High Yield commentary

Market commentary

The first half of 2022 proved a challenging period for the capital markets, with every major asset class suffering significant negative returns. In the second quarter, high yield (Bloomberg U.S. Corporate HY Index) declined 9.83%, IG credit (U.S. Credit Index) fell 4.69%, while leveraged loans (CS Leveraged Loan Index) fell 4.35%.

In fact, June witnessed the second worst monthly performance for high yield since 2008 and the first quarter was the worst quarterly performance since the pandemic-driven quarter of 1Q2020. The Fed's dovish talk that briefly positively swung markets in late May was proven overly optimistic by continued unexpectedly high U.S. inflation reports (up 8.6% in May, followed by 9.1% in June). Continued stubborn inflation has forced the Fed to move faster than maybe they had hoped just weeks prior, ultimately deciding on a 75bp June rate hike versus a more palatable 50bps. This rate move did seem to calm the markets temporarily as investors witnessed a more directionally focused Fed that seemed more intent on reducing inflation, even at the possible expense of the economy. The 10-year Treasury yield was extremely volatile inter-month peaking at 3.54% before rallying (post the Fed move) back down to 3.01%, only 15bps higher than where it began the month. Equities and credit markets now however must shift focus to the higher likelihood of recession (as opposed to just interest rate moves) and the resultant impact on corporate earnings.

High yield market spreads widened out sharply (+152bps) to 586bps in June reflecting this new reality for a yield-to-worst of 8.89%. June spread levels eclipsed the last taper tantrum (545bps) in the 4th quarter of 2018, but it is unlikely the Fed will come to the rescue this time around. While high yield markets do appear temptingly cheap based on price and yield, we caution that spreads are still uncomfortably tight if indeed a recession is in the offing.

With such a risk off mentality permeating in risk markets, it is strange that high yield showed little dispersion in June (unlike May) in performance by ratings. All quality cohorts performed poorly, although the delta return between Ba(s) and Caa(s) in such a negative month was surprisingly only 64bps. Dispersion between issue size was present. Large versus small issue spreads tightening 43bps to 77bps in June (from 120bps in May) as larger bonds underperformed, reversing their May outperformance. High yield retail fund outflows remained significant and now total a whopping $42.1bn year-to-date. U.S. high yield new issuance was up from May but still only a fraction (at $9.9bn) of typical average June levels of about $25bn (since 2010). There was simply nowhere to hide sector-wise as all high yield sectors were in the red during the quarter, sometimes deeply so.

There were two large defaults in the quarter: Endo Pharmaceutical and Revlon (neither are in the portfolio) but LTM default rates still remain extremely low at 1.08% (JP Morgan) and are still on pace to be in the relatively modest 1.25%-1.5% range for 2022.

Strategy commentary

The strategy's total return was significantly better than the benchmark for the quarter, with its outperformance driven by the cohorts where our credit selection delivers the most value: B and Caa rated issues and small size issues.

Like the index, all sectors were in negative territory within the strategy. Basic industry portfolio companies outperformed as well as energy credits. Consumer centric names were also individual laggards as investors brace for weakening consumer spending.

Source: Bloomberg, JPMorgan. Past performance is not necessarily indicative of future results. Performance shown above is gross and does not reflect the deduction of management fees. Please see disclosure at end for additional, important information. Please see the GIPS Reports attached for complete performance, including net, and benchmark descriptions. Any targeted performance results mentioned herein may not be achieved and materially different performance results may occur.

In terms of positioning, this past quarter we exited certain credits more exposed to the interest rate sensitive housing sector.

Our outlook for the high yield market depends largely on the outcome of the Fed's rate hike regimen, and how effective the Fed is at reducing inflation. If we see core inflation materially recede from current levels while real economic growth remains positive, we expect high yield will more closely mirror the returns of equities, an asset class to which it is closely correlated, as both respond to the health of the economy. However, if stagflation ensues, we expect high yield bonds to behave more like investment grade bonds, with returns driven in large part by Treasury rate movement, as opposed to corporate performance.

