

SMID-CAP CREDIT UPDATE

Over the past 10-years, Hotchkis & Wiley has operated its high yield (HY) investment strategy with its core thesis being that a disconnect exists in the HY market that produces opportunities for investors that can focus on small- and mid-cap (SMID) issuers. At a macro level, the HY market is dominated by huge mutual fund complexes that prefer to invest in large-cap (LCAP) HY issues for a variety of reasons (liquidity, availability of external research, multiple capital structure investment avenues, etc.). This tends to skew demand in favor of LCAPs because these issuers represent a minority of the total number of issuers in the HY market. Over time, we see the effects of this disconnect in the form of a structural richness of LCAP credit valuations. The opposite is the case for SMID credits. Here, because of variety of factors like issuer size, information asymmetry, rating agency bias, etc., this disconnect produces a structural cheapness in SMID valuations. This phenomenon does not occur in isolation. We observe this smaller issuer discounting or SMID premia in a variety of markets (e.g. bank debt, equity, etc.).

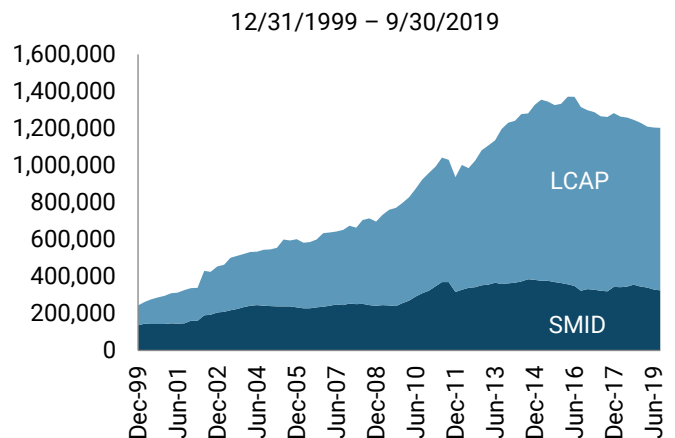
At the same time, we believe that the investment risks of every credit is a function of the inherent fundamentals rather than the technical factors that influent valuations. Side-by-side, two credits with identical fundamentals, differing only in the size of their debt balances, should probably involve similar compensation over the long run (short-term liquidity advantages diminish at the point of principal and interest repayment). Our strategy is to rely on our deep research platform and nimble asset footing to disproportionately seek exposure to SMID credits and systematically capture the SMID premia. This produces a portfolio of credits with a structural overweight of SMID credits relative to its representation in the indices. We published an extensive assessment of this subject in a September 2016 newsletter. That piece showed that both nominal and risk-adjusted returns favored the SMID capitalization portion of the HY market under short- and long-term horizons.

The recent underperformance of our strategy has led us to re-evaluate the findings of that earlier newsletter. Our intent does not call into question the SMID advantage, but rather to explore if and how the thesis has somehow been influenced or altered by factors we did not detect in our earlier work.

REVIEW OF MARKET TRENDS

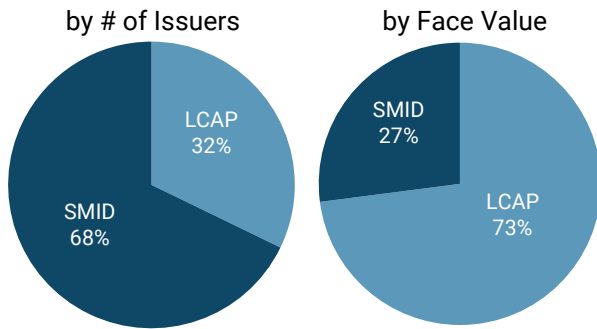
In our last newsletter, SMID accounted for roughly 25% of the market value of the HY market. As can be seen in Charts 1 and 2, SMID's have maintained a relatively constant nominal face value within the HY market over the past several years. LCAP issuers, on the other hand, fell in proportion to the overall market over the last three years. Historic levels of bank loan issuance and bond issue cannibalization was probably the driving factor that explains this decline.

