

BARROW HANLEY

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OCTOBER 2020 LEVERAGED FINANCE UPDATE

HIGH YIELD AND LOAN MARKET RECAP

The High Yield (HY) market experienced a turbulent October with initial gains of +1.6% by mid-month. As COVID cases increased globally and stimulus negotiations failed, the HY market reversed course and finished the month with just the coupon return of +0.47%.

Leveraged Loan (LL) returns also experienced a similar pattern as HY. The LL market was +0.17% for the month, losing 0.40% in the final week. Returns were dispersed across ratings quality. BB-rated LL underperformed with a -0.18% return, while B-rated LL were +0.15% and CCC-rated LL posted +0.47%.

HY new issuance slowed from the breakneck pace of previous months to \$35B, bringing the YTD total to \$385B. LL managed to surpass HY with \$46B in issuance, with the YTD total issuance increasing to \$359B (\$252B net issuance, ex-refinancing). It was the highest issuance month for loans post-COVID.

DEFAULT ACTIVITY

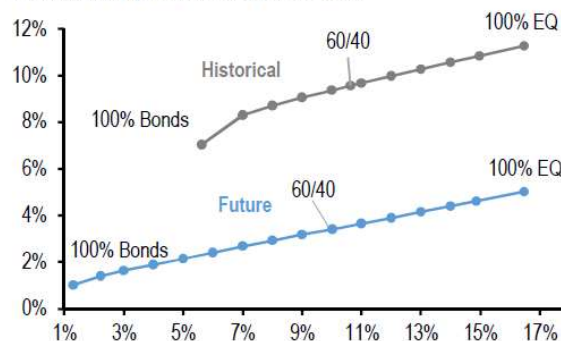
Default rates in HY were +0.5% to 6.3% while LL decreased 0.27% to 4.0%. Defaults have been concentrated within a few industries. Energy comprised 33% of all HY and LL defaults, followed by Telecom at 12% and Retail at 11%. The stress across Energy is not a surprise. Energy bonds represent over 50% of all HY bonds trading at or below \$70. While LL market stress is not as concentrated, Energy still comprises 15% of all loans trading at or below \$80. Services, Gaming & Lodging, and Healthcare each comprise roughly 10% of these stressed LL trading at depressed levels.

ALLOCATING TO HYBRIDS

Recently, JPMorgan analyst Jan Loey published a research note suggesting investors should consider altering their traditional 60/40 equity/fixed income portfolio allocation. With rates at low levels, future returns are likely to be materially lower than historical results.

Figure 8: Efficient Frontiers, historical since 1983 and forward for next 10 years

%, annual, 1983- 2019, except for end points, intermediate points have 10% minimum allocation to any asset class

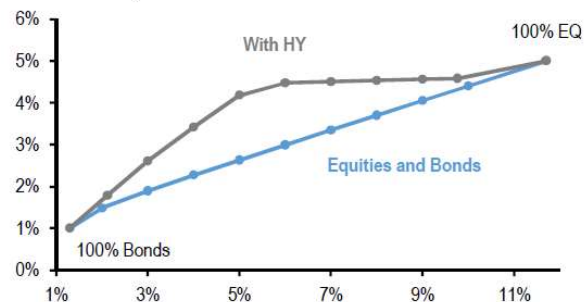


Source: J.P. Morgan, Bloomberg, S&P, Refinitiv.

Loeys recommended investors consider 40% equities, 20% traditional bonds, and 40% Hybrids for portfolios. Loeys defines Hybrids as HY, LL, CLOs, convertible bonds, CMBS, mortgage REITs, Utility equities, and Preferred shares. Portfolios including hybrids are likely to earn better risk-adjusted returns. Loeys presents an efficient frontier with bonds and equities, adding in differing levels of HY. As seen in the chart below, points on the efficient frontier shift meaningfully higher and to the left (less risk) with substantial allocations to HY.

Figure 10: Efficient Frontiers, 10-year forward-looking returns and risks with US Equities and US Agg, with and without HY bonds.

%, except for end points, intermediate points have 10% minimum allocation to any asset class



Source: J.P. Morgan, Bloomberg, S&P, Refinitiv. Correlations based on history since 1983. Vol for US Agg lowered to line up with lower yield. Vol based on table 3.

ALLOCATIONS FOR EFFICIENT FRONTIER WITH HY

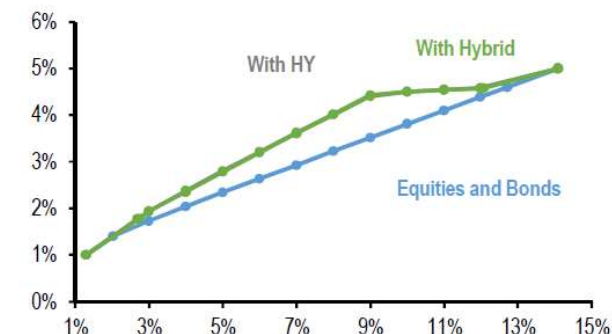
| Allocation | Portfolio Returns | Portfolio Risk | US Agg | HY | EQ |
|------------|-------------------|----------------|--------|-----|------|
| 1 | 1.0% | 1.3% | 100% | 0% | 0% |
| 2 | 1.8% | 2.1% | 80% | 10% | 10% |
| 3 | 2.6% | 3.0% | 58% | 32% | 10% |
| 4 | 3.4% | 4.0% | 37% | 53% | 10% |
| 5 | 4.2% | 5.0% | 17% | 73% | 10% |
| 6 | 4.5% | 6.0% | 10% | 65% | 25% |
| 7 | 4.5% | 7.0% | 10% | 48% | 42% |
| 8 | 4.5% | 8.0% | 10% | 33% | 57% |
| 9 | 4.6% | 9.0% | 10% | 20% | 70% |
| 10 | 4.6% | 9.8% | 10% | 10% | 80% |
| 11 | 5.0% | 11.7% | 0% | 0% | 100% |

Source: J.P. Morgan

The next chart below shows the efficient frontier using the all-encompassing definition of Hybrids.

