Mesirow

High Yield | Commentary

Market overview

Equity and fixed income markets finished the second quarter strong, as investors displayed continued optimism that the Federal Reserve will cut interest rates by year end. Slowing Core PCE, a weaking job market and declining personal spending each contributed to the market's sentiment.

The Bloomberg US Corporate High Yield Index was up +1.09% for the quarter, bested by the Credit Suisse Leveraged Loan Index which increased 1.86%.

Treasury rates were up over the quarter, with the 5-Year and 10-Year Treasuries up 16bps and 20bps respectively. The Federal Funds target rate was left unchanged.

The Bloomberg US Corporate High Yield Index option-adjusted spread widened, increasing 10bps over the quarter to 309bps. The Credit Suisse Leveraged Loan Index 3-Year discount margin, meanwhile, was relatively unchanged for the quarter, finishing at 507bps, down only 3bps.

A total of $15B in defaults and distressed exchanges occurred in the high yield bond and leveraged loan markets in 2Q2024 ($2.5B in bonds and $12.7B leveraged loans), a relatively modest quarter compared to recent history. (For context, $21.9B bonds and loans were impacted by defaults and distressed exchanges in 1Q2024, and $20.9B were impacted on average per quarter during 2023). As of June 30, 2024, the LTM par-weighted default rate for US high yield bonds and leveraged loans stood at 1.79% and 3.10%, respectively. As discussed in our previous publications, the 25-Year average high yield and leveraged loan default rates, by comparison are 3.4% and 3.0%, respectively. (JP Morgan)

High yield market overview

The Bloomberg US Corporate High Yield Index increased +1.09%.

- **CCC-rated bonds lagged:** BB-rated bonds returned +1.37%, B-rated bonds returned +1.18% and CCC-rated bonds returned -0.38%.
- **Industry performances were mostly positive:** Pharmaceuticals (+9.49%) was the best performing while Wirelines (-3.01%) was the worst.
- **Issue size performance was consistent:** Large issue sizes ($1B+) were up +1.09%, mid-size issues ($500M-$1B) were up +1.08% and small issue bonds ($200-$500M) were up +1.19%.

Loan market overview

The Credit Suisse Leveraged Loan Index returned +1.86%.

- **CCC-rated loans lagged:** BB-rated loans returned +1.84%, and B-rated loans returned +2.05%, while CCC-rated loans returned +0.72%.
- **All industries were positive:** Food and Drug was the best performing sector returning +2.65% for the quarter, while Media/Telecommunications was the worst performing returning +0.40%.
- **Small loans outperformed:** Small issue size loans (less than $500M) increased 2.30%, mid-size issues ($500M-$1B) increased +1.95% and large issue sizes ($1B+) returned +1.75%.

Source: Bloomberg, JP Morgan. | Mesirow High Yield Management ("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.

Performance review

The Mesirow High Yield strategy outperformed its benchmark in 2Q2024, overcoming the headwinds posed by the market's preference for higher quality bonds.

By rating, the majority of outperformance during the quarter was driven by strong security selection in B-rated holdings. Industry-wise, individual credits within the Communications and Consumer Cyclical sectors were responsible for most of the quarter's outperformance. Conversely, credits within the Capital Goods sector were a drag. Regarding issue size, almost all of the quarter's outperformance came from small issue size names.

Outlook and positioning

The high yield credit market has demonstrated remarkable resilience post-COVID, with credit spreads remaining range-bound at levels significantly below the historical average of 575bps. This trend has persisted through 2024, with the market accurately predicting (so far) the absence of a recession and with option-adjusted spreads remaining relatively tight at 309bps as of quarter-end.

Default rates, which were exceptionally low post-COVID, saw a modest increase in 2022 and 2023. However, they currently stand almost 50% below the long-term average and appear to be stabilizing or even declining. This trend is supported by favorable fundamentals in the high yield space:

- Leverage ratios are well below historical averages.
- Interest coverage ratios are significantly above historical norms.
- Corporate cash flow for high yield issuers, while flat over the past year, remains at elevated levels following three strong years post-COVID.