Chart 1: Issuer Composition of the HY Market



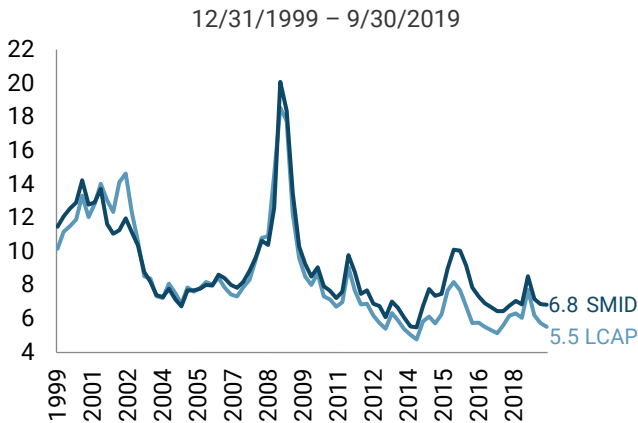
When we look deeper at the changes that occurred in the broader HY market over the last several years, Chart 2 shows that a more nuanced change has taken place. Compared to our previous newsletter, as a percentage of the overall HY market, the number of SMID issuers and face value have declined slightly (2%) over the last several years. Here too, bank loan issuance and bond issuance cannibalization played a part in the SMID market.

Chart 2: HY Market by Issuer and Face Value (9/30/19)



We also think the disproportionate number of SMID bankruptcies that occurred in aftermath of the Energy, Metals and Mining (EM&M) contraction that produced aggregate SMID default rates of well over 5% in 2016-2017 also contributed to the SMID issuer decline.

Chart 3: Yield-to-Worst (YTW) for SMID and LCAP



In terms of yield-to-worst (YTW), LCAP nominal yields rarely exceed that of SMIDs. The exception tends to be in the early stages of a broad-based bear-market when investors tap the most liquid and consequently largest capitalization portion of the market first to fund outflows. The early 2001-2002 Telecom, Media and Technology (TMT) contraction is an obvious example where LCAP yields exceeded SMID yields. The Global Financial Crisis (GFC) in 2008-2009 is another example, albeit less severe.

When isolating the YTW spread we can further see how localized the EM&M contraction was.

Chart 4: YTW spread between SMID and LCAP

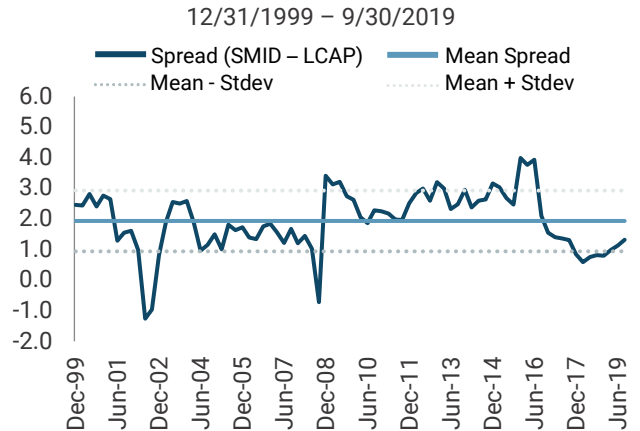


Chart 4 shows the long-term mean and +/- one standard deviation of the spread history between YTW of SMID and LCAP HY. The only time the spread between SMID and LCAPs went negative has coincided with the two major economic contractions as represented by the shaded regions on the chart. The EM&M contraction produced a significant contraction in the spread which exceeded the mean spread minus one standard deviation of the mean, but it did not generate a negative spread.