Regardless of the outcome, credit markets now must consider the higher likelihood of recession, the timing/severity of any downturn and the impact on corporate earnings.

That said, for investors focused on generating income, success will likely be determined by avoiding panic selling, selecting solid credits, and maintaining a proven investment approach.

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About Mesirow

Mesirow is an independent, employee-owned financial services firm founded in 1937. Headquartered in Chicago, with locations around the world, we serve clients through a personal, custom approach to reaching financial goals and acting as a force for social good. With capabilities spanning Global Investment Management, Capital Markets & Investment Banking, and Advisory Services, we invest in what matters: our clients, our communities and our culture.

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GIPS REPORT – MFIM FIXED INCOME HIGH YIELD COMPOSITE

Gross and Net of Fees Total Returns from March 1, 1999 – June 30, 2022

			Year end				Annual Performance results				
Year	Firm assets (millions)	MHY assets (millions)	High Yield USD (millions)	Number of accounts	Non-paying fees (%)	Carve out (%)	Composite gross (%)	Composite net (%)	Barclays high yield (%)	Composite dispersion (%)	Composite 3-yr ex-post STD (%)	Index 3-yr ex-post STD (%)
1999	–	507	507	2	1	1	4.81	4.38	1.49	n/a	n/a	n/a
2000	–	465	465	2	1	1	-8.42	-8.88	-5.86	n/a	n/a	n/a
2001	–	648	648	2	1	1	7.14	6.60	5.28	n/a	n/a[2]	n/a[2]
2002	–	888	888	2	1	1	11.63	11.08	-1.41	n/a	8.01	10.34
2003	–	1,265	1,265	2	1	1	23.64	23.03	28.97	n/a	7.03	10.65
2004	–	1,522	1,522	3	1	1	16.00	15.43	11.13	n/a	4.14	8.38
2005	–	1,536	1,536	2	1	1	6.81	6.28	2.74	n/a	4.48	5.55
2006	–	14	14	1	100	100	18.61	18.03	11.85	n/a	4.63	3.95
2007	–	297	11	1	100	100	7.59	7.06	1.87	n/a	4.70	4.74
2008	–	207	8	1	100	100	-17.70	-18.12	-26.16	n/a	10.14	13.41
2009	–	270	10	1	100	100	44.33	43.63	58.21	n/a	11.57	16.93
2010	–	295	11	1	100	0	16.94	16.36	15.12	n/a	11.72	17.03
2011	–	310	27	2	0	0	4.44	4.06	4.98	n/a	7.23	11.09
2012	–	334	40	1	0	0	14.63	14.00	15.81	n/a	5.40	7.08
2013	–	817	520	7	1	0	9.41	8.90	7.44	n/a[1]	5.33	6.41
2014	–	797	593	8	1	0	3.14	2.68	2.45	0.7	4.01	4.50
2015	–	757	617	8	1	0	-1.02	-1.45	-4.47	0.7	4.26	5.26
2016	–	841	742	7	–	–	15.18	14.67	17.13	–	4.57	6.00
2017	4,772	526	512	1	–	–	8.90	8.45	7.50	–	4.24	5.65
2018	4,137	873	859	2	–	–	-1.02	-1.37	-2.08	–	3.81	4.66
2019	3,895	1,199	1,124	3	–	–	13.02	12.58	14.32	–	3.79	4.07
2020	6,706	1,407	1,338	4	–	–	9.00	8.55	7.11	–	12.39	9.37
2021	6,168	1,421	1,301	4	–	–	12.12	11.67	5.28	–	12.25	9.13
Current YTD Performance Results - PRELIMINARY												
6.30.2022	4,905	1,130	1,015	4	–	–	-10.59	-10.77	-14.19	–	12.53	9.97

Past performance is not necessarily indicative of future results.

