

Hotchkis & Wiley High Yield Webinar Replay

January 2018



What's in Store for the High Yield Market in 2018

Listen in to a recent conference call featuring Portfolio Manager Ray Kennedy as he discusses the 2017 high yield market, and the backdrop for 2018.

 **Audio Replay**

 **Presentation**



Hotchkis & Wiley High Yield Fund - Average Annual Returns as of December 31, 2017

	4Q17	1 Year	3 Year	5 Year	7 Year	Since 3/31/09
I Shares (net of fees)	0.99%	8.24%	6.32%	5.72%	6.88%	11.16%
I Shares (gross of fees)	1.17	8.99	7.07	6.46	7.63	11.94
ICE BofAML BB-B US HY Constr. Index	0.39	6.98	6.06	5.59	6.80	10.97
ICE BofAML US High Yield Index	0.41	7.48	6.39	5.80	6.94	12.32

The Fund's total annual operating gross expense ratio as of the most current prospectus is 0.74% for I Shares; net expense ratio is 0.70%. The Advisor has contractually agreed to waive advisory fees and/or reimburse expenses through October 31, 2018. The performance shown represents past performance. Past performance is no guarantee of future results and current performance may be higher or lower than the performance shown. Investment results and principal value will fluctuate so that shares, when redeemed, may be worth more or less than their original cost. To obtain performance data current to the most recent month-end, access our website at www.hwcm.com.

Transcript

Operator: Greetings. Welcome to the Hotchkis & Wiley High Yield Strategy Conference Call for Investment Professionals. At this time all participants are in a listen-only mode. A question-and-answer session will follow the formal presentation. If anyone should require operator assistance during the conference, please press star, zero on your telephone keypad. As a reminder, this conference is being recorded. I'd like to turn the conference over to your host, Mary Papamarkou. Thank you, you may begin.

Mary Papamarkou: Thank you, operator. Welcome, everyone, and good afternoon. My name is Mary Papamarkou, Managing Director of Mutual Fund Distribution. I'm joined today by Ray Kennedy, Portfolio Manager. And on behalf of everyone at Hotchkis & Wiley, thank you for joining us today.

Today we'll be conducting a review of the Hotchkis & Wiley High Yield strategy, our fourth quarter performance, a 2017 year end review, market outlook, and strategy positioning. All lines have been muted for today's call, but please feel free to submit questions through the chat function at any time and we'll do our best to answer as we go along. We will take operator-assisted questions at the end of the call.

Some key updates about our firm and the High Yield strategy. As of December 31, 2017, our firm's assets totaled over \$32 billion. The High Yield strategy had approximately \$4.1 billion in total assets, of which approximately 2.8 are in the mutual fund and the remainder in separate institutional accounts.

So, let's get started. I'll start with a quick background of our team before turning the call over to Ray. Our team is led by Portfolio Managers Ray Kennedy and Mark Hudoff, along with Richard Mak and Patrick Meegan. As you are aware, the research analysts at Hotchkis & Wiley are organized by industry and support both our equity and income strategies. The average tenure of a Hotchkis & Wiley analyst is 14 years at the firm, and we had no changes to the team in the fourth quarter. And with that, I will turn our discussion over to Ray.

Ray Kennedy: Good afternoon, everybody. We're on our eighth year of doing these webinars, so that's, I guess, a milestone in itself. First of all, I'll talk about alpha for the quarter and then for the year. This is on [Page 3](#) of the slides. Again, a good year for us, we outperformed our benchmark. We also outperformed the benchmark for the broad-based high yield market, and I'm happy to say that it was really a lot of reasons, it wasn't necessarily just driven by any particular sector or any particular overweight in a sector. Of most of the alpha, almost all of it, came from individual security selection. The dominant area was basic industries and energy.

Basic industries is a pretty encompassing area that incorporates everything from metals and mining to chemicals to building materials. And a lot of our core portfolio is based in those sectors because that kind of represents hard asset-type lending, which is something we like to do. And some of the names that did well there range from things like Century Aluminum to Weekley Homes to Ashton Woods, etc. And the energy sector, again, just a spattering of names ranging from Shelf Drilling to Lonestar to PBF.

Also, I'm happy to point out that our telecom sector did very well this year. Our underweight in wirelines was very accretive to the portfolio. Our underweight in Sprint, while it's been difficult at times, contributed well to outperformance because of the failure of T-Mobile and Sprint to merge.