These metrics paint a notably more positive picture for high yield bonds compared to loans and investment-grade bonds, where financial metrics have deteriorated significantly.

Looking ahead, we believe that a soft landing has largely been achieved, and defaults are likely to remain low in the high yield market, even in the absence of Federal Reserve rate cuts. If a typical recession were to occur, we anticipate the market-wide default rate to remain below 5%, significantly lower than the 13% predicted by rating agencies during the COVID crisis (which only reached 6.7% in reality).

However, several factors warrant careful consideration:

- Persistently high federal deficits (four times pre-COVID levels) pose a long-term threat to economic stability.
- Increasing regulatory costs may have a cumulative and significant impact, potentially leading to stagflation rather than outright recession.
- Long and intermediate-term interest rates, in our view, will remain elevated, regardless of potential Fed actions to reduce short-term rates.

In terms of portfolio strategy, though risk is increasing in the loan market, loan credit spreads are slightly above the long-term average, making a case for the relative attractiveness of the asset class.

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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 and follow us on LinkedIn.

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GIPS REPORT – HIGH YIELD COMPOSITE

Gross and Net of Fees Total Returns from January 1, 2014 – June 30, 2024

	Year end						Annual performance results				3-year annualized dispersion	
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(2) (%)	Bloomberg US Corp. High Yield Index(2) (%)
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
2023	5 or fewer	1,089	1,457	3,963	0	0	15.65	15.15	13.44	n/a	5.86	8.24
Current Performance Results												
2024 YTD	5 or fewer	829	2,331	4.841	0	0	5.07	4.85	2.58	n/a	5.74	8.27

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 12.31.2023. 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 12.31.2023. The verification and performance examination reports are available upon request.

*Creation date is 03.01.1999. * Performance and Composite inception are 03.01.1999.*
Benchmark returns are not covered by the report of independent verifiers.
All returns are calculated and presented in US dollars.

Mesirow Financial Investment Management, Inc. ("MFIM") is an investment adviser registered with the Securities and Exchange Commission under the Investment Advisers Act of 1940.ßor purposes of claiming GIPS compliance, as of 01.01.2010, the firm is defined as Mesirow Financial Investment Management - Fixed Income divisions. The Mesirow Financial Investment Management - Fixed Income groups 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 Mesirow Financial Investment Management - Fixed Income groups was managed by MFIM or its predecessor firms prior to 01.01.2005. MFIM provides investment management services to separately managed accounts, limited partnerships, public mutual funds/Registered Investment Companies (RICs) and Collective Investment Trusts (CITs).

The Mesirow Financial Investment Management - Fixed Income business unit includes the Mesirow Financial Investment Management - Strategic Fixed Income (formerly Core Fixed Income) group and the Mesirow Financial Investment Management - High Yield Fixed Income group and manages portfolios primarily for institutional investors adhering to an investment process incorporating fundamental analysis of security valuation factors and drivers. The composites within this business unit vary primarily by duration and the type of originator of the security.

Effective 10.23.2017, MFIM Fixed Income completed the lift-out of the High Yield team from a former and unaffiliated registered Investment Advisor.

Effective 05.29.2020, MFIM Fixed Income completed the lift out of the Analytic Fixed Income Team from a former and unaffiliated registered Investment Advisor, Chicago Equity Partners (CEP) which its team, became an integral part of MFIM Fixed Institutional Fixed Income. On 05.29.2020, MFIM acquired the asset management rights for a portion of the managed portfolios from an independent investment advisory firm and retained all the principals and employees related to such portfolios. Effective 11.30.2022, the MFIM Fixed Income - Analytic Fixed Income business discontinued operations. Accounts either transferred to the Strategic Fixed Income business unit or terminated its relationship with Mesirow.

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.

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..

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

Performance information that is provided gross of fees does not reflect the deduction of 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 Form ADV Part 2 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. 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.
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.