Mesirow Financial Investment Management Institutional – Fixed Income claims compliance with the Global Investment Performance Standards (GIPS®) and has prepared and presented this report in compliance with the GIPS standards. Mesirow Financial Investment Management Institutional – Fixed Income has been independently verified for the periods 01.01.1996 through 12.31.2021. A firm that claims compliance with the GIPS standards must establish policies and procedures for complying with all the applicable requirements of the GIPS standards. Verification provides assurance on whether the firm's policies and procedures related to composite and pooled fund maintenance, as well as the calculation, presentation, and distribution of performance, have been designed in compliance with the GIPS standards and have been implemented on a firm-wide basis. The High Yield Composite has had a performance examination for the periods from 03.01.1999 to 12.31.2021. The verification and performance examination reports are available upon request.

Creation date is 03.01.1999. Performance and Composite inception are 03.01.1999.

Mesirow Financial Investment Management, Inc. ("MFIM") is an investment advisor registered with the Securities and Exchange Commission under the Investment Advisers Act of 1940. The "Entity" is defined as Mesirow Financial Investment Management Equities and Fixed Income, which is comprised of the GIPS-compliant units of MFIM which specialize in managing portfolios for institutional clients adhering to an investment process geared towards institutional investors. The historical performance presented prior to the creation of the division was managed by MFIM or its predecessor firms prior to 01.01.2005. For purposes of claiming GIPS compliance, as of 01.01.2010, the "Firm" is further defined as the Fixed Income business unit, Mesirow Financial Investment Management Institutional – Fixed Income, which manages portfolios primarily for institutional investors adhering to an investment process, incorporating fundamental analysis of security valuation factors and drivers.

Effective 10.23.2017, the Firm completed the lift out of the High Yield Team, now Mesirow High Yield ("MHY"), from a former and unaffiliated registered Investment Advisor, Pacific Income Advisers. The High Yield Team, along with the High Yield Composite, became an integral part of the Firm. The current Portfolio Management Team consists of the original members, less one, and they are the only individuals responsible for selecting the securities to buy and sell.

The list of composite descriptions, the Firm's list of pooled fund descriptions for limited distribution pooled funds and the Firm's list of broad distribution pooled funds is available upon request. Policies for valuing investments, calculating performance, and preparing GIPS Reports are available upon request. Benchmark returns are not covered by the report of independent verifiers.

Results are based on fully discretionary accounts under management, including those accounts no longer with the firm. The Performance presented from 03.01.1999 to 4.30.2010 was generated while the Portfolio Managers were affiliated with a prior firm. Prior to 05.01.2010, the track record was reviewed for conformance with the portability requirements of GIPS standards. The predecessor firm was also verified, and the composite underwent a performance examination from inception in 03.01.1999 to 12.31.2009 by Ashland Partners & Company LLP. The High Yield Composite had been examined for the period of 05.01.2010 – 06.30.2016 while at Pacific Income Advisers (PIA). PIA had been verified for the period of 01.01.1994--06.30.2016.

The High Yield Composite consists of portfolios whose major concentration is in high yield bonds, both public and private. Equity-linked securities purchased in conjunction with debt securities, and equity securities obtained in exchange offers or insolvency proceedings, as well as leveraged corporate loans, and ETFs (in certain circumstances when onboarding a new account) may also be included. The portfolios are considered to be substantially fully invested, with minor cash holdings, at such time as the portfolio consists of at least 85% high yield bonds. This High Yield Composite definition was amended as of October 2019 to more fully reflect the intended strategy. On 01.01.2009, a substantially large equity position (comprising several securities) became non-discretionary and was transferred from the High Yield Composite portfolio when the client restricted the portfolio manager from selling the positions due to tax consequences.

Prior to 11.01.2010, the High Yield Composite was named the U.S. High Yield Composite. It is not for use with the general public and may not be redistributed. Please reference the last page of this presentation for important additional information.

Beginning 05.01.2010, composite policy requires the temporary removal of any portfolio incurring a client initiated significant cash inflow or outflow of 20% of portfolio assets or greater. Additional information regarding the treatment of significant cash flows is available upon request. The U.S. Dollar is the currency used to express performance.