Chart 5: Option Adjusted Spread (OAS) of SMID and LCAP

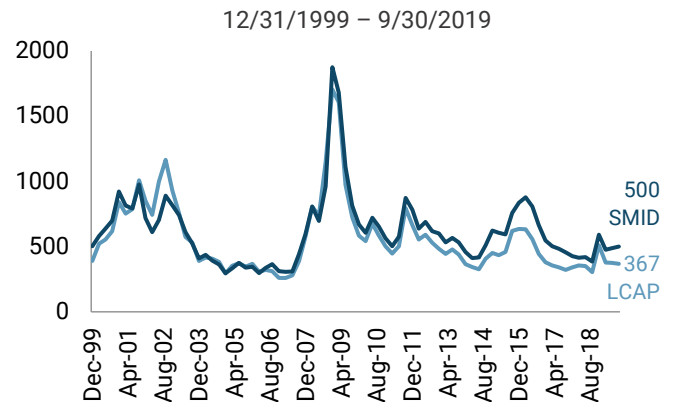
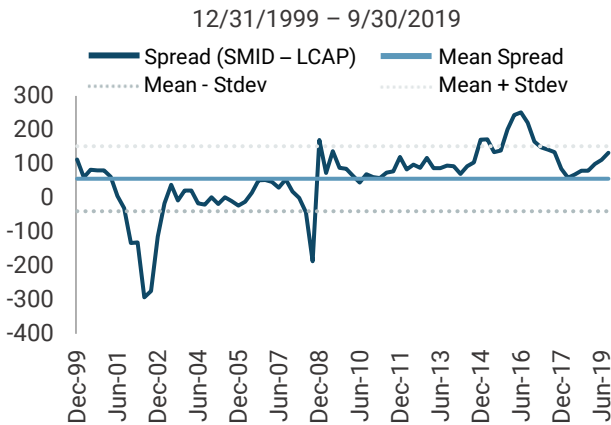


Chart 5 provides a more isolated view of the differences in compensation between the Option Adjusted Spread (OAS) of SMID and LCAP bonds. Like YTW, nominal OAS levels provide a similar context to the YTW charts (i.e., SMID OAS rarely falls below the LCAP OAS).

Chart 6: OAS spread between SMID and LCAP



Over the long history, the average spread between SMID and LCAP is approximately 56 basis points. This is an aggregate number that includes a variety of smaller capitalization issuers. As we showed in the previous newsletter, this spread increases in inverse proportion to the size of the issue. Chart 6 portrays the OAS spread between SMID and LCAP, and includes the whole series mean and +/- standard deviation thresholds of the spread. What’s interesting to note is that since the GFC, the spread has been roughly banded by the mean of 56 bps on the low side and 152 bps on the high side (mean +1 standard deviation). The exception occurred during the EM&M sector recession between 2014 and 2016 which was clearly a SMID concentrated issue.

Chart 7: Modified Duration of SMID and LCAP

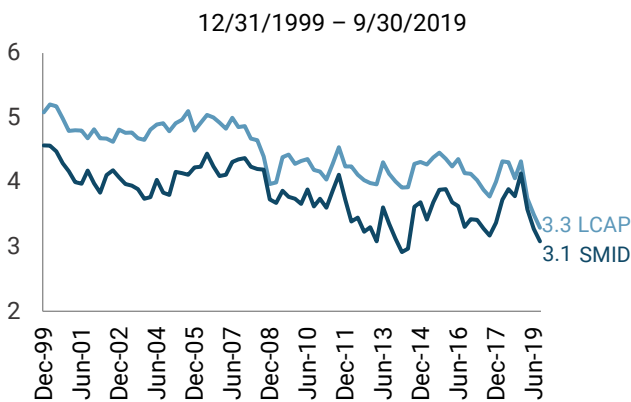


Chart 7 provides a review of modified duration for SMID and LCAP markets. LCAPs generally have longer modified duration compared to SMIDs. This is mainly a function of differing issuing patterns with LCAPs tending to be of higher quality and having longer issuance maturities. A significant proportion of LCAP

bonds are issued non-call life to suit the preference of investment grade buyers who like the precise maturity for hedging. SMIDs, on the other hand, skew lower in rating agency quality, exhibit shorter call-structures and seldom involve bullet maturities. The result is the tendency for SMIDs to have lower modified duration.

