HIGH YIELD

MARKET COMMENTARY

In 2020, investors witnessed the devastating impact of a worldwide pandemic on the global economy. While the effect was severe, investors perceived it as a transitory event, and recognized the stimulative influence of massive monetary and fiscal intervention. The ICE BofA US High Yield Index returned +6.5% in the fourth quarter, moving it into positive territory for the year. The index finished calendar year 2020 at +6.2%, which is far from heroic but quite impressive considering at one point during the year it was down more than -20%. Outperforming market segments during the fourth quarter were generally underperforming market segments over the course of the year. Lower rated credits outperformed higher rated credits in the quarter but underperformed in the year; small and mid cap credits outperformed large cap credits in the quarter but underperformed in the year; energy credits outperformed the broad market significantly in the quarter but underperformed significantly in the year.

The market's yield-to-worst ("YTW") declined from 5.8% to 4.2% during the quarter while spreads ("OAS") narrowed from 541 basis points to 386 basis points. The market's YTW and OAS were 5.4% and 360 basis points at the beginning of the year, respectively. Short term interest rates changed very little during the quarter, though long-term rates rose modestly, steepening the yield curve. Over the course of the full year, however, rates fell as the FOMC cut the Fed Funds target rate from 1.75% to near-zero. Short-term rates declined more than long-term rates, steepening the yield curve.

The pandemic stressed the high yield market in a meaningful way, which can be observed by elevated default activity. The 109 defaults representing $140 billion in par value represents the second most default activity ever recorded in a calendar year behind 2009's $205 billion (figures include bonds, loans, and distressed exchanges). The default rate, including distressed exchanges, finished the year at 6.7%, well above the 20-year average of 3.1%. About one-third of 2020 defaults were energy credits; the default rate excluding energy would be a more modest 4.5%. Post default recovery rates hit an all time low in 2020, at 21%--the previous low had been 22% in 2001. Recovery rates in the energy sector were particularly low (~13%). Excluding energy, the market's recovery rate would have been a more modest 29%. The market's average over the past 25 years has been about 40%. At year's end, bonds priced at distressed levels, or less than 50% of par value, represented just 0.6% of the entire market. This is down considerably from the 10-year high of 8.9% reached in March. Only 1.7% of the market is priced at less than 70% of par.

There were 523 rating agency downgrades during 2020, representing $677 billion in par value—a new record for a calendar year. This compares to just 177 upgrades representing $213 billion in par value. Accordingly, the upgrade/downgrade ratio was less than 0.35 for the year as measured by par or number of issues. This ratio has only been lower during the tech bubble burst and the financial crisis.

Fallen angels and new issuance also both set records in 2020. There were 63 new fallen angels that entered the market, representing $238 billion in par value. This easily surpassed the prior record of $150 billion set in 2009. The $450 billion in new issuance was also a new high, exceeding the $399 billion reached in 2013. About 58% of 2020's new issuance was used for refinancing, with just 8% used for LBO financing. Only 11% of new issuance was rated CCC, slightly below average (16%). Of this, about two-thirds was used for refinancing. While new issuance has been extensive it has not been overly aggressive.

Calendar year 2020 was challenging in a myriad of ways. We held steady in our commitment to the principles of bottom-up, value-oriented credit picking and worked as a team to ensure existing investments remained prudent and to find new ideas in an ever-changing environment. We will continue to do both. Our team remains entirely intact, the firm is healthy, and we are optimistic that our clients will be rewarded by our commitment and effort. It was reassuring to observe our time-tested investing style come back into vogue during the most recent quarter and we are optimistic that this reversion could be powerful and lasting. We look forward to the new year with enthusiasm.

ATTRIBUTION – 4Q20

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 fourth quarter of 2020. Small and mid cap credits outperformed large cap credits modestly, which is conducive to our approach. Positive credit selection drove more than 90% of the outperformance in the quarter. Credit selection in basic industry was the largest positive contributor by a wide margin, followed by positive credit selection in capital goods, healthcare, retail, and media. The underweight allocation to telecommunications was also helpful. Credit selection in transportation and banking were modest detractors.

The portfolio lagged the indices over the full calendar year. Much of what helped during the most recent quarter hurt over the course of the entire year. The overweight exposure to small and mid cap credits hurt during the year as they lagged large cap credits. Credit selection in energy and retail were the largest detractors over the year, partially offset by positive credit selection in the basic industry and automotive sectors.

(continued)

HIGH YIELD

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

Fundamentals (4)

We increased the score from 3 to 4. Economic data has improved, the reopening process remains ongoing amid the vaccine rollout, and expansion appears underway. Corporate liquidity remains strong, defaults appear to have peaked, but COVID-19 infection rates have stalled reopening efforts which would derail or delay an expansion.

Technicals (4)

We left the score unchanged. 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 political landscape remains contentious.

Valuation (3)

We decreased the score from 4 to 3. Yields declined and spreads narrowed. Reopen progress and the increase in fallen angels helps offset the move in valuations. Spreads are at 386 basis points, but the dispersion of spreads is wide—the latter is conducive for active credit pickers. The small/mid spread advantage relative to large caps is more than 100 basis points.

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 BB-B US High Yield Constrained 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 and ICE BofA BB-B US High Yield Constrained 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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