And the only area I can really point to that was really a detractor from performance was the consumer space and we'll talk a little bit about that in the next slide. But, the reason I mention that is that's a very topical area, it tends to be a pretty small part of the high yield market. You know, we wish we had avoided things like PetSmart, but we're animal lovers, too, and thought that would basically do well.

Anyway, so if you turn to [Page 4](#), this is specifically for the quarter. What worked: the underweight in telecom, as I mentioned, the underweight in Sprint; our overweight in the industrials, the, General Cable, for example, Navistar, Momentive Performance - our overweight in industry. What was a detractor: largely the consumer names such as, like, PetSmart, and you know, we'll see if some of these recover. I think there's--I think we've oversold the consumer sector in the high yield market. It turned out that the fourth quarter wasn't as bad as everyone expected and we've already seen a rebound in some of these bonds, so we're optimistic.

So, if you turn to the [Next Page](#), this is the positioning. One thing I would like to point out as you look at the Lonestar Resources and you look at the allocation and say it's pretty significant. The bonds were called in mid-December when they did a new issue, so technically we carried both bonds over the measurement period as of December 31st, and that's something that just tends to happen. That bond has since been redeemed and the exposure has been reduced in half. So, just kind of a timing thing.

In terms of the sectors, a few things. One is the telecom sector, we continue to be underweight. I don't know if we're going to add more to that sector given the underperformance. It looks attractive, there are certain aspects of some of these names that suggest that they've been oversold in the wireline space. The core of it being, as you can guess, people are not renewing land lines and the competitive threat from cable and wireless is hurting them. But we'll continue to reevaluate that.

In terms of our overweight, the only other thing I'd point out is the energy sector, it grew a little bit and that was largely just because of outperformance of our bonds. We've actually had three bonds recently get acquired by other companies, so we expect that exposure to actually start decreasing pretty well over the next 12 months or so.

We increased our healthcare exposure marginally, just because we found value in that space. That's going to continue to be an interesting area for high yield investors. There's both good and bad aspects right now in healthcare as we adjust to the new tax system, which had tertiary impacts on the ACA. But, we will see how that evolves over the next 12 months.

In terms of the outlook for the high yield market, we never quite hit our coupon, so we may outperform, we may underperform - I shouldn't say that, I should say, the high yield market will outperform or underperform the coupon. We expect to have our traditional alpha.

But, it's just a tough call about how that will play out: some of this will be driven by treasuries, some of this will be driven by the level of volatility. But, I think all of us look positively to the economic backdrop that's out there supporting industry fundamentals, and so we expect margins to continue to grow. Margins are actually increasing. We expect declining defaults. Leverage ratios will probably continue to tick down a little bit. M&A really was not supportive in the recent tax bill because of the deductibility of interest, and so that will be kind of a fundamental that will kind of keep the exogenous risks at--in check.

The technicals are a very interesting part of the high yield market right now. We're having probably the highest number of calls and tenders we've ever had in our portfolio. Some of its vintage effect, a lot of these bonds were issued 8, 10 years ago and they're now in their call period or they're reaching the point where they're attractively callable. And so, we're watching a lot of activity driving the refinancing of that.

The other thing that's been happening is the loan market has been taking some market share technically from the high yield market as companies use the loan market to refinance high yield bond. And with the, again, changes in taxes, you're probably going to see a little bit less--fewer issues and you're probably going to see a little bit more cash brought back and used to basically retire debt.

So, net-net, I mean everything points to a reduction in supply or a supply that kind of stays flat, and demand that will probably continue to be strong as investors seek income in a world where there's not much income to be found. So, we expect right now the new issue volume to go up about--probably about 5% to 10%, at worst, over last year's volume.

There's a lot of attention in The Wall Street Journal in the last day or so about the amount of issuance that occurred in the high yield market in the first two weeks. Well, as you would guess, the press kind of missed the most recent news, which is the new issue market literally just ended, it seemed about three days ago, and there's been nothing going on. So, year-to-date through last week, the issuance was up about 15%, and now, after the end of this week, it will be up only 5% because it--a lot of the banks, brought it, forward their issuance.

So, the technical backdrop is positive from a supply standpoint. It's--the challenge, of course, is just - where are the flows? And we continue to be a little bit constructive on flows, but it's tough to call so that's why we assign it a 3.