Chart 8: Modified Duration Spread between SMID and LCAP

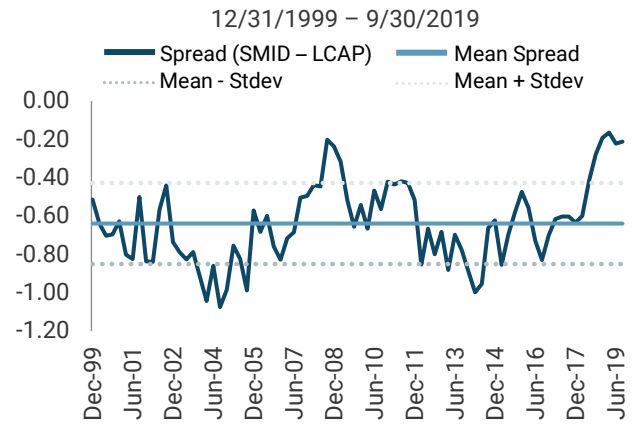
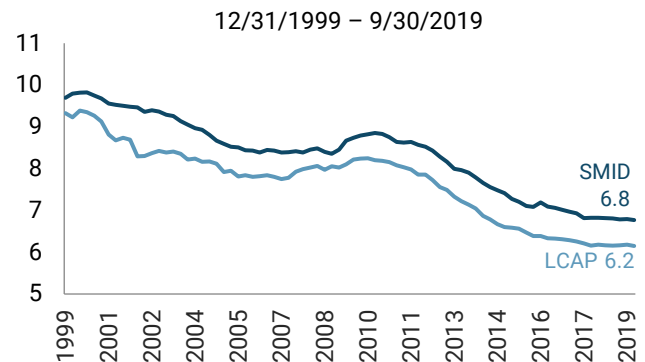


Chart 8 shows that the modified duration spread between SMIDs and LCAPs has reached very compressed levels seen last around the GFC. We view this narrowing of duration differentials to be a consequence of a few notable influences. First, over the past three years we have witnessed a massive refinancing wave that has been broadly implemented across capitalization size. Next, the tenor of new issues associated with the refinancing has materially shortened over the same period. Finally, we believe these factors have been driven by late cycle uncertainty regarding the Fed and the path for government interest rates.

Chart 9: Par-weighted average coupon of SMID and LCAP



Like modified duration, par-weighted coupons for SMID and LCAP HY have declined meaningfully over time as shown in Chart 9.

Chart 10: Par-weighted coupon spread between SMID and LCAP

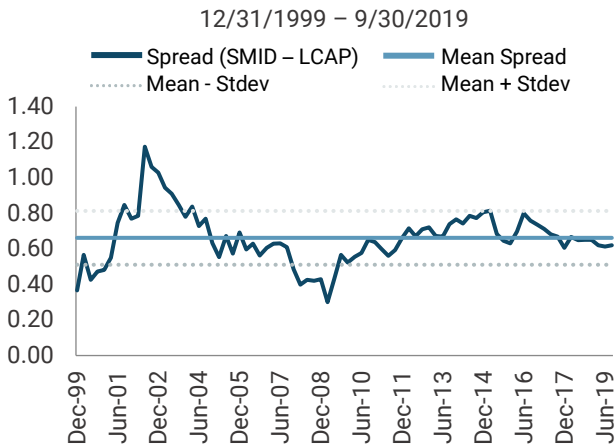
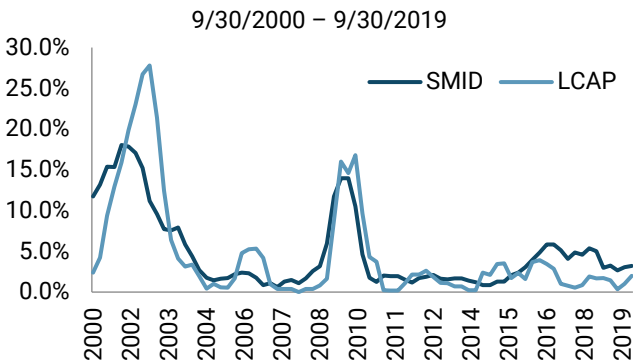


Chart 10 shows that of all the valuation metrics we have reviewed (YTW, OAS, Modified Duration, Coupon), coupon spreads between SMIDs and LCAPs appear to have the most stable relationship, especially in the period after the GFC.

