HIGH YIELD

MARKET COMMENTARY

The ICE BofA US High Yield Index returned +0.9% in the first quarter of 2021. Another round of fiscal stimulus was signed and delivered. The $1.9 trillion bill raised the total COVID fiscal response to $5.3 trillion; this sum equates to about 25% of pre-COVID GDP or roughly $16,000 for every American. The bill's passage was widely anticipated and consequently sparked little reaction from the high yield bond market. The acceleration of vaccine availability prompted investor optimism; however, as it was announced that all Americans 16 and older should be eligible by May 1st. On the economic front, the labor market showed signs of improvement as initial jobless claims fell to the lowest level since the pandemic began. The housing market continued its upward trend and consumer confidence also hit its highest level in a year. WTI crude oil prices rose 22% in the quarter, closing the quarter at $59/barrel after peaking at $66 in early March. Corporate America performed well with most US companies exceeding consensus earnings expectations during the quarter. The signs of near-term recovery, coupled with the Fed's expanding balance sheet, seemingly point to increased inflation. The gap between the 10-year treasury note and 10-year TIPS, a proxy for expected inflation, finished the quarter at its highest level since mid-2013.

In response to increased growth and inflation expectations, interest rates rose with the 10-year treasury yield rising from 0.92% at the beginning of the quarter to 1.74% at its end. Short rates changed very little, which resulted in the yield curve steepening. The high yield market fully absorbed the rise in interest rates, as spreads tightened about 50 basis points while the yield-to-worst remained almost entirely unchanged (it moved from 4.24% to 4.27% over the course of the quarter). Three non-mutually exclusive segments of the high yield market were notable outperformers in the quarter: 1) lower rated credits; 2) small and mid cap credits; 3) energy. The portfolio benefited from the latter two, as it has an outsized exposure to small and mid cap credits and is also overweight the energy sector.

Defaults in the first quarter totaled $3.4 billion in par value, including one distressed exchange, which represented the third lowest quarter of the past five years. The trailing 12-month default rate now stands at 5.4%. While this is higher than the 3.5% long-term average, it is remarkably tolerable considering the 12-month period encompasses the most significant global pandemic in several generations. Excluding the energy sector, the default rate would be 3.1%, below the long-term average. The post default recovery rate remains near all time lows, however, at 22% compared to the 25-year average of about 40%.

Less than 0.5% of the high yield market trades at distressed levels, or less than 50% of par value. For perspective, this number exceeded 10% of the market one year ago (3/31/2020). This reflects the high yield market's strong fundamental backdrop, to which we assigned a rare "5" rating. During the first quarter, rating agency upgrades outpaced downgrades about 2 to 1 as measured by either par value or number of issues. The new issue calendar remains robust with about $160 billion in new issuance during the quarter. Annual new issuance has averaged about $300 billion over the past decade so this year's pace is well ahead of recent averages. Refinancing has dominated this new issuance; however, which reduces the supply burden on the market. More than 75% of the quarter's new issuance was used for refinancing, and only 10% was used for LBO activity.

We remain committed to our bottom-up credit picking process. Our penchant for small and mid cap credits effectively opens our investable universe beyond what many of our peers even consider. This often allows the portfolio to exhibit a yield/spread advantage, but our focus on the more senior parts of the capital structure help us control risk. As we look forward, we believe our clients will continue to benefit from this simple and time-tested combination.

ATTRIBUTION – 1Q21

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 first quarter of 2021. Small and mid cap credits outperformed large cap credits, which helped relative performance considering our overweight to the former. More importantly, however, credit selection was positive in large, mid, and small cap credits. Credit selection was particularly helpful in energy, followed by media, healthcare, and retail. The overweight exposure to energy and underweight exposure to telecom also benefited relative returns. Credit selection in basic industry, leisure, services, and automotive detracted from performance.

(continued)

HIGH YIELD

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

Fundamentals (5)
We increased the score from 4 to 5. Everything is poised to improve with the massive stimulus and support by the Federal Reserve. Cash balances are at record levels and most economists see growth anywhere from 5% to 10% over the next 12 months. Default rates will likely go below 2% and stay there for a prolonged period. In the near-term, fundamentals are as good as they can get, though we will watch the Fed's resolve if/when inflation begins to emerge.

Technicals (4)
We left the score unchanged at 4. The only reason this is not a 5 is that we continue to see a large new issue calendar. Upgrades are outpacing downgrades. Most of the new issue calendar is focused on refinancing, limiting the supply impact on the market. Investors seem willing to embrace yields around 5% and durations around 3 when compared to investment grade corporate alternatives which exhibit half the yield and double the duration.

Valuation (3)
We left the score unchanged at 3. Despite spreads more than 300 basis points for an asset class that is higher in quality than it has been at any points in the past 20 years, the average coupon continues to drift lower with new issues regularly pricing in the 5% area.

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 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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