HIGH YIELD

MARKET COMMENTARY

The ICE BofA US High Yield Index returned +0.9% in the third quarter of 2021. The index reached an all-time high in mid-September, up +1.4% for the quarter before declining throughout the remainder of the month. Economic developments over the quarter were mixed. Real GDP grew an impressive +6.7% in the most recent quarter (seasonally adjusted quarter-over-quarter). The positive momentum in labor markets slowed, however, as many businesses are contending with serious labor shortages. Business owners are hopeful that labor availability will improve due to the expiration of enhanced pandemic unemployment benefits in September, though higher wages and benefits appear likely. This fuels already-tight supply conditions and increases inflationary pressures. Inflation persisted above 5% (year-over-year), its highest level in well over a decade. The Fed voted to keep its target Fed Funds rate near zero until the economy approaches "maximum employment and inflation has risen to 2 percent and is on track to moderately exceed 2 percent for some time."[1] There have been some increasingly hawkish comments from FOMC members, with some suggesting that the economic recovery warrants tapering in the near term. The yield on the 10-year treasury note began and ended the quarter at about 1.5% but fell below 1.2% intra-quarter. Shorter and longer duration treasuries experienced similar moves during the quarter, i.e., there was little change to the yield curve.

Yields rose and spreads widened across the broad high yield market, albeit ever so slightly. The yield-to-worst and spread over treasuries on the ICE BofA US High Yield Index increased 0.23% and 11 basis points, respectively, over the quarter. The index closed the quarter with a yield-to-worst of 4.1% and spread over treasuries of 315 basis points. Performance deviations by credit quality, sector, size, etc. were unusually small during the quarter, as all major segments of the credit market performed similarly.

The default environment is exceptionally benign. The quarter experienced the lowest default volume, including distressed exchanges, in more than 7 years. That puts calendar year 2021 on pace to be the lowest default year in more than a decade. The trailing 12-month default rate ended the quarter at 0.99%, also the lowest level in more than 7 years. Post default recovery rates have also improved (39%) to in line with long-term historical averages (40%). This represents a substantial improvement from the unusually low recovery rates of 2019 and 2020, which were 23% and 22%, respectively. High yield market revenue has increased nearly 40% since the depths of the COVID crisis, while EBITDA has risen by 80%. Net leverage across the market has declined to well below average, while cash on hand remains well above average. The low default environment is a direct byproduct of these healthy corporate fundamentals. Unfortunately, low yields and tight spreads are also a byproduct.

Rating agencies have been upgrading credits at a rapid pace compared to downgrades. The issuer-weighted upgrade/downgrade ratio reached an all time high of 1.72 to 1, a remarkable rise from 0.34 to 1 at the start of the year (a ratio of more than 1.0 to 1 indicates more upgrades than downgrades, and vice versa). The volume-weighted upgrade/downgrade ratio is even higher, reaching a record 2.35 to 1.

At $410 billion, new issuance in 2021 has already surpassed every prior year except 2020 ($450 billion). Liberal new issuance can warrant investor caution, but the primary market has remained rather well behaved. More than 60% of all new issuance has been used for refinancing, while less than 20% has been earmarked for LBO/acquisition activities—the latter is a more aggressive use of capital. These figures are reasonably close to long-term averages. Also, just 14% of new issuance has been CCC-rated, slightly lower than average.

We continue to focus on credits with attractive asset coverage, often in the more senior parts of the capital structure. We will also continue to make the most of our research advantage in small and mid cap credits, which provides us a yield/spread advantage relative to the market without assuming unnecessary risk.

ATTRIBUTION – 3Q21

The Hotchkis & Wiley High Yield portfolio (gross and net of management fees) slightly underperformed the ICE BofA US High Yield Index and the ICE BofA BB-B US High Yield Constrained Index in the third quarter of 2021. Performance dispersion by credit quality, size, and sector was noticeably low across the high yield market. Accordingly, there were no major portfolio themes that were material contributors or detractors in the quarter. Slightly positive credit selection in utilities and technology was not enough to overcome negative credit selection in the basic industry sector, which was the largest detractor in the quarter.

(continued)

[1] https://www.federalreserve.gov/monetarypolicy/files/monetary20210922a1.pdf

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

Fundamentals (4)
The fundamentals score remained unchanged from last quarter. Revenue and cash flow have been robust. Leverage has declined and liquidity remains high. Defaults are also on the decline. EBITDA margins are elevated, perhaps at unsustainable levels.

Technicals (3)
The technical score remained unchanged from last quarter. The Fed has maintained its dovish stance. There is an attractive yield/duration profile. Supply/demand appears a bit unbalanced, however, as new issuance remains elevated while fund flows are tepid.

Valuation (2)
The valuation score remained unchanged from last quarter. Excess spreads (after adjusting for low defaults) are reasonable, so long as defaults remain subdued. The dispersion of spreads is sufficiently wide, a good sign for active credit pickers. However, yields are low are spreads are tight.

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 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 discipline used in managing accounts in the High Yield strategy may prevent or limit investment in major bonds in the ICE BofA US High Yield and ICE BofA BB-B US High Yield Constrained and returns may not be correlated to the indexes. 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.

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Investing in high yield securities is subject to certain risks, including market, credit, liquidity, issuer, interest-rate, inflation, and derivatives risks. Lower-rated and non-rated securities involve greater risk than higher-rated securities. High yield bonds and other asset classes have different risk-return profiles, which should be considered when investing.

Market Disruption: The global coronavirus pandemic has caused 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 has the potential to negatively impact the firm’s investment strategies and investment opportunities.

All investments contain risk and may lose value. The commentary is for information purposes only and should not be considered as investment advice or a recommendation of any particular security, strategy or investment product. Portfolio managers’ opinions and data included in this commentary are as of September 30, 2021 and are subject to change without notice. Any forecasts made cannot be guaranteed. Information obtained from independent sources is considered reliable, but H&W cannot guarantee its accuracy or completeness. Certain information presented is based on proprietary or third-party estimates, which cannot be guaranteed and are subject to change.

Past performance is no guarantee of future results.