High Yield commentary

Market commentary

The fourth quarter was positive overall, but December was a reminder of the tumultuous year it has been for high yield investors. While the market as measured by the Bloomberg US Corporate High Yield Index was up 2.6% in October and 2.17% in November, it pulled back in December with a return of -0.62%. For the quarter, the high yield market returned 4.17%. Loans, as measured by the Credit Suisse Leveraged Loan Index, returned 2.33%, although loans outperformed bonds by a whopping 10.13% for the year because their floating rate coupons insulated them from the major force acting on bond prices this year, the historically large increase in intermediate maturity Treasury yields.

The high yield gains in October and November were fueled by improving outlooks for both interest rates and inflation, coupled with limited new issue supply. The more favorable outlook culminated in the best two-month rally for the high yield market since April-May 2020. However, investor optimism quickly reversed in the second half of December, which erased some of the gains made earlier in the month and quarter.

For 2022 as a whole the market returned -11.19%, its worst annual performance since 2008. As bad as it was, the high yield market's performance was still better than almost every other major asset class: -16.1% for the S&P 500, - 13.01% for the Bloomberg U.S. Aggregate Bond Index and -20.09% for the MSCI Emerging Markets Index. Commodities were the big winners in 2022, finishing up more that 16% according to the Bloomberg Commodities Index. In credit assets, bank loans fared the best returning -1.06% (Credit Suisse Leveraged Loan Index).

In terms of quality for high yield, Ba and B bonds performed well in Q4, while Caa bonds continued to lag the pack, as they have all year.

	Q4	2022
Overall	4.17	-11.19
Ba	4.31	-10.80
B	4.93	-10.26
Caa	0.51	-16.29

Source: Bloomberg.

All industries were in positive territory in Q4, with gaming, oil field services and pharmaceuticals leading the charge, each finishing the quarter up nearly 9%. By comparison, media and entertainment was the most notable laggard in Q4, barely posting a positive return at 4bp. Retailers were also weak, reflecting the slowdown in consumer spending.

These industry themes largely echoed sector performance for 2022. Refining and oil field services were the best performing in 2022 (6.59% and 4.40% respectively) while media (-16.37%) and retailers (-20.93%) were among the worst. Pharmaceuticals was the top industry performer in Q4 (+8.42%), but the worst performer for the year at -25.44%. The large defaults of Endo Pharmaceuticals and Bausch Health in the year largely drove the sector's disparate 2022 return.

Issue size was less of a driver of high yield performance in Q4 but for 2022 as a whole, large issue sizes underperformed compared to small and mid-size issues. For 2022, this is not too surprising, as the longer duration of larger issues was a headwind for most of 2022 given the move in interest rates.

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.

	Q4	2022
Overall	4.17	-11.19
0-200MM	3.99	-4.58
200-500MM	3.89	-9.05
500MM-1BN	4.58	-10.38
1BN+	3.91	-12.88

Source: Bloomberg.

US high yield bond and loan default rates (including distressed exchanges) increased year-over-year to 1.65% and 1.59%, respectively. (JPM). That is still well below long term averages. Looking ahead, the consensus within rating agencies (Fitch, S&P) and banks (BAML, JPM) is for an increasing default rate in 2023 for both asset classes (within a range of 2.5%-5%). While this is a doubling of current trends, this demonstrates current market consensus on the potential for a mild U.S. recession. These default forecasts are much lower than have been experienced in prior recessions, reflecting the general higher quality of high yield balance sheets exiting the pandemic years. Both high yield corporate debt leverage and interest rate coverage are at historically benign levels. Debt leverage has never been lower (3.6x net and 4.0x gross) and interest rate coverage has never been higher (5.8x), according to BAML. Additionally, there are few issues maturing over the next two years in the high yield bond or loan markets; JPM has calculated the total is $262bn in maturities by the end of 2024, or only 8% of the leveraged credit market. In light of the default picture and the general health of the high yield universe, as well as the most recent inflation and jobs data, it is not surprising that the market is not pricing in a recession at all – as of year-end, the credit spread on the Credit Suisse index was 64bp (12%) below its long-term average.

Strategy update

As is typical when we see a large market run up in a short period of time, the high yield strategy lagged the benchmark in Q4. However, it bested the benchmark in 2022, as its early outperformance through the market's downturn more than made up for its 4Q relative underperformance.

For the quarter, the strategy's allocation to leveraged loans (particularly lower quality loans) was a hindrance after being a tailwind in prior quarters. About half of the remaining underperformance during the quarter outside of the loan allocation drag was due to our overweight of Caa bonds and underweight of Ba bonds. As stated above, Caa bonds lagged during the majority of 2022. And while our Caa bonds did outperform the market Caa cohort by roughly 50bps in Q4, they were still left behind by the run up in higher quality issues, which was almost 300bps greater.