Figure 12: Efficient frontiers 10-year out with US Equities and US Agg only, with HY, and with Hybrids. Risk is average of 1-yr vol and 10-year yield based uncertainty.

%, except for end points, intermediate points have 10% minimum allocation to any asset class. HY and Hybrid frontiers lie on top of each other.



Source: J.P. Morgan, Bloomberg, S&P, Refinitiv, REITs.

ALLOCATIONS FOR EFFICIENT FRONTIER WITH HYBRIDS

| Allocation | Portfolio Returns | Portfolio Risk | US Agg | Hybrid | EQ |
|------------|-------------------|----------------|--------|--------|------|
| 1 | 1.0% | 1.3% | 100% | 0% | 0% |
| 2 | 1.8% | 2.7% | 80% | 10% | 10% |
| 3 | 1.9% | 3.0% | 77% | 13% | 10% |
| 4 | 2.4% | 4.0% | 65% | 25% | 10% |
| 5 | 2.8% | 5.0% | 54% | 36% | 10% |
| 6 | 3.2% | 6.0% | 43% | 47% | 10% |
| 7 | 3.6% | 7.0% | 32% | 58% | 10% |
| 8 | 4.0% | 8.0% | 21% | 69% | 10% |
| 9 | 4.4% | 9.0% | 10% | 80% | 10% |
| 10 | 4.5% | 10.0% | 10% | 49% | 41% |
| 11 | 4.5% | 11.0% | 10% | 29% | 61% |
| 12 | 4.6% | 12.0% | 10% | 11% | 79% |
| 13 | 4.6% | 12.1% | 10% | 10% | 80% |
| 14 | 5.0% | 14.1% | 0% | 0% | 100% |

Source: J.P. Morgan

We firmly believe in portfolio diversification. As future returns in traditional fixed income will likely remain muted in the next few years, there is merit in adding additional exposure to what Loeys describes as hybrids. We see the current market as an ideal time to allocate to higher yielding strategies.

| BHMS Strategy Returns | Mo | QTD | YTD | Index |
|----------------------------|--------|---------|----------|-----------------------------|
| High Yield Composite Gross | -0.06% | -0.06% | 2.65% | BHMS |
| High Yield Composite Net | -0.08% | -0.08% | 2.44% | BHMS |
| Bank Loan Composite Gross | 0.22% | 0.22% | -0.43% | BHMS |
| Bank Loan Composite Net | 0.19% | 0.19% | -0.54% | BHMS |
| Asset Class | Mo | QTD | YTD | Index |
| HY Return | 0.47% | 0.47% | 0.17% | ICE BAML HY Index |
| HY BB Return | 0.50% | 0.50% | 3.24% | ICE BAML BB HY Index |
| HY B Return | 0.48% | 0.48% | -1.47% | ICE BAML B HY Index |
| HY CCC Return | 0.28% | 0.28% | -8.07% | ICE BAML CCC HY Index |
| Leveraged Loan Return | 0.17% | 0.17% | -0.66% | CS Leveraged Loan Index |
| LL BB Return | -0.18% | -0.18% | -2.26% | CS Leveraged Loan BB Index |
| LL B Return | 0.15% | 0.15% | 0.00% | CS Leveraged Loan B Index |
| LL CCC Return | 0.47% | 0.47% | -3.27% | CS Leveraged Loan CCC Index |
| HYG | 0.40% | 0.40% | -0.85% | Ishares Iboxx High Yield |
| BKLN | -0.83% | -0.83% | -2.78% | Invesco Senior Loan ETF |
| S&P 500 Return | -2.66% | -2.66% | 2.77% | S&P 500 |
| Russell 2000 Return | 2.09% | 2.09% | -6.77% | Russell 2000 Index |
| CS Leveraged Equity Index | -2.65% | -2.65% | -5.23% | CS Leveraged Equity Index |
| 10yr Beg | 0.69% | 0.69% | 1.92% | 10yr Treasury |
| 10yr End | 0.88% | 0.88% | 0.88% | 10yr Treasury |
| 10yr Return | 0.86% | 0.86% | 8.33% | 10yr Treasury |
| | Beg Mo | Beg Qtr | Beg Year | Ending YTW/STW |
| HY YTW | 5.76% | 5.76% | 5.41% | 5.75% |
| HY BB YTW | 4.40% | 4.40% | 3.85% | 4.34% |
| HY B YTW | 6.00% | 6.00% | 5.38% | 6.08% |
| HY CCC YTW | 11.77% | 11.77% | 11.80% | 11.59% |
| HY STW | 545 | 545 | 372 | 535 |
| HY BB STW | 403 | 403 | 213 | 388 |
| HY B STW | 574 | 574 | 370 | 575 |
| HY CCC STW | 1,154 | 1,154 | 1,012 | 1,126 |
| LL YT3Y | 6.02% | 6.02% | 6.27% | 6.08% |
| LL BB YT3Y | 3.93% | 3.93% | 4.29% | 3.99% |
| LL B YT3Y | 5.70% | 5.70% | 6.36% | 5.80% |
| LL CCC YT3Y | 13.94% | 13.94% | 15.29% | 14.27% |
| LL ST3Y | 579 | 579 | 461 | 583 |
| LL BB ST3Y | 369 | 369 | 262 | 372 |
| LL B ST3Y | 547 | 547 | 470 | 555 |
| LL CCC ST3Y | 1,371 | 1,371 | 1,365 | 1,403 |

Source: Barrow Hanley

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