WHAT ABOUT DEFAULT RATES?

Chart 11 shows that there are significant divergences in default trends between SMID and LCAP credit. Our contention is these divergences are functionally a bi-product of sector-level influences.

Chart 11: Default Rates for SMID and LCAP



The big spike in LCAP defaults in the 2000-2003 period was the result of the TMT crisis that was heavily concentrated in the LCAP part of the market. The mini LCAPs default surge in 2006 that coincided with the big-3 auto-maker downgrades into HY was broad based,

but significantly tied to energy and delayed TMT defaults. The last big default surge in LCAPs was in the aftermath of the GFC driven by the mid-2000 era LBOs that could not survive much beyond that recession. Interestingly, over the 20-year period we have data, SMID defaults have materially exceeded LCAPs only in a few relatively short periods discussed below.

Chart 12: Spread between SMID and LCAP default rates

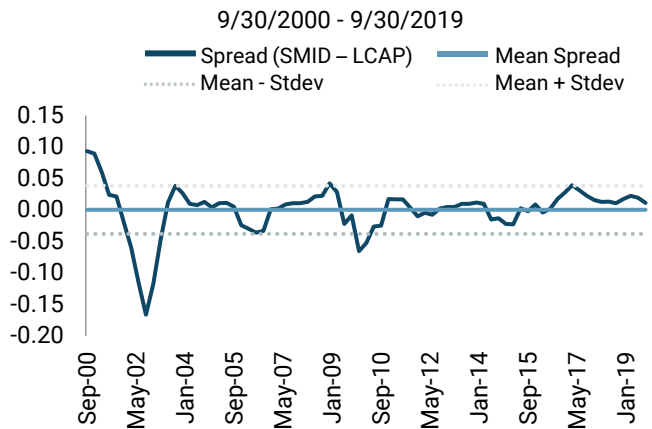
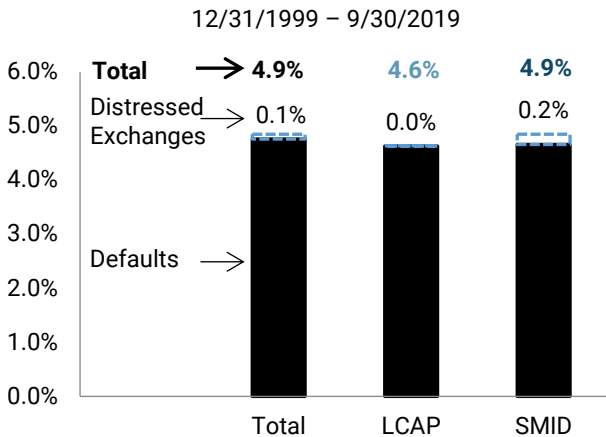


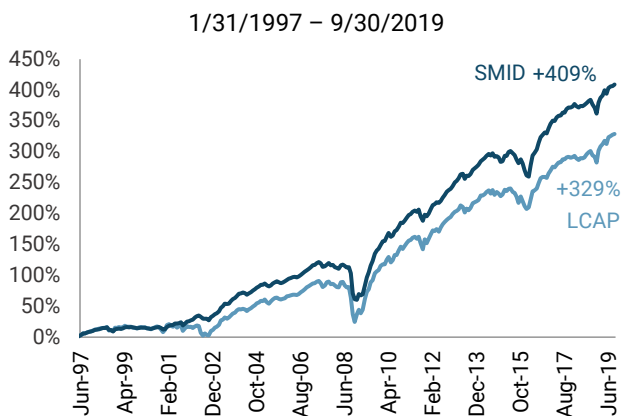
Chart 12 shows the spread between default rates of SMID and LCAP issuers over time. This spread averages approximately zero with a +/- 3.8% standard deviation over time. We do not include distressed exchanges in these graphics because they are a relatively recent phenomenon (since around the GFC). The four relevant periods where SMID defaults significantly exceeded LCAPs were 1999, 2003, 2009 and late 2016. In 1999 and 2009, SMID defaults exceeded LCAPs as part of broad economic contractions. Simply put, when a recession hits, SMID credit tends to feel the liquidity contraction first which results in default rates that accelerate before it is felt at LCAPs. The 2003 period was a variation on this theme. Tight liquidity, anemic economic conditions and final capitulation in TMT related credits produced the elevated SMID default rate relative to LCAPs. The most notable example of a SMID default surge relative to LCAPs, outside of a recession, occurred in the period following the EM&M crisis that started with energy and metal end market price collapse in 2014/2015.

