October 2019

Hotchkis & Wiley High Yield Webinar Replay

3Q High Yield Market Update

Listen in as Mark Hudoff discusses 3Q19 performance and portfolio positioning, along with our current outlook on the high yield market

Audio Replay **Presentation**

Hotchkis & Wiley High Yield Fund - Average Annual Returns as of September 30, 2019

	3Q19	1 Year	3 Year	5 Year	10 Year	Since 3/31/09
I Shares (net of fees)	-0.65	1.43	4.61	4.07	7.74	9.57
I Shares (gross of fees)	-0.48	2.16	5.35	4.81	8.50	10.34
ICE BofAML BB-B US HY Constr. Index	1.68	7.87	5.99	5.49	7.62	10.05
ICE BofAML US High Yield Index	1.22	6.30	6.07	5.36	7.85	11.07

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, 2020. 30-Day SEC Yield with Expense Waiver: 6.49%; 30-Day SEC Yield w/o Expense Waiver: 6.44%. *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 3Q High Yield Call for Investment Professionals conference call. 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 *0 on your telephone keypad. Please note, this conference is being record.

I would now like to turn the conference over to your host, John Haase, with Hotchkis & Wiley. Thank you. You may begin.

John Haase: Thank you, Devon, and good afternoon, everyone. Thank you for joining us on the Hotchkis & Wiley 3Q high yield market update call. Again, my name is John Haase and I am joined today by Mark Hudoff, Portfolio Manager on the High Yield strategy.

The purpose of today's call is to provide an update on performance for the third quarter of 2019 as well as providing an outlook on the high yield market more generally. As the operator mentioned, all lines have been muted, but please feel free to submit any questions you may have via the online chat function.

Without further delay, Mark, why don't we go ahead and turn to slides three and four, to talk about attribution?

Mark Hudoff: Okay. Thanks, John. Thanks, everyone, for attending. Looking at page three, attribution by credit quality, the performance was a little disappointing versus the benchmark, for sure. If I go through the categories, investment grade, a bit of a drag, just not so material. In double B, it was really a combination of a couple of names underperformed really against the backdrop of a structural underweight in double Bs. Our strategy just sets up better in the small cap space, which is dominated by lower quality.

So, anyway, underweight in weight. A little bit of underperformance in terms of the double Bs that we did have, led to roughly a 30 basis points drag. Single B's, a drag on the portfolio both from a performance and an overweight point of view. That's where single Bs--the difference between single Bs and double Bs, single Bs underperformed double Bs--well, excuse me, back up, that's where small cap influence is most apparent. Small caps underperformed large caps by nearly 20 basis points in the quarter. And you can see from the weights there, we were considerably overweight.

We did have some credit events. They weren't crystallized with a bankruptcy or anything like that, but just some price declines, McDermott and Mallinckrodt most notably. I'll talk about that a little later.

In the triple C and lower, a little bit of overweight in both categories, but the noted rated category is about 4%--a little over 4%. A disappointing performance. Same with the non-rated, disappointing performance with that weight. So, that combination's roughly 80 basis points of underperformance for the quarter.

All in all, a little bit of a tough quarter, I mean a lot of things going on that contributed to that. We continue to see treasuries move around a 10-year rally. During the quarter, that correlation issue end up in a, combined with our underweight in double Bs, hurt us. The overweight in single Bs not really very, as correlated, certainly to rates - ended up being a drag in addition to the credit events.

If we turn to page four, you could see the sector level, what happened. Effectively, the big drags in the portfolio, go to the bottom of the sheet, energy and healthcare really centers on a couple, on three sectors. In the case of energy, it’s broken down to oil field services, and oil field services I already mentioned McDermott, that was a big loser in the quarter. Although, KA Deutag was also--those are both in oil field services, and both of them shared some event risk that just crept up on the market and all of a sudden, these bonds underwrote a lot of volatility.

In the case of E&P (exploration & production), E&P was really a combination of multiple names, wasn't really so much an individual name that underperformed but just broad-based underperformance. I guess the one name that does step up and was notable in the quarter was Whiting, again, with a refinance problem that came up, the market just is not tolerating any refinance risk on these credits. Ultimately, Whiting was able to renegotiate their asset-back line and in doing so, solved the problem. Bonds haven't come back all the way, but much better than they were by the end of September.

