{Credit Loss}}$$

The chart below shows the liquidity premium for the high yield market historically. In formulating this data series, we use Moody’s actual default and post-default recovery rates. As of October 31st, the liquidity premium is 521 basis points, which is 1.3 standard deviations above the historical median of 248 basis points.



The following chart shows the 1-year returns of the market in various *liquidity premium* environments. Historically, when the liquidity premium on the market was more than 1.0 standard deviations above the median, as it is today, the market returned +31.4% over the following twelve months—this is well above the high yield market’s average historical return of +9.2% per annum.

Chart 9: High Yield Market Average Return Over Following 12 Months Based on Various Levels of Liquidity Premium

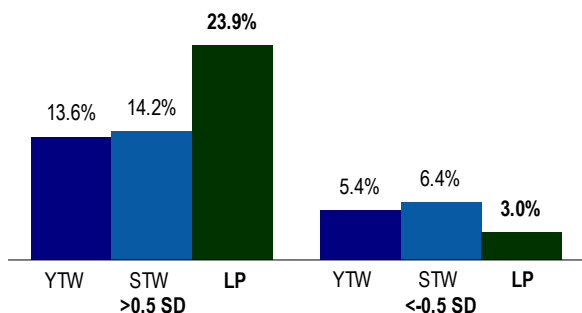


It should be noted that, like the other measures, the liquidity premium has its own limitations. The most notable is that future default rates and recovery rates are unknown and must be estimated. What gives us comfort in thinking about the LP is that defaults rates tend to subsist below average for extended periods, punctuated by short periods of very high default rates. Also, the central focus of our research is to avoid defaults.



The following chart shows the 1-year returns of the market when the three tools we explored (YTW, STW, and liquidity premium) are more than 0.5 standard deviations from their respective medians. The chart indicates that the liquidity premium is a better gauge of identifying unusual future performance.

**Chart 10: High Yield Market Avg Return Over Following 12 Months
YTW vs. STW vs. Liquidity Premium**



Conclusion

Our objective for this newsletter was to evaluate whether or not the current high yield market is attractively-valued by exploring several methods. We looked at traditional metrics like YTW and STW, and introduced a concept we refer to as the liquidity premium. The low YTW implies that the current high yield market is richly valued, but it fails to consider the underlying reason—historically low Treasury yields. We believe spread-to-worst is a more perceptive measure. The current STW, while not extraordinary, suggests that the high yield market remains attractively-valued.

Finally, the liquidity premium suggests that the high yield market remains considerably attractive. This measure captures the excess yield available to investors after compensating for expected default and recovery rates. If defaults spike unexpectedly, the LP could provide misleading valuation conclusions. To address this, investors should monitor economic fundamentals and high yield market technicals (fund flows, new issue trends, etc.). We believe the economy is recovering, albeit tepidly. Liquidity in the financial system remains constructive, investors continue to search for yield, and the monetary regime is likely to remain accommodative for a considerable period—an environment supportive of continued low default rates. Low default rates and wide spreads improve the liquidity premium and further support our contention that the high yield market remains attractive.

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

^aJP Morgan, Moody's

Chart Data Sources: 1-2: Credit Suisse; 3: Barclays, Credit Suisse; 4-5: Credit Suisse; 6-7: JP Morgan, Moody's; 8-10: Credit Suisse, JP Morgan, Moody's Performance Charts (2, 5, 9 & 10): Each of these charts shows the performance for the high yield market over a 12-month period following the observation date. Using 12.5% data point in Chart 2 as an example: all observations (using month end data) where the YTW was greater than its historical median were procured and then calculated what the high yield market returned over the following 12 months. These observations are then averaged to arrive at 12.5%.

The High Yield Market represents all corporate bonds rated below BBB- (or equivalent; including non-rated) by the major rating agencies, as defined by Credit Suisse. The ratings are based on the period between 1/1/86 and 10/31/10.

Past performance is not a guarantee or reliable indicator of future results. All investments contain risk and may lose value. Investing in the debt securities is subject to certain risks including market, interest-rate, issuer, credit, and inflation risk. Investment in lower-rated and non-rated securities presents a greater risk of loss to principal and interest than higher-rated securities.

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