The most challenging part, of course, is valuation in this current environment. Same broken record spoken by just about every asset class: everything seems tight, all P/E ratios seem high, all treasury spreads seem too low. So, the low in our--the high yield market was around 275 in 2007. When you quality adjust that, because we're a higher-quality market than we were today, we're still pretty far from the lows that were found in previous markets versus our investment grade brethren are actually seeing historic lows, even below the averages that they saw in 2007. And that's despite a market that's almost 2 times larger than it used to be.

If you turn to [Page 7](#), a little bit about the fundamentals and elaborating on things like leverage. Again, leverage is still higher than we probably would like to see in the market, but it's definitely trending back down. One of the things to think about is the impact of the new tax ruling or the new tax laws. It probably will incentivize companies to reduce leverage over time. Clearly, companies are penalized from a tax standpoint by having interest costs that are too high relative to their EBITDA, and then, of course, the way the tax law works, relative to their EBIT. So, all that points to lower leverage as a trend and higher interest coverage as a trend. So, again, fundamentals look okay from that standpoint.

Defaults are really not an issue at this point, if you look on [Page 8](#). One of the things that's kind of interesting to look at is that between 2003 and--let's say, 2003 or 4 and 2008, that was about a four-year cycle. Interestingly enough, that between 2010 and 11 and 2015, a four-year cycle, so while we didn't probably realize it at the time, we went through a mini default cycle in 2015. A lot of us just thought it was an industry-specific issue, but really when you look back at it over time, you realize the default cycles hit every about four or five years and we probably just hit one. So, that probably gives us a little bit of tailwind now going forward for the next few years. Recovery rates, which are really a function of timing and defaults, have recovered back to their kind of historical average. And, again, that's supportive of the asset class.

If you turn to [Page 9](#), which has the maturity calendar, one of the things we occasionally will add to this chart is comparing this to other markets. And when you do compare the maturity calendar relative to where we have been historically, it's actually much more attractive, i.e., less debt three years out, and that's the measurement I use, it's outstanding than it has been previously. So, we've bought ourselves a little bit of breathing room here. So, again, that bodes well for keeping defaults low.

Turn to [Page 10](#), where are we in terms of the high yield market today? We actually shrunk a little bit last year. That's an odd statement, but some of that was changing of the index composition--this one is the JPMorgan index--but we actually did shrink in terms of net supply versus net bonds that left the market; it shrunk about 30 billion. It's just notable that again the tax laws out there basically are going to incentivize fewer issuance.

The market has grown 1.6 times since 2008, but the investment grade market is almost 2--is probably over 2 times larger than it was since 2008. Why do I point that out? It's because, never fear, our market will grow, because when we do go through a new default cycle the level of BBBs that are in the investment grade market are at record highs and we expect them to eventually come back down to our market.

If you turn to the flows, flows have probably been the biggest challenge in terms of the high yield market. We just--they're just unpredictable. We can go through weeks of billions of inflows and the following week billions of outflows. And they're not timers, it's just systematically rebalancing. So far, year-to-date it's been more of a negative flow, but at the same time, our cash level has been building and our calls and tenders have been extremely high. So, investors are not short cash trying to put it to work.

In terms of the new issue calendar, I touched on this a little bit earlier. 2011--or 2017 was up over the previous years. We expect it in 2018 to be kind of flat to 2017. Again, LBO activity just continues to be anemic. There is an--it's a difficult chart to see, but if you look at kind of that red section on your screen, which is acquisition and LBOs, as a percentage of the 2006 and 2007 markets it was huge, and relative to the 2017 market, or even really the 2014 and 15 market, it's nominal.

What the private equity firms are doing with their money, I have no idea, but they have a lot of it and they just can't get deals done in this environment, given the high prices. And there continues to be a regulatory overhang that keeps leverage muted at most--through most banks. So, that's probably going to be a trend that's going to continue in the near term.

If you turn to [Page 12](#), this is something we have started talking about a lot about three years ago, when the Third Avenue issue arose in the high yield market. A few things to just point out is that, by almost all measures, liquidity has been improving in the high yield market. Trading activity, the number of bonds held by dealers, even in terms of the turnover of the bonds in the market. We're actually double the turnover rate of the investment grade market, meaning we have more trading activity. It's probably a function of profitability for the trading desks as they tend to put more activity or more resources to the high yield market. But the point is that liquidity is very strong right now. You know, it's nothing like it was in the mid-2000s, we don't expect that to be. But, it continues to kind of be an issue that we're moving forward rather than backwards and will be supportive in the market in the long-term.