If I go to healthcare, I said it was one sector, it was pharmaceuticals. Pharmaceuticals coming under a lot of pressure with the global settlement negotiations going on to fund or to try to resolve the Purdue bankruptcy, or in conjunction with, the Purdue bankruptcy related to opiate risk. It's very difficult to scope that risk, we know it's a long-tailed risk. There's a lot going on in that space.

Mallinckrodt and Endo Pharmaceutical, which we hold both, were under--saw a lot of pressure; Endo less so, it's more leveraged, it's a brand name pharmaceutical manufacturer of opiates that's negative, but it has a great cash pile. And so, the market is viewing that relatively constructively, there’s several years of runway in that credit.

Mallinckrodt's a little more difficult, they have less cash, they have a couple of obligations, they're a little bit unknown related to a suit on pricing that hasn't been disclosed yet. Actually, the regulator hasn't disclosed it. And so, that started the problem and then, all the negotiations.

On the other hand, Mallinckrodt is a generic manufacturer of opiates and in our estimation, the generic guys are just basically pill factories. They're not doing anything off label, like some of the contentions related to Purdue where they were selling off label. They basically--they just take phone calls and produce pills.

So, in the case of Mallinckrodt, we see them as a participant in the settlement, generally speaking, but not as exposed to the ultimate outcome. That remains to be seen. We're still working on it and paying very close attention to it.

On a positive side is automotive. Basically, parts manufacturers are starting to come back. For the quarter, we saw a real risk off trade that filtered into the market related to decelerating macroeconomic numbers. And the parts guys, in addition to Ford and GM, widening, backing up in yield. They just had to sell off in sympathy. Some of that came back in the third quarter.

In leisure was basically gaming. Regional gaming in particular was helpful for the portfolio. And those were basically the bright spots in the portfolio. And all in all, a pretty tough quarter.

But, with that, I'm going to switch to page five and just talk about where we're sitting right now in the portfolio. You can see the overweight, underweight. Structurally, we tend to be overweight more cyclical industries. That's just the--really fits with our research model. You can see that that's very clearly the case on the bar chart on the left-hand side.

Wireless and telecom hurt us in the quarter, just not being exposed to the Sprint-T-Mobile merger hurt, that was probably 12--no, that's probably--just a little over 20 basis points for the quarter. We're underweight banking and telecom and satellite and telecom--or banking and finance, satellite, and telecom. Those weren't too much of an effect in the portfolio.

As I look at the overweight, we still feel very strong about industrials. Our view on the economy is that we're going to muddle through. We think that a lot of the hand ringing about recession in 2020 is probably overdone. All the tripwires that we look at are not pointing to a recession and the imminent recession, if that. We think also that 2020 is going to be a big year for spending as it relates to the election--coming election.

We also think that in some sense, the trade problem, which has certainly become a drag on the economy, is within the administration's control in terms of turning it off and turning it on. And we're starting to see some partial traction in that area.

So, we continue to remain strong in the industrial and the more cyclical credits. We're underweight in some of the less cyclical credits. We're going to wait and see on the Sprint-T-Mobile merger, that's something that--again, we're very bearish long-term on Sprint. In the context of a merged entity, it's a much different story. But, remain watching that and we'll wait and see.

On a characteristic side of the portfolio, pretty typical look at the portfolio. The small cap bias generating a lot more yield than the index. Average coupon's not too much of an advantage over the market. Dollar price discount of about five points--almost five points.

Duration's a little short. We don't really have a--it's not that we don't have a view on duration, it's just that duration is a very sloppy concept in high yield, particularly as you get lower and lower in the credit quality universe. At a .4 correlation to rates, single Bs--the duration discussion, it should be really centered on the credit, it shouldn't be centered on the interest rate sensitivity.

Double Bs a different story. Nevertheless, with the--with our view of--a limping along okay economy, no recession, and after we've seen the moves and the global toggle towards easing, we think most of that's out of the way. I will say if you look down at the bottom of page five in the asset allocation, we have been adding bank debt. Bank debt is really coming to a lot of pressure recently for a variety of reasons. One, namely that LIBOR starts to go down when the Fed tightens--I mean when they ease.

And so, you've seen that in combination with the technicals and the CLO market. It's just that bank debt's been for sale. And we like some bank debt and have been adding. This is a relatively full position for us. I think that the--in the context of the life cycle of this portfolio, this is probably the highest it's been.

That said, we would like to have more room for it. We can anticipate if we want--the day that we do end up in a recession, we think that the mass amounts of bank debt that has been plowed into this market's going to set up for a very attractive technical buy of bank debt.

