Hotchkis & Wiley
High Yield Webinar Replay

January 2019

Hotchkis & Wiley

High Yield Market - Looking Ahead in 2019

Listen in on a recent conference call featuring Portfolio Manager Ray Kennedy as he provides an update on the high yield market and outlook for 2019.

Audio Replay **Presentation**

Hotchkis & Wiley High Yield Fund - Average Annual Returns as of December 31, 2018

	4Q18	1 Year	3 Year	5 Year	7 Year	Since 3/31/09
I Shares (net of fees)	-5.31%	-3.41%	6.65%	3.25%	6.01%	9.57%
I Shares (gross of fees)	-5.12	-2.71	7.40	3.98	6.76	10.34
ICE BofAML BB-B US HY Constr. Index	-3.87	-2.04	6.33	3.88	5.69	9.56
ICE BofAML US High Yield Index	-4.67	-2.26	7.27	3.82	5.94	10.73

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 August 29, 2019. 30-Day SEC Yield with Expense Waiver: 8.07%; 30-Day SEC Yield w/o Expense Waiver: 8.65%. *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 and welcome to the Hotchkis & Wiley Fourth Quarter High Yield call for Investment Professionals. At this time, all participants are in a listen only mode. If anyone should require operator assistance during the conference, please press *0 on your telephone keypad. As a reminder, this conference is being recorded. I would now like to turn the conference over to your host, Mary Papamarkou. Thank you. You may begin.

Mary Papamarkou: Thank you operator. Good afternoon, and welcome to the Hotchkis and Wiley High Yield Strategy Webinar for Investment Professionals. My name is Mary Papamarkou, Managing Director, and today I'm joined by Ray Kennedy, Portfolio Manager. On behalf of everyone at Hotchkis and Wiley, thank you for joining us today.

We will be conducting a review of the portfolio performance and positioning with a discussion on our 2019 market outlook. All lines have been muted for today's call. 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.

Some key updates about our firm and the high yield strategy--as of December 31, 2018, our firm assets totaled approximately $27 billion. The high yield strategy had approximately $3.7 billion in total assets under management, of which approximately 2.4 billion are in the mutual fund, and the remainder in separate institutional accounts. With that, let's go ahead and get started. And I will turn it over to Ray.

Ray Kennedy: Good afternoon, everybody. Happy 2019. Can't believe we're here already; but, I'm also happy that 2018 is over. Start on Page 2, for those of you who are watching on the computer screen. Wasn't our best year, and a few reasons for that, it was a great first nine months, but a bad last three months. I'm happy to say that the results, over the longer period, are still very, very good. We'll talk about that in a little bit more detail.

If you turn to Page 3, this is part of the story for what happened in 2019. If you look at the difference between BBs and Bs, being a small, mid oriented portfolio manager, you tend to have a little bit more single Bs. And just the differential in performance between those two was a large part of our detraction from performance in 2018.

If you turn to Page 4 that talks about by sector--so, one part was just having the overweight in the small and mid area versus the benchmark. But, the second thing was underperformance in security selection in the energy space. We surprisingly had some selection issues and they detracted substantially from performance. Some will come back, some will not. This is the first time we've actually had something like this in the energy space. Up to this point, our allocations in energy have actually been accretive in performance versus the benchmark. So, wish I could give you a complex description of it, but it really comes down to three names where we basically overweighted the natural gas sector where there were some operational problems at those credits. But, like I say, we're constructive on them coming back. When you take those two factors away, it wasn't such a bad year.

So, if you turn to Page 5--where are we today? The Fund today has a yield to worst of about 8.8%. This compares to about 8% for the broad base market and 7.3% for the BB-B Constrained. The difference basically represents that small mid allocation that we have, which also results in a slightly lower duration; the carry is still also positive. So, one of the things to consider as you look forward is that it's rare to have back-to-back negative years in high yield.

If you turn to Page 6, this talks a little bit about our sector allocation. Not much has changed there. Actually, energy has come down a little bit. But, continue our underweight in the telecom space. We've talked a lot about wire line in Sprint. We are not necessarily constructive on the Sprint/T-Mobile merger, but I also think that right now, at this point, it's a coin flip as to whether that'll occur, given the dynamics in the market there. The other thing, in terms of the overweight--again, reflective of the style that we have, which tends to be names that you won't see in most portfolios--they tend to be unusual opportunistic ideas that--most of which are public, by the way--that we take advantage of.

Mary: So, I'm going to actually pause here for a second, Ray, and ask a question. We are still overweight energy. How has oil price volatility impacted the firm's outlook on energy, and what is the overall impact on the high yield market?

Ray: So, last year, energy did underperform versus the high yield market. Just, kind of put it in perspective, the spread of high yield at the beginning in the energy space for the year was about 347 basis points versus, at the end of the year about 410, that's without the energy. With the energy, which widened out about, during that period, 150 basis points. So, the market widened out about 80, and energy widened out about 150. So, it did have an impact. And, again, some of that will come back. Nothing like we saw in 2015 and early 2016, which was largely driven by very, very low commodity prices. Companies today are much lower leveraged, and so, the impact has been less so. What drove the widening here has been more in the natural gas space, rather than in the oil space, and some of the services. But, we're actually constructive on oil at these levels. I think there's more upside than downside and feel like, with the companies that continue to focus on deleveraging represent good opportunities for us to add to our portfolio.

Mary: Great.

Ray: So now, I'm going to turn to Page 7 and talk about the market. With this strange market, very mixed conditions, that's why we started out with that headline. In one sense, fundamentals are still okay. We've seen some deleveraging. We've seen some growth in revenues and earnings. We will soon find out whether that trend's going to continue in fourth quarter and into 2019 as companies go through and give us their yearend results. But, the other thing we are looking at is some uncertainty out there. Things like the trade war, China, continue to weigh on operational results. So, something to consider there.

From a technical standpoint, this is really the story of high yield in the last 12 months and could be the story in 2019. Last year, we saw significant outflows, but at the same time, we saw a new issue counter that essentially died, that balanced the market. And so, typically we see large outflows, we see a significant sell off, that didn't occur last year. Maybe some will say that occurred the last few weeks in December, but, we've already seen the snap back from that. And we're kind of in this very strange balance where we have a very nominal new issue calendar, where coupons are actually bigger than the new issue calendar, and, at the same time, we've been seeing outflows. This year has been mixed. We go through strong weeks of inflows, and then, we'll see outflows occur pretty quickly.

Liquidity is still surprisingly good in this market. Even the selloff in December, while difficult to manage through at times, was orderly, and you could get trades done. So, again, it's a very strange technical market. But, it's balanced, is the best way to describe it. So, the term I like to use, an old PIMCO term, stable disequilibrium.

Valuation--clearly, we started the year at a very attractive valuation at a yield in excess of 8%. We've rallied a little bit to about the seven and a quarter area. That's probably attractive at this point, but, it's not table pounding. And therein lies the dilemma for investors. If the Fed does start cutting or stops raising, you may see money come into this asset class now because people will look at the attractive yields and spread and look at it with the idea, basically, increasing their exposure.

Mary: So, given that, what are performance expectations for the asset class?

Ray: They range in this market, originally, from about 0% to as high as 8%. The person that was at 0% has actually raised it based upon the rally this year. I think it's fair to say that somewhere between a 4% to an 8% is fair game. Possibly though, the 4%--if I were to probably wait--the 4-5% is probably more where I could potentially see this going. It all really depends on where the Fed is, where the trade war goes, where China ends up, and whether or not we do see a more pronounced slowdown.

But, I think one thing we all feel good about is it should be a positive return this year. There's actually one person who came out that said if the yields are more than 7%, that, historically, you have a pretty good shot at having 8% or higher type return. From here on out, where we've--based upon the rally in the first three weeks, if you basically took that level and added the coupon for the rest of the year, you could be looking at something like 10%. That doesn't seem possible. But, that's obviously statistically in the cards also. So, I think you just kind of work with those ranges, and be prepared for volatility like we've seen in the last few years.

Mary: Great. Thank you.

Ray: Page 8 talks a little bit about the leverage. We've talked about the fundamentals that they continue to basically improve a bit in high yield. And this is despite any uptick in energy. One of the things that's interesting to watch in the energy market is, in the old days, four times used to be the accepted leverage for energy companies. Now, they need to be leveraged two times to basically get credit by their equity investors for being fiscally disciplined. So, again, fundamental trends that seems favorable.

Defaults--I don't think any of us are expecting a material increase in defaults. I think they're--one of the questions that typically gets asked is--Pacific Gas and Electric. Will that come through the high yield market? And the answer is no. If they do declare bankruptcy by the end of January, it will be an investment grade bankruptcy, which is a rare event, by the way, to occur that quickly. But, it will not be a high yield default. So, I think, for investors, they should probably be thinking elevated over maybe the last year or two but still below historical averages of 4-5%.

Turn to Page 10. Upgrade ratings--one of the things that continues to be positive for the market is the CCC market continues to shrink. From a new issue standpoint, we just see nominal new issues coming from the CCC market. The upgrade/downgrade ratio, which was very positive last year—we'll probably continue to see it maybe stay somewhat positive, though not at the same levels. Some of the sectors you have to worry about are, besides energy, possibly the auto sector, which is seeing increasing pressure.

Page 11--I mentioned fund flows. This is the story. We have a market that has been shrinking in terms of actual size of the high yield market. That happened before, like in 2006, 2007. We kind of saw a little bit of a slowdown there. This has been more pronounced. Of course, the story has been the bank loan market and how that is taking market share, technically, away from the high yield market. Supporting that, of course, has been the flows, and you've seen the large outflows in 2018; this year it has been positive, but it continues to be somewhat volatile.

Mary: So, there--given the flows from high yield to bank loans and the Fed's dovishness, how attractive is high yield relative to bank loans right now?

Ray: Bank loans--last year, bank loans were the darling of the fixed income asset class. For the first nine months, no one could find enough bank loans. Issuers in our market went to the bank loan market, both for first and second liens. Come October, November, they were no longer wanted at the dance. Everyone was basically running from the asset class, and, clearly, in December, especially the last few weeks, the sell-off accelerated where bank loans were probably at some of their worst monthly performance ever. Some bank debt was off anywhere from four to five points. It's rallied since then.

But, the story now is out there, which is the demand on the bank loan--for bank loans, both by retail investors, institutional investors, and CLOs has clearly waned. And we probably are driving--a lot of that can be attributed to the Fed. A lot of that can just be attributed to the fact that, I think, people realized the asset class was overreaching. We saw basically non-covenant deals, deals done without call protection, deals done for companies that no one even knows anything about. It's an institutional problem that's developing in the bank debt market, which is--it's a limited information asset class, which is something that hadn't occurred previously where it was basically just the top part of the high yield market.

So, from an attractiveness standpoint, pretty much across the board, everyone thinks that high yield is the more attractive asset class, especially if you think the Fed is done or is at least slowing down at this juncture. But, more importantly, it's an asset class that probably got a little bit over its skis. We're hearing that the CLO arbitrage is probably not as attractive as it used to be. And some have said that it's not even there. It really depends on where you can place your BBB type paper. But, it's going to be interesting to watch and see how this evolves.

We've already seen, in the high yield market this year, issuance shift from the traditional bank debt market, second lien or even first lien and actually going to the high yield market on a secured basis. So, basically, we're buying the equivalent of bank debt, i.e., secured, but with call protection, and, in some cases, even better covenants.

Mary: Great.

Ray: The last point I'd make is, in terms of Excess Spread--this is really where the rubber meets the road, so to speak in high yield, which is - are you getting paid for the defaults? And the answer is yes by today's measures and definitely, if you compare it to where it was the last few years. We don't see, as I said earlier, a significant pick up in defaults and the compensation of the spread, even with the recent tightening, still would suggest that it's attractive to be in, which is why none of us are pounding on the table saying, "Let's put all the chips on the table into high yield," but having some chips in--makes a lot of sense, especially at these spread levels and if you think the Fed is basically going to slow down or even possibly pause. And some actually think they may cut.

Mary: So, to that end, what are your thoughts on the negative sentiment on the asset class, given our perspective and even a small allocation to high yield may be appropriate in a well-diversified portfolio.

Ray: I always like to joke that we're the Rodney Dangerfield of asset classes, we don't get any respect. But, we're a fundamental part of the financing part of the credit market. Given where we are in terms of our view that we do not see a recession, that we do see at least a stability in terms of leverage, we do see spreads that have been wider than historical levels over the last few years, and given that our view that the Fed has probably at least paused for a while, high yield does seem to be attractive. And, we have seen some increased allocations by institutional investors, hence the flows we've seen into the market.

So, I think it's an asset class that people still should have in their portfolio, and I think it's an asset class that, if you were to do a level of allocation, where last year was a one, five is--one is a low level, five is your peak level, we're at least a two and maybe even a three now, given the current valuations in the market.

Mary: Great. Thank you, Ray, for your insight on high yield, and thank you, everyone, for joining us today and for your interest in the Hotchkis and Wiley High Yield strategy. Have a great day.

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Top ten holdings as of December 31, 2018 as a % of the Fund's net assets: American Zinc Recycling 1.4%, Weekley Homes LP 1.1%, Century Aluminum Co. 1.0%, Rayonier A.M. Products Inc. 0.9%, Rain CII Carbon LLC 0.9%, Ashton Woods USA LLC 0.9%, Shelf Drilling Hldgs Ltd. 0.9%, GEO Group Inc. 0.9%, Enviva Partners LP 0.9%, and Townsquare Media Inc. 0.9%. Fund holdings are subject to change and are not recommendations to buy or sell any security.

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