High Yield | Commentary

The high yield market ended 2023 with a bang as investors plunged headfirst into risk assets while eyeing Federal Reserve rate cuts in 2024. The Bloomberg US Corporate High Yield Index (Bloomberg) jumped 3.73% in December, closing the quarter up a whopping 7.16%. The Credit Suisse Leveraged Loan Index (CS Index), likewise, continued its almost uninterrupted 2023 rally, up an additional 1.61% in December and posting a 2.85% increase for the quarter. With 4Q now in the books, both indices finished the year up more than 13.00%.

As the quarter ended, Treasury rates fell significantly in December for the second month in a row. The 5-Year Treasury rate fell 45bps and the 10-Year rate fell 48bps. The Federal Funds target rate was left unchanged.

High yield credit spreads continued their tightening, ending the year at 323bps (Bloomberg, Option Adjusted Spread). The CS Index 3-Year discount margin also decreased to 528bps.

Default activity picked up in October and November but was light in December. For 2023, the par-weighted US high-yield default rate (including distressed exchanges) was 2.84%, which compares favorably to the long-term annual default of 3.40%, according to JP Morgan. The loan default rate (including distressed exchanges), however, was higher than its long-term average, finishing 2023 with par-weighted default rate at 3.15% versus a long-term average of 3.0%.

Bond market overview

For the fourth quarter, the Bloomberg Barclays HY Corporate Index increased +7.16%.

- **All major rating cohorts were positive, with lower quality somewhat surprisingly underperforming:** CCC-rated bonds were up +6.64%, B-rated bonds were up +7.07% and BB-rated bonds gained +7.35%.
- **All industry returns were positive, with financial services leading the way:** Brokerage/asset managers/exchanges was the best performing industry (+11.79%), banking was up +9.37% and finance companies were up +8.40%. Also among the top performers were retailers at +10.01%. Oil field services was the most significant laggard at +3.10%.
- **The largest bonds led returns:** Large issues ($1B+) were up 7.65%, while mid-size ($500M–1B) and small issues ($200–500M) were up +7.10% and +6.51%, respectively.

Loan market overview

The CS Index produced a +2.85% return in the fourth quarter.

- **B-rated loans outperformed in 4Q:** The B-rated cohort returned +3.00%, the BB cohort returned +2.65% and the CCC-rated cohort added +2.52%.
- **All industries were positive:** Forest products/containers was the best performing sector, gaining +3.48%, while consumer durables was the worst performing sector returning +2.12%.
- **Large loans bested smaller loans:** Large issue size loans ($1B+) returned +3.04%, compared to mid-size issues ($500-$1B) which returned +2.55% and small issue size loans (less than $500M) which returned +2.53%.

Performance review

The High Yield strategy turned in a total return of 4.87%, gross (4.76%, net) in the fourth quarter, trailing the benchmark's (Bloomberg) 7.16% return for the period. For 2023, the strategy outperformed with a 15.58% gross return (15.08% net) vs the benchmark's 13.44% return.

Source: Bloomberg, JPMorgan. | Mesirow High Yield ("MHY") is a division of Mesirow Financial Investment Management, Inc., ("MFIM") an SEC-registered investment advisor. | Past performance is not indicative of future results. | Please see the disclosures at the end for additional, important information. Any performance mentioned above is supplemental; please see the GIPS Report that is included for complete performance and benchmark descriptions.

The strategy's duration is roughly a year shorter than the benchmark, and while this was a benefit earlier in the year with rising Treasury rates, during the last two months it has been a major detractor to performance with rates now falling. Our shorter duration, was also responsible for about 40% of the strategy's performance lag in the quarter.

Our positioning in terms of issue size was also a detriment in the fourth quarter. Smaller bonds and loans underperformed, which meant our overweight allocation was ultimately a drag on performance. Similarly, our overweight of lower rated bonds and loans was also a detractor, as those rating cohorts modestly underperformed during the quarter.

Finally, in terms of industry, our overweight of energy and transportation (lagging sectors in 4Q) and underweight of communications (a top performing sector) had an adverse effect on relative performance.

As discussed in our prior commentaries, it is typical for our strategy to underperform while the high yield market is in "risk on" mode. In such instances, new money tends to be put to work quickly, and typically not in the credits we hold, as our names tend to be smaller and not large enough for ETFs to buy aggressively. Therefore, our strategy tends to lag during abrupt rallies, but often catches up in subsequent weeks and months as the market recalibrates relative value.

Outlook and positioning

A massive downward shift in Treasury rates began in November, seemingly triggered by statements made by the Treasury regarding its quarterly refunding process.

In the past, the Treasury Department issued T-Bills, notes and bonds in fixed percentages, placing an importance on the auctions being predictable. However, in a shift, the November release shared that the Treasury would deviate from past tradition and instead issue fewer long-term bonds and more short-term debt in future refundings. This statement sent a ripple through markets, with market practitioners interpreting the pivot as the Treasury Department believing that rates are now at their highs and set to fall in the future, making longer maturities issued today less attractive from the issuer's point of view.

We believe investors buying into the Treasury rally seem to have missed the forest for the trees — the percentage increase of short-term issuance was minimal, less than 2% of the total amount being refunded. The forest is the sheer amount of refunding taking place, which is a staggering $776B for 4Q2023 and $816B for 1Q2024. Roughly speaking, over the next decade, net issuance (a close proxy for annual deficits) will be about 5 times its level before the Covid-19 outbreak, and these increases in spending are permanent. Those bonds will have to be sold largely without the participation of China and Japan, two large traditional buyers, and without the Fed artificially depressing rates by purchasing trillions of dollars itself in the latest iteration of "easing." That is to say, bonds must find real buyers if the Fed is no longer printing money. For these reasons, we remain unconvinced of the legs of this recent rate rally and are instead inclined to believe intermediate and long (but not short) Treasury rates will rise in 2024.

As of the date of this writing, January 24, intermediate rates have abruptly reversed their late 2023 decline and are already up 24bp in 2024.

We believe high yield spreads may have rallied too quickly (given light supply and recent strong inflows), so we are cautious about further spread tightening in the market absent the economy really accelerating. If we are correct on the longer end of the yield curve, this could be more of a driver of high yield returns going forward than credit spreads. We continue to like our lower duration positioning and our mix of bonds (85%) and loans (15%).

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GIPS REPORT – HIGH YIELD COMPOSITE

Gross and Net of Fees Total Returns from March 1, 1999 – December 31, 2023

	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	–	0	0	15.18	14.67	17.13	n/a	4.57	6.00
2017	5 or fewer	512	526	4,772	0	0	8.90	8.45	7.50	n/a	4.24	5.65
2018	5 or fewer	859	873	4,137	0	0	-1.02	-1.37	-2.08	n/a	3.76	4.59
2019	5 or fewer	1,124	1,199	3,895	0	0	13.02	12.58	14.32	n/a	3.74	4.02
2020	5 or fewer	1,338	1,407	6,706	0	0	9.00	8.55	7.11	n/a	12.23	9.24
2021	5 or fewer	1,301	1,421	6,168	0	0	12.12	11.67	5.28	n/a	12.08	9.00
2022	5 or fewer	717	898	3,616	0	0	-10.38	-10.76	-11.19	n/a	12.70	10.97
Current Performance Results												
2023	5 or fewer	1,089	1,457	3,963	0	0	15.58	15.08	13.44	n/a	5.85	8.24

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 12.31.2022. 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 12.31.2022. The verification and performance examination reports are available upon request.

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

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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 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 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

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.

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