HIGH YIELD

MARKET COMMENTARY

The ICE BofA US High Yield Index returned +9.6% in the second quarter of 2020, recovering some of its first quarter decline; the index is -4.8% since the beginning of the year. Most US states took steps to reopen during the quarter, and the Federal Reserve announced additional actions to further stimulate the economy: continue large scale asset purchases, hold interest rates near zero through 2022 if needed, and initiate purchases of individual corporate bonds. Employment and consumer spending improved more quickly than the market anticipated, helping fuel the rebound in credit markets. An increase in COVID-19 cases accompanied the reopening efforts; however, which muted the recovery.

There was little performance dispersion in the quarter by credit rating, but there were large differences by sector. Energy credits led the way, returning +33%. Automotive, banking, and leisure credits were next best, returning +14%, +11%, and +10%, respectively. Transportation, media, and services credits lagged the broad market, returning +3%, +4%, and +5%, respectively. Small/mid cap credits outperformed large cap credits by about 3 percentage points, partially reversing the large performance difference in the first quarter. Unlike the first quarter, treasury yields changed little; the yield on the 2-year note declined about 10 basis points, the yield on the 10-year note was about flat, and the yield on the 30-year bond increased about 10 basis points. This resulted in a slight steepening of the yield curve.

In the second quarter, $82 billion worth of bonds defaulted or were involved in a distressed exchange, which represents an all-time high for a calendar quarter. The number since the beginning of the year is $106 billion, which would eclipse any calendar year on record outside of 2009 when $205 billion worth of bonds defaulted or were involved in a distressed exchange. The default rate, including distressed exchanges, closed the quarter at 6.6%--a 10 year high. Energy has comprised 30% of the default volume year-to-date; the sector's default rate stands at more than 19%. Excluding energy, the high yield market's default rate would be 4.2%, only slightly higher than long term averages. The trailing 12-month, post-default recovery rate is just 17%, which represents a record low, well below the long-term average of about 40%.

At the beginning of the quarter, nearly 9% of the high yield market traded at less than 50% of par value. Due to both default activity and spread tightening, this number fell to 2.5% of the market by quarter's end—energy credits represent nearly two-thirds of this. Credit rating downgrades have outpaced upgrades nearly 5 to 1 this year (497 downgrades to 101 upgrades). Fallen angel volume this year has also been record-setting. Since the beginning of the year, 47 fallen angels have migrated from investment grade to high yield, totaling $191 billion in bonds. This surpassed the previous annual record of $150 billion set in 2009 and has changed the composition of the index meaningfully, most notably by increasing the weight in autos and energy.

ATTRIBUTION – 2Q20

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 second quarter of 2020. Small and mid cap credits outperformed large cap credits, which helped relative performance—the opposite occurred in the first quarter, in a big way, which was major headwind for our small/mid cap focus. From a sector perspective, overall credit selection was decidedly positive, with the portfolio outperforming 15 of the 19 high yield sectors. Services, transportation, basic industry, leisure, and automotive were the largest positive contributors. The underweight exposure to telecommunications also helped. Negative credit selection in energy and capital goods detracted from performance, along with the modest underweight exposure in energy.

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

Fundamentals (2)

We increased the score from 1 to 2 after having lowered it last quarter due to COVID-19. Economic data are improving, and the reopening process remains ongoing. Corporate earnings and guidance remain weak, and COVID-19 infection rates have risen amid reopening efforts.

Technicals (3)

We increased the score from 2 to 3 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.

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 640 basis points, and the dispersion of spreads is wide—the later 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.

HIGH YIELD

Unless otherwise noted, the "high yield" or "broad" 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 Index and ICE BofA BB-B US High Yield Constrained indices and returns may not be correlated to the indices. 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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