Capital Income
2017 Commentary

Hotchkis & Wiley

December 31, 2017

INVESTMENT STRATEGY

The Hotchkis & Wiley Capital Income portfolio invests in both value equity securities and high yielding fixed income securities with an emphasis on income generation. The long-term allocation target between value equities and high yielding fixed income securities is 50/50. The portfolio has two benchmarks, the S&P 500 Index ("the equity benchmark") and the ICE BofA Merrill Lynch US Corporate, Government & Mortgage Index ("the fixed income benchmark"). These benchmarks are averaged, using the portfolio's long-term allocation targets, to produce a "50/50 blended benchmark" to help assess performance.

MARKET COMMENTARY

The ICE BofAML US High Yield Index posted a positive return in each calendar quarter of 2017, finishing the year up +7.5%. The index has posted positive performance in 8 consecutive quarters. The S&P 500 Index returned +21.8% in 2017, and for the first time in its 91-year history generated positive performance in every month of a calendar year.

Large cap equities outperformed small cap equities and growth outperformed value. The market was fueled by strong corporate earnings, a supportive economic environment, an accommodative central bank, and then received an additional boost with the passage of tax reform. Following the rally, the overall market's valuation appears above normal but not wildly so. The S&P 500 trades at 20x next year's consensus earnings and 3.2x book value, which is 0.8 and 0.6 standard deviations higher than historical averages, respectively[1]. Valuations are reasonable despite the market's 9 year rally because: 1) the market was significantly undervalued 9 years ago; 2) lower interest rates justify higher price multiples; 3) earnings growth has been resilient, and; 4) the market expects continued earnings growth in 2018.

The first three items above are relatively uncontroversial while the fourth is more uncertain. Tax reform should provide a permanent earnings benefit to the market as a whole but not all companies will benefit equally. The repatriation clause allows companies to bring cash held overseas back into the US at a more favorable rate than previously anticipated. This creates an opportunity for management teams to add value for shareholders via productive investments, share repurchases, etc. The reduction in the corporate tax rate from 35% to 21% should provide a broad near-term earnings boost but only companies with core competitive advantages, barriers to entry, and/or pricing power will retain this benefit permanently. Companies operating in highly competitive industries with low barriers to entry and commodity-like products or services are likely to see this benefit competed away until earnings eventually reflect cost-of-capital returns. Thus, when estimating a company's earnings post tax reform, it is important to look beyond its current and projected effective tax rates and assess management's skill at allocating capital effectively as well as the quality of the underlying franchise.

The high yield market finished the year with a yield-to-worst of 5.8%, which is 0.3% lower than it was at the beginning of the year; the market's spread over treasuries finished the year at 363 basis points, which represents a 59 basis point tightening over the course of the year (the interest rate on similar duration treasuries rose slightly). The treasury yield curve flattened over the year. The FOMC increased the Fed Funds target rate by 25 basis points three different times during 2017, moving the rate from 0.75% to 1.50% by year-end. This precipitated a comparable rise in short-term treasury rates but long-term rates actually fell slightly. We pay close attention to the yield curve because it has inverted prior to each of the past 7 recessions—while it has flattened, it remains upward sloping.

[1] 1990 through 2017

Including distressed exchanges, the par-weighted high yield bond default rate in 2017 was 1.45%. For perspective, the default rate in 2016 was 4.26%. The primary reason for the decline in defaults was the energy sector; the sector's default rate went from 15.6% in 2016 to 2.1% in 2017. Across the market, revenue, earnings, and cash flow have grown, financial leverage has declined, liquidity has improved, and the maturities are well-termed. Fortunately, these factors have led to low defaults; unfortunately, these factors have led to tight spreads.

We continue to believe that equity and credit markets can be driven by fads and temperament in the short run but fundamentals and valuation prevail in the long run. Accordingly, we commit to maintaining our unwavering dedication to the principals of long-term, fundamental value investing, and will invest in the part of the capital structure that provides the most attractive risk/return profile.

ATTRIBUTION AND MANAGEMENT DISCUSSION: 2017

The Hotchkis & Wiley Capital Income portfolio (gross and net of management fees) underperformed the 50/50 blended benchmark in 2017. The average equity weight was 56% and the average high yield bond weight was 44% over the course of the year. The equity overweight was a modest positive performance contributor because equities outperformed high yield bonds; the magnitude of this benefit was smaller than it should have been because the equity portion of the portfolio underperformed the equity benchmark. High yield