HIGH YIELD

MARKET COMMENTARY

The ICE BofA US High Yield Index returned +2.8% in the second quarter of 2021. While the threat of new COVID variants persists, vaccination levels increased and new cases slowed. Consequently, state and local governments continued to ease closures/restrictions spurring renewed economic activity. Manufacturing rose and labor markets improved, highlighting the potential for tight supply conditions. Consumer prices rose 5% year over year, the fastest level in more than a decade. In response, Fed Chairman Powell reiterated his view that inflationary pressures would be transitory. WTI crude oil touched $74/barrel, its highest level in more than two years. Corporate earnings continued to show strength, with most US corporations surpassing consensus earnings expectations.

Medium/long term interest rates fell during the quarter while yields on the short end rose slightly, thus flattening the yield curve. The 10-year treasury note declined from 1.74% to 1.47% over the quarter. The high yield market followed suit, with yields falling and spreads tightening. The yield-to-worst for the high yield market fell by (0.4%), from 4.3% at the beginning of the quarter to 3.9% at quarter end. Spreads over treasuries tightened by 32 basis points, closing the quarter at just over 300 basis points. Yields and spreads are considerably lower/tighter than historical averages. While these relatively rich valuations leave less room to absorb negative shocks, the low yields/spreads are supported by healthy fundamentals.

Defaults/distressed exchange activity over the first six months of 2021 was the high yield market's lightest in a decade. The trailing 12-month par-weighted default rate, including distressed exchanges, ended the quarter at less than 1.9%. This is a far cry from the 6.7% level at the beginning of the year. Defaults in calendar year 2020 represented $140 billion in par value (includes bonds, loans, and distressed exchanges). Year-to-date, this figure is $8.5 billion. The trailing 12-month upgrade/downgrade ratio is 1.34 to 1, which is the highest level in nearly 7 years; the trailing 6-month ratio is more than 2 to 1. Lower rated credits outperformed higher rated, fallen angels outperformed originally issued high yield bonds, small and medium credits outperformed large caps, and energy was the top-performing sector by a wide margin (WTI crude rose +24%).

The primary market is on record-setting pace, with nearly $300 billion in new issue volume since the beginning of the year. There was $450 billion in new issuance in 2020, which surpassed the prior record of $399 billion in 2013. Two-thirds of new issuance has been for refinancing, mitigating pressures from increased supply. About 15% of new issuance has been used for M&A activity, which is lower than historical averages, albeit modestly so.

We continue to focus on well-capitalized credits, with a penchant for the often overlooked small and mid cap segment of the market. This results in a yield/spread advantage relative to the benchmark, and because we generally focus on the senior part of the capital structure, it can be attained without assuming undue risk. We believe this combination should continue to benefit our clients.

ATTRIBUTION – 2Q21

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 2021. The strategy's focus on, and corresponding overweight allocation to small and mid cap credits helped relative performance. The largest contributor to relative performance was positive credit selection in energy, though the overweight position in energy also helped. The energy sector was by far the best-performer for both the portfolio and the indexes. Positive credit selection in retail also helped. Credit selection in basic industry was the largest performance detractor in the quarter, followed by credit selection in consumer goods.

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

Fundamentals (4)

We lowered the score from 5 to 4. Record stimulus and continued support from the Federal reserve remain supportive. Balance sheets remain strong, the outlook for growth positive, and so the outlook for defaults is rather benign. Inflationary pressures pose a risk, however, with rising material and labor costs.

Technicals (3)

We lowered the score from 4 to 3. Upgrades continue to outpace downgrades. The new issue calendar is robust, though most of the activity has been for refinancing purposes. Fund flows remain tepid.

Valuation (2)

We lowered the score from 3 to 2. Yields and spreads are both well below average levels. Spreads over treasuries of close to 300 basis points reflects a market that is priced for an optimistic environment, providing little room for negative surprises.

Unless otherwise noted, the "high yield" market refers to the ICE BofA US High Yield Index

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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 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 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 June 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. 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.

Past performance is no guarantee of future results.