Chart 13: Long-Term Default Perspective



In Chart 13, we quantify the difference between SMID and LCAP defaults and include the effect of distressed exchanges. Over the 20-year data set that starts in 12/31/1999, the total long-term default rate is 4.8%. Including distressed exchanges adds 0.1% to bring the total default rate to 4.9%. Breaking the HY market into its constituent market cap cohorts shows that SMIDs have a marginally higher default rate compared to LCAPS of 4.6% vs. 4.7%, respectively. Including distressed exchanges, the difference is 30 bps (e.g., 4.6% vs 4.9%).

Chart 14: Longer term cumulative performance difference between SMID and LCAP

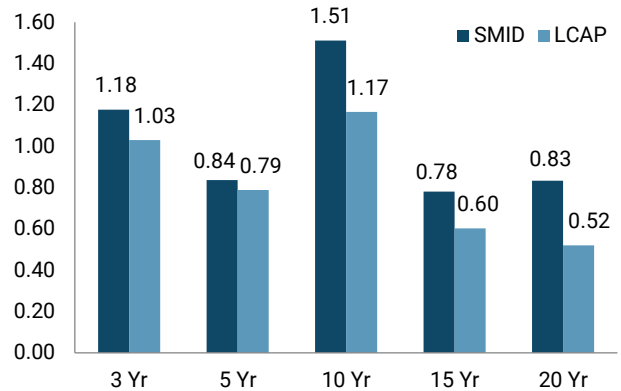


As can be seen in Chart 14, the long-term thesis of SMID outperformance remains intact. From the chart we find that over the long run, SMIDs have cumulatively outperformed LCAPs, which is consistent with our 2016 newsletter findings.

RISK-REWARD

A good way to think about the trade-off between return and volatility of SMIDs and LCAPs is through the use of the Sharpe Ratio formulation that seeks to isolate the amount of excess return over a risk-free rate per unit of market volatility. The following chart summarizes Sharpe ratios for SMID and LCAP bonds over various time periods.

Chart 15: Sharpe Ratios for SMID and LCAP (9/30/19)



Here we find that SMIDs continue to produce higher Sharpe ratios than LCAPs across all meaningful periods. However, the magnitude of the difference has diminished since our last newsletter. This makes sense, because the post GFC era has been dominated by financial system scrutiny. Implementation of Dodd-Frank re-regulation measures has fundamentally elevated liquidity in the hierarchy of bank capital market priorities. The effect has been to favorably treat liquid issues (LCAPs) in terms of trading compared to less liquid issues (SMID).

Another way to quantify risk-reward is compare default-induced loss rates to the compensation associated with SMID and LCAP OAS. Analytically, we analyze SMID and LCAP default cohorts and assemble the corresponding post-default recovery rates for each cohort, by year. Unfortunately, we only have post-default recovery rates for the two cohorts going back to 12/31/2008. Subtracting default losses from the OAS compensation produces a spread in excess of default losses for SMID and LCAP credit (Chart 16).