Finally, selection also hindered the strategy in Q4. Surprisingly stubborn supply chain issues, rising rates, and rapidly shifting consumer habits (coming out of the pandemic years) have been a challenge for a handful of our credits. While we expect most of these to eventually rebound (and we continue to hold or even add to these positions in some cases), we have exited or downsized select credits which we believe may have permanent free cash flow impairment in light of future economic conditions.

Heading into 2023, we remain cautiously optimistic and still comfortable maintaining our unusually large spread differential vs the benchmark (~300bp today vs our long-term average of ~150bp.) We remain underweight in areas of the market where we feel higher rates and weaker consumer spending may persist (automotives, building materials, retail) but overweight areas where we believe valuations and tailwinds remain attractive (the midstream and oil field services components of the energy complex).

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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. To learn more, visit mesirow.com.

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GIPS REPORT – HIGH YIELD COMPOSITE

Gross and Net of Fees Total Returns from March 1, 1999 – December 31, 2022

	Year end						Annual performance results				3-year annualized dispersion[2]	
Year	No. of portfolios	Composite Asset at end of period ($MM)	MHY Assets at end of period ($MM)	Total Firm Assets ($MM)	Non paying fee (%)	Carve out (%)	MFIM (gross) Composite (%)	MFIM (net) Composite (%)	Bloomberg US Corp. High Yield Index (%)	Composite Dispersion [1] (%)	MFIM (gross) Composite (%)	Bloomberg US Corp. High Yield Index (%)
1999	5 or fewer	507	507	–	1	1	4.81	4.38	1.49	n/a	n/a	n/a
2000	5 or fewer	465	465	–	1	1	-8.42	-8.88	-5.86	n/a	n/a	n/a
2001	5 or fewer	648	648	–	1	1	7.14	6.60	5.28	n/a	n/a	n/a
2002	5 or fewer	888	888	–	1	1	11.63	11.08	-1.41	n/a	8.01	10.34
2003	5 or fewer	1,265	1,265	–	1	1	23.64	23.03	28.97	n/a	7.03	10.65
2004	5 or fewer	1,522	1,522	–	1	1	16.00	15.43	11.13	n/a	4.14	8.38
2005	5 or fewer	1,536	1,536	–	1	1	6.81	6.28	2.74	n/a	4.48	5.55
2006	5 or fewer	14	14	–	100	100	18.61	18.03	11.85	n/a	4.63	3.95
2007	5 or fewer	11	297	–	100	100	7.59	7.06	1.87	n/a	4.70	4.74
2008	5 or fewer	8	207	–	100	100	-17.70	-18.12	-26.16	n/a	10.14	13.41
2009	5 or fewer	10	270	–	100	100	44.33	43.63	58.21	n/a	11.57	16.93
2010	5 or fewer	11	295	–	100	0	16.94	16.36	15.12	n/a	11.72	17.03
2011	5 or fewer	27	310	–	0	0	4.44	4.06	4.98	n/a	7.23	11.09
2012	5 or fewer	40	334	–	0	0	14.63	14.00	15.81	n/a	5.40	7.08
2013	7	520	817	–	1	0	9.41	8.90	7.44	n/a	5.33	6.41
2014	8	593	797	–	1	0	3.14	2.68	2.45	0.7	4.01	4.50
2015	8	617	757	–	1	0	-1.02	-1.45	-4.47	0.7	4.26	5.26
2016	7	742	841	–	–	–	15.18	14.67	17.13	–	4.57	6.00
2017	5 or fewer	512	526	4,772	–	–	8.90	8.45	7.50	–	4.24	5.65
2018	5 or fewer	859	873	4,137	–	–	-1.02	-1.37	-2.08	–	3.76	4.59
2019	5 or fewer	1,124	1,199	3,895	–	–	13.02	12.58	14.32	–	3.74	4.02
2020	5 or fewer	1,338	1,407	6,706	–	–	9.00	8.55	7.11	–	12.23	9.24
2021	5 or fewer	1,301	1,421	6,168	–	–	12.12	11.67	5.28	–	12.08	9.00
Current Performance Results - PRELIMINARY												
2022	5 or fewer	717	898	3,616	–	–	-10.38	-10.76	-11.19	–	12.70	10.97

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.

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.

Calculation of Risk Measures: Annual / 3 Years 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.

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:

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 Definition

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.

Mesirow Financial Investment Management, Inc. and its affiliated companies and/or individuals may, from time to time, own, have long or short positions in, or options on, or be a market maker in, any securities discussed herein and may also perform financial advisory or investment banking services for those companies.