Turn to [Page 13](#) and this is the valuations. Of course, this is where we all would love to see some improvement, but it's probably not going to happen in the near-term, given the fundamental backdrop. We may just be down here for a while. Year-to-date, as we speak, the spreads are tighter by about 25 basis points, but that's almost all treasuries. We've absorbed almost all the treasury backup. Remember that statistical duration of high yield is about 4, but the realized duration is actually much, much shorter. And what I mean is that you measure duration off a theoretical calculation of call, but bonds get called for so many reasons, many of them just driven by M&A or better attractive financing alternatives. And because of that, we tend to have much less treasury

sensitivity than would be calculated versus an investment grade bond or even like a high-quality BB bond. So, that's one of the reasons that the market has absorbed the backup in treasury rates so far.

Turn to [Page 14](#), what does that mean in terms of excess spread? We're a little bit below the historical average, if you start compensating for defaults. If you expect the defaults to fall further, we're probably being adequately compensated. We're nowhere near the lows of historical periods, such as 2007, 2000, etc., but it's something that's worth keeping an eye on. In other words, we're a fairly-valued market: we're not rich and we're not necessarily cheap.

If you turn to [Page 15](#), I'll just end here by talking about the leveraged loan market. It's a very topical subject in the leverage finance market. The leverage loan market has just seen a significant amount of flows, a significant amount of new issues. It's a market that is 60% driven by structured finance, meaning it's not you or me buying loans, it's a vehicle buying a loan that's going into leverage. And that's one of the reasons you saw a significant amount of issuance last year.

But what that also means is that there's been a significant amount of repricing, and already I think investors have realized that their yields have not been going up at the level that they thought. And that's because companies, when they see the strong demand, first thing they do is turn around and say we're going to reprice our loan or we're going to refinance you back out, and we've seen a significant compression in spreads in that market. Remember, bank loans are either callable at any time or callable after one year, versus a high yield bond is not callable for three years and then it calls at a stepdown, so you have much more protection on your coupon.

So, we'll continue to see how that evolves in the bank loan market. Companies will probably continue to use it as a source of financing, but the investor base may start pushing back. And that could have implications in terms of new issues in the high yield market and possibly even give us a little better entry point for more attractive purchases.

Mary: Before we go ahead and open it up to our audience, is there something that keeps you up at night, that concerns you, whether it's geopolitical or domestic, with regards to the asset class or maybe a particular industry?

Ray: The high yield market this year is going to really be impacted by what happens in healthcare and what happens in consumer. I think most of us feel that energy is going to be kind of a non-event for the overall high yield market, but healthcare is kind of the wild card.

The change in the tax law did have the secondary impact of impacting the ACA, and there's been a lot of regulatory push to control pharma. And one of the mysteries that's been going on in the healthcare sector is admissions. Hospitals are seeing lower admissions--it's been a trend for about the last three years--and if that doesn't turn around, you could see a lot of pressure in that sector. And that's one area that's very micro to the high yield market that we focus on, besides the consumer, which is the continued transition from a physical marketplace to an e-commerce marketplace.

Outside of high yield, it really is just a complete wildcard. I cannot put any probability on geopolitical risk out there, whether it's a trade war, whether it's a political crisis in the US or maybe even in Europe, or whether it's, you know, just an outright war that evolves. And so, it's--I think we are all heightened to it, but because we can't quantify it, we just have to accept that it's a risk that's out there that would affect all risk asset classes, not just high yield.

Mary: Great. Thanks, Ray. We're going to go ahead, operator, and open up the call to questions from our audience.

Operator: Great, thank you. If you'd like to ask a question, please press star, one on your telephone keypad. A confirmation tone will indicate your line is in the question queue. You may press star, two if you would like to remove your question from the queue. For participants using speaker equipment, it may be necessary to pick up your handset before pressing the star keys. One moment please, while we poll for questions. Once again, it's star, one if you'd like to ask a question. And it appears there's no further questions. Ms. Papamarkou, do you have any closing comments to make?

Mary: We're just going to say thank you everyone for your interest in Hotchkis & Wiley and the High Yield strategy and for participating on today's webinar. Have a great day.

Ray: Thank you all.

Operator: This concludes today's teleconference. You may disconnect your lines at this time. Thank you for your participation.

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