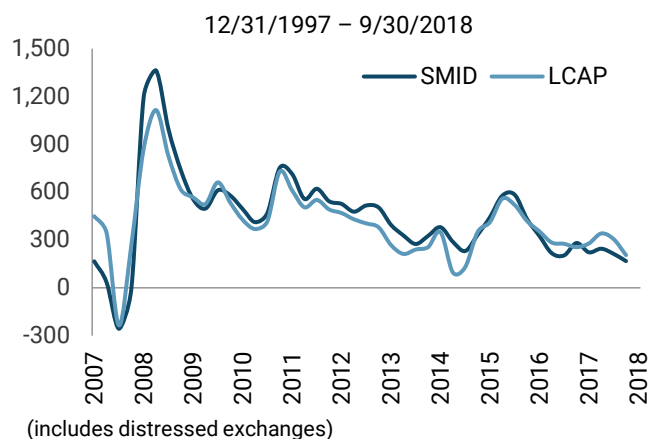
Chart 16: Default Loss Adjusted Excess Spread for SMID and LCAP

Chart 16 shows that over the approximately 10 years of data, default adjusted excess spreads for SMID generally exceeds LCAPs by around 25 bps. Like we have found in previous periods, this is not an absolute relationship. Around the GFC we see that LCAP excess spreads have exceeded SMIDs. The more recent periods around 2017 and 2018 also favored LCAPs. We have tested the relationship between default adjusted spreads for SMID and LCAP, but the spread doesn't provide a consistent leading indicator for future returns for the respective cohorts. Our conclusion is that the default-adjusted spread, while an important relative valuation metric, is too dependent on trailing defaults rather than forward defaults.

CONCLUSION

Broadly, we find that much of the results from our previous newsletter still hold true - SMIDs continue to offer a viable and fruitful segment of the HY market as compared to the LCAP segment. Our long-term thesis of SMID outperformance remains intact, which is consistent with previous findings.

Nonetheless, the point of this review is to put a finer point on the SMID opportunity. Namely, the SMID advantage is not absolute. Periods before and sometimes after recessionary periods can produce difficult short-term underperformance for SMIDs compared with LCAPs. The other nuance is that sector level dislocations like in the EM&M crisis of 2015/16 can disproportionately affect SMID relative to LCAPs. This impact can also take several years to flush out. The more recent underperformance of SMIDs appears to be a mix of macro-economic concerns leading up to

the end of 2018, in which some market participants feared could lead to a 2019 recession, and sector level dislocations in the broad category of cyclically related credits. Cyclical companies, both in actual results and expectations, have borne the brunt of the US tariff policy impact. Add late cycle caution and post-Dodd-Frank regulations that have encouraged liquidity in the financial system makes the underperformance of the SMID cohort relatively explainable.

Moreover, we must consider the possibility that market participants have recognized the relative value inefficiency in SMID credits and begun to broadly exploit the valuation opportunity. We still believe that the "constituency bias" exists in the case of large funds preferring LCAPs, but over the years, we have observed a SMID indexing phenomenon that has begun to creep into the HY market. This indexing occurs when large managers hold multiple non-concentrated positions SMIDs names (3-5 bps positions in their overall fund footing). This additional buying could affect the SMID premium with incremental demand. Irrespective of these technical factors, the risk-reward characteristics appears to have become less dominant as compared to our previous findings.

At Hotchkis & Wiley, we still see plenty of opportunity to capture the SMID premia for uniquely positioned credits. Using our three-factor assessment of the HY market, over 2019, we have seen a relatively material weakening in *Fundamentals* to what we characterize as below average, reflecting the slower economic conditions. This is somewhat balanced by our *Technical* and *Valuation* indicators that remain at average levels. Our view is that late cycle concerns will continue to be a modest headwind as we lead up to next-year's election in 2020. Given the benefit of our work on SMIDs, we think it is prudent to enforce stricter position limits on the bulk of our SMID holdings. In addition, we will not hesitate to underwrite new LCAP names where the SMID-LCAP valuation spreads look too tight. In our next newsletter, we will provide an outlook for 2020 and include more details regarding our strategy and tactical plans.

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Data sources: Charts 1-10, 14, 16: ICE BofA Merrill Lynch, Bloomberg, HWCW; Charts 11-13, 15: JPMorgan, Bloomberg, HWCW.

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