HIGH YIELD

MARKET COMMENTARY

The ICE BofA US High Yield Index returned +4.7% in the third quarter of 2020, after returning +9.6% in the second quarter. This nearly brings it into positive territory for the year (-0.3%) despite its dismal first quarter (-13.1%). Corporate America demonstrated impressive resilience in its quarterly results, which seemed to allay continued worries about the prevalence of COVID-19 and Congress' stalemate over a new stimulus package. Meanwhile, the Fed continues to signal easy monetary policy for the foreseeable future, maintaining a subdued economic outlook. COVID-19 cases reaccelerated for the first time in months, but hospitalizations and deaths remained downward trending—there was a large jump in tests administered which could explain the mixed developments.

The high yield market's yield-to-worst declined from 6.8% to 5.8% over the course of the quarter, while spreads over treasuries narrowed from 644 to 541 basis points. Treasury yields moved very little in the quarter—yields on the short end declined nominally and yields on the long end increased nominally, resulting in a slight steepening of the yield curve. Within the high yield market, lower rated credits outperformed, as yields/spreads decreased/narrowed more than for higher rated credits. Small and mid cap credits outperformed large cap credits modestly, and fallen angels outperformed credits originally issued as high yield.

During the quarter, 26 bonds defaulted or went through a distressed exchange, for a total of $19 billion in par value. This was tame compared to the 51 defaults for $80 billion in par value that occurred during the second quarter—the second most in the high yield market's history. The trailing 12-month default rate, including distressed exchanges, was 6.4% at the end of the quarter. Excluding the energy sector, which has accounted for about one-third of this year's defaults, the default rate is a more modest 4.3%. The $123 billion in defaults/distressed exchanges since the beginning of the year makes 2020 the second highest default year on record, trailing only the $205 billion that defaulted during the financial crisis in 2009. Notably, post-default recovery rates are near record lows, with the trailing 12-month recovery rate at about 15% compared to the long-term average of 40%. Less than 2% of the market trades at distressed prices (less than 50% of par value), more than half of which resides in the energy sector.

Rating agency downgrades have exceeded upgrades by a large margin. The upgrade/downgrade ratio stands at 0.38 (a ratio above 1.0 indicates more upgrades than downgrades, and vise-versa). The $600 billion in downgrades this year represents a new record for the market, though these "records" are a bit misleading as the size of the overall market has grown significantly in recent decades. The $194 billion of fallen angels entering the US high yield market in 2020 marks yet another record. The new issue calendar has been quite active in 2020, with about $300 billion in total new issuance, a run rate that is about in line with the most active years on record. About two-thirds of the total issuance was used for refinancing. Only about 10% was CCC-rated issuance, nearly all of which was for refinancing.

Roughly 60% of high yield issuers are small or mid cap (by number), though this group comprises less than 20% of the total market (by total par value of issuance). While small and mid caps have outperformed over the long term, the group has underperformed significantly in the past year. This has represented a meaningful headwind for our investment style—we have a penchant for this overlooked segment of the market—but the spread widening between these two groups represents an interesting opportunity looking forward. The ICE BofA US Small Cap Index exhibits a spread over treasuries of 632 basis points. This is 130 basis points wider than its large cap counterpart, almost twice its long-term premium. The portfolio exhibits a similar spread advantage, reflecting our conviction that select opportunities are especially attractive in today's environment.

ATTRIBUTION – 3Q20

The Hotchkis & Wiley High Yield portfolio (gross and net of management fees) outperformed the ICE BofA US High Yield Index and the ICE BofA BB-B US High Yield Constrained Index in the third quarter of 2020. Small and mid cap credits outperformed large cap credits by a small magnitude, which was a modest performance tailwind. The bulk of the outperformance is attributable to positive credit selection. Credit selection was positive in 13 of the 18 BofA sectors, with basic industry leading the way. Credit selection was also positive in the healthcare, media, and automotive sectors. The overweight position in basic industry and underweight position in telecommunications also helped relative performance. Credit selection in the retail, energy, and utility sectors detracted from performance.

(continued)

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OUTLOOK (SCORING SCALE: 1=VERY NEGATIVE...5=VERY POSITIVE)

Fundamentals (3)
We increased the score from 2 to 3. Economic data are improving, and the reopening process remains ongoing, and expansion appears underway. Corporate liquidity remains strong, defaults appear to have peaked, but COVID-19 infection rates have risen amid reopening efforts which would derail an expansion.

Technicals (4)
We increased the score from 3 to 4 as the Fed has taken decisive steps to support credit markets. We have observed strong primary market issuance and fund flows into the asset class have been positive. Elevated defaults/downgrades offset some of these positive attributes, and the election outcome could increase fiscal policy risk.

Valuation (4)
We left the score unchanged. Yields declined and spreads narrowed but reopen progress and the increase in fallen angels helps offset the move in valuations. Spreads are at about 541 basis points, and the dispersion of spreads is wide—the latter is conducive for active credit pickers. The small/mid spread advantage relative to large caps is wide. The uncertain COVID-19 outcome keeps our optimism about valuations in check.

Unless otherwise noted, the "high yield" market refers to the ICE BofA US High Yield Index

Composite performance is available at www.hwcm.com, located on the strategy's Performance tab. Returns discussed can differ from actual portfolio returns due to guideline restrictions, cash flow, tax and other relevant considerations. Portfolio characteristics and attribution based on representative High Yield portfolio. The performance attribution is an analysis of the portfolio's return relative to the ICE BofA US High Yield Index and is calculated using trade information and does not reflect cash flow transactions and the payment of transaction costs, fees and expenses. Absolute performance for the portfolio may reflect different results. No assurance is made that holdings, or all investment decisions by H&W were or will be profitable. The High Yield strategy may prevent or limit investment in major bonds in the ICE BofA US High Yield, ICE BofA BB-B US High Yield Constrained and ICE BofA US Small Cap and returns may not be correlated to the indexes. The ICE BofA index data referenced is the property of ICE Data Indices, LLC ("ICE BofA") and/or its licensors and has been licensed for use by Hotchkis & Wiley. ICE BofA and its licensors accept no liability in connection with its use. See www.hwcm.com / *Index definitions* for full disclaimer.

Quarterly characteristics and portfolio holdings are available at www.hwcm.com, located on the strategy's Characteristics and Literature tabs. Portfolio information is subject to the firm's portfolio holdings disclosure policy.

Market Disruption: The recent global coronavirus pandemic has caused and continues to cause disruption in the global economy, unprecedented business and travel disruption and extreme fluctuations in global capital and financial markets. H&W is unable to predict the consequences of the upheaval caused by coronavirus pandemic, which, depending on the severity and the length of the outbreak, has the potential to negatively impact the firm's investment strategies and reduce available investment opportunities.

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