GIPS REPORT – MFIM FIXED INCOME HIGH YIELD COMPOSITE (CONTINUED)

Prior to 01.01.2010, carve-outs reflect the capping of cash to 8% of Net Asset Value on an account which represents the personal holdings of one of the portfolio managers in order to align such cash amount to the level typical of an institutional account.

Performance / Net of Fee Disclosure

Returns are presented gross and net of management fees and include the reinvestment of all income. Returns do not reflect the deduction of investment advisory fees. Client returns will be reduced by such fees and other expenses that may be incurred in the management of the account. Advisory fees are described in Part 2 of Form ADV of MHY. As of 10.01.2013, net of fee performance was calculated using actual management fees. Prior to 10.01.2013, net of fee performance was calculated using the highest annual management fee applied to the gross results on a monthly basis. For the period 04.01.2011 through 09.30.2013, the highest management fee was 0.65%. Prior to 03.31.2011, the highest management fee was 0.50%. Actual investment advisory fees incurred by clients may vary. When applicable the standard deviation will be calculated as an equal-weighted standard deviation calculated for the accounts in the composite the entire year. The management fee schedule is as follows:

Vehicle	Fee Schedule
High Yield Composite Strategy (described in MHY's Form ADV, Part 2)	0.60% on the first $25 million 0.55% on the next $25 million 0.50% on the next $50 million 0.45% on the balance.
High Yield CIT Strategy	0.40% on all assets – Founder Class (First $100 million) [Closed]* 0.55% on all assets – Class A (under $25 million)** 0.48% on all assets – Class L ($25 million and above)**

*The Founders share class was closed to new investors 01.21.2022 after reaching $100 million in assets under management.

**Class A Units are available to Participating Plans investing less than $25 million and Class L Units are available to Participating Plans investing $25 million or more.

An actual fee charged to an individual portfolio may vary by size and type of portfolio. Fees are collected quarterly, which produces a compounding effect on the total rate of return net of management fees. As an example, the effect of investment management fees on the total value of a client's portfolio assuming (a) $1,000,000 investment, (b) portfolio return of 8% a year, and (c) 0.60% annual investment advisory fee would reduce the portfolio's value by $6,292 in the first year, by $36,614 over five years and $89,411 over 10 years. Actual investment advisory fees incurred by clients will vary.

Benchmark Definitions

The primary benchmark was formerly the Credit Suisse High Yield Index. The benchmark was changed to the Barclays U.S. Corporate High Yield Index on 05.01.2010, since the Portfolio Management Team believes it is more commonly recognized as the industry standard index for the high yield asset class. The index was renamed the Bloomberg Barclays U.S. Corporate High Yield Index, following Bloomberg's acquisition of Barclays Risk Analytics and Index Solutions (BRAIS) in August of 2016. The Bloomberg Barclays fixed income benchmark indices have since been rebranded as the "Bloomberg Indices" as of 08.24.2021, further updating the benchmark name to the Bloomberg U.S Corporate High Yield Index. The Bloomberg U.S. Corporate High Yield Index measures the USD-denominated, high yield, fixed-rate corporate bond market. Securities are classified as high yield if the middle rating of Moody's, Fitch and S&P is Ba1/BB+/BB+ or below. Bonds from issuers with an emerging markets country of risk, based on Bloomberg EM country definition, are excluded.

Calculation of Risk Measures: Annual / 3 Year Dispersion

1. N/A = Information is not statistically meaningful due to an insufficient number of portfolios in the composite for the entire year. Composite dispersion presented is the equal-weighted or asset-weighted standard deviation of the gross annual returns of portfolios in the composite for the entire year.

2. N/A = The 3-year Ex-post standard deviation isn't presented since there aren't 36 monthly returns available prior to this period. 1999 is a partial period from March 1 through December 31. The three-year annualized Ex-post standard deviation measures the variability of the composite gross returns, and the benchmark returns over the preceding 36-month period. It is not required to be presented for annual periods prior to 2011, or when a full three years of composite performance is not yet available.

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