But, again, we think it's down the road and so, we're not - this is more about relative value, if you could buy yield on a structured or on a senior structure and not underwrite any kind of real duration risk, it looks like a good trade for us.

If we turn the page, you can see on page six the long-term advantage that--of small caps versus large caps. It is timing specific. Last nine months have been fairly tough. coming up on a year, on small caps versus large caps. Some of that's risk off, some of that's just liquidity issues in the marketplace.

We're coming out with a quarterly report, we're going to review the whole small cap versus large cap space. Hope to have that out by the end of the month, maybe first couple of weeks in November. But, hopefully, we'll have some interesting anecdotes that come out of that.

Last page that I'll cover is just, you can see there are fundamentals, the blocks that we use: technicals, fundamentals, valuation. We've been downgrading fundamentals. Couple of things - first of all, the macro scene has decelerated, there's no question about that. We're not--we don't intend to look back, or as a rearview mirror exercise, this is actually a view we have of the next three months or so, maybe into six months. So, we see pretty tepid growth out there.

We have seen some strains develop, defaults have picked up, they're running about 2.5% with distressed exchanges or 275 on an LTM basis for bonds. That's heavily in retail and energy. I think first quarter, we look at first quarter and are a little wary in the E&P space because there's a lot of refinancing that needs to get done in the first half of next year. And we think that that could result in some volatility in the oil and gas space and then broadly the energy space.

So, we’ve downgraded the fundamentals. We think probably the expectations on earnings have overshot on the downside because we think that fundamentally the U.S. economy is still doing okay. And we really just look to a resolution of the trade situation in order to resolve to the upside this funk we're in right now.

Technicals, pretty balanced. I think we're going --our forecast is end the year with about 270, 275 billion. That's basically run rating the existing supply. That's down for the past several couple of years. It's more like an average issuance year. Fund flows have been whippy. A lot of money in the beginning of the year. Some of it's trickled out. So, it's pretty balanced.

Valuation on a long-term basis, in yield space, it's not that attractive. In spreads base versus defaults, it still looks pretty attractive. So, very mixed picture there. We think it's all about late cycle investing being a tough slog. This is really the time when you try to avoid the losers. And unfortunately, we haven't gotten--we haven't been hit by losers, but we've underwrite some volatility in some credits that we think will make it. But, they certainly have gone through and tested their mettle in some cases.

And with that, John, I don't have anything else.

John: Great. Thanks, Mark. And at this time, I'll remind our audience that if you do have a question, please feel free to submit it via the chat function in the WebEx. In the meantime, Mark, I've got a question about default and recovery rates. Can you give a quick update on what you're seeing for the quarter and maybe what you're going to possibly see looking ahead?

Mark: Sure. I mean, I think that the 275 was--let's just call it 250, 2.5%. I've seen some of the strategists out there moving up from 2% to year-end, at that 270. Not really migrating it much higher next year. I think that reflects fairly the paradigm we're in.

Recovery rates have been declining over the past couple of years and I don't see that changing. In fact, late cycle it ebbs and flows--recovery rates ebbs and flows, we're so late in this cycle that I don't see recovery rates coming back. So, I think those continue to drift lower.

And so, that is a little bit of a concern in--as it relates to looking at the downside of the marketplace. But, it's very idiosyncratic in terms of geospecific, but I don't think it goes back to 40, which is 40, 41, it's the unsecured default rate over the long run. We're running closer to 35% right now. I can see definitely, if we get a bunch of defaults or a pickup in defaults, say, bumping up to 3% in the first quarter on an LTM basis because of refi risk in the energy space and couple of other areas, that could put pressure on default rate--I mean, the recovery rates.

The thing is that the recovery rate is kind of a weird calculation and it's a calculation based on 30 days after where the bond prices are. It's not full cycle recovery rate, which is very difficult to calculate. And so, it's a little--it's a good indicator, it's a good rough cut at the downside valuations in a high yield market. But, in no way is it a particularly precise exercise. And so, I think there's going to be pressure just technically late cycle on these rates.

John: On a related note, we've seen spreads in the energy sector widen to about 717 basis points at quarter end, which is about 315 basis points wider than the overall market. Do you continue to see pressure in the energy patch altogether? Or, do you see areas of opportunity?

Mark: Well, it's a good question and it's--the answer is we are seeing--it's a very weird time in the energy space. But, we are seeing some traction in offshore, particularly drilling. The whole dynamic of natural gas in the United States and the disconnect between natural gas and oil, which was historically very closely linked (prices), has created a lot of chaos in the high yield market.

I think we need to see some production either shut in or--through reorganization, or through consolidation, probably more like consolidation. We also need to see distribution continue to get filled out so that people don't have this stranded oil. That's really the problem right now is you've got stranded oil. In more cases, you have stranded gas and no one is bidding on that stuff.

We are going to see some auctions this fourth quarter on good--dry gas assets and we'll just see who shows up for those auctions and see where they bid them. But, in the near term, I think that companies with good balance sheets or--and/or good banking relationships that sustain their liquidity profile are going to be the winners. And I think what you really do when you look at that aggregate spread, you realize that there's really two markets in E&P, there's those with and those without.

Those with, that is with balance sheet, with liquidity, with low leverage, those guys are doing pretty good and they have limited, but they do have access to the capital market. If you're a without character, high leverage, near term maturity, stranded assets, not a great place to be. I've had discussions with oil and gas guys--people who had said this is really a tough, tough market. And it belies the headline WTI. You'd think that this would be okay for a lot of producers. But, the reality is that it's very tough slogging right now.

In oil field services--domestic oil field services, particularly, regression and things like that are just in very tough space because they are a levered play on these other stories.

John: Thank you, Mark. And one last question before we go. Turning back to our Outlook and specifically technicals, you show mixed market liquidity. Would you be able to elaborate a little bit more on that, please?

Mark: Yeah. It's weird. Again, we're doing this study on small caps versus large caps. The conundrum is that trading volumes over the past nine years have gone up. Inventory held at banks ebbs and flows. And right now, it doesn't look particularly alarming. But, the dynamic in the market is that higher quality names are easily underwritten by trading desks. And higher quality can come in the way of a couple factors. Large capitalization is one thing. The other thing that does it is just good pristine balance sheets.

Smaller off the run names, it really is idiosyncratic to the name. If you have a small cable company, well, that's got fungible assets and people understand it and things like that. Might be small cap. Might be a niche cable provider. But, that will still have liquidity. And maybe it's a 300 million size deal. And then, that surprises you because you might have another 300 million size deal with a better balance sheet, but maybe a little bit more uncertain business story. Maybe it's more complicated, less fungible, and less valuable. That one may be very much appointment only.

And so, it is a strange time. There's also other threads that are filtering into the marketplace. One of them is that the pricing services have incrementally become much more aggressive at scraping data and declaring stale marks of no consequence and picking up new marks and flowing those through to pricing. And that becomes somewhat problematic because let's say it's a small company that nothing really has changed from quarter to quarter in terms of results. And let's say that there's three banks, one of them is a large bank and two small agency traders are the other people that quote the name. If they keep the quote flat for a long period of time, the pricing companies will describe that as a stale price, and then, they'll look for any movement away from that.

So, there may be price moves by agency guys on their axis, they have nothing to do with actually a clearing price. They're just trying to scare people into doing a trade because they take no risk. And we've seen that happen several times with the small cap space where you'll see a bond get marked down in IDC pricing, or whatever the service is, over and over and over. And you go back to them and you say, what's going on? And they say, well, we saw a new market. And then, we can see that new market and the market is driven by a guy or woman or a person who has nothing to do, in terms of knowledge about the credit, actual trading risk, but he's just moving it down to see if he can scare some action out.

And it's really the downside of the agency model because these guys eat what they can kill. And the reality is it used to be that that would be averaged into a bunch of quotes. Now, given the stale consideration, they go straight to that new quote and it's really amazing. I've had some very heated conversations with the agency brokers saying, "Why are you moving this down? You're not even trading it. You're not doing anything other than changing the price." I can't do anything about that, but I just wanted to understand their story. And the story just comes down to they're just trying to scare up business.

And it's--if you're a bank and you see a bond falling in the pricing services and there's no information, why would you underwrite that? You wouldn't. And so, we end up with these pockets of illiquidity that is for a variety of reasons. Anyway. So, it's a mixed picture, certainly.

John: Thank you, Mark. That's very helpful. At this time, I have no other questions. I would like to thank everyone for dialing in to today's call. And we certainly look forward to speaking with you again soon. Thank you so much.

Operator: This concludes today's teleconference. You may now disconnect your lines at this time. Thank you for your participation and have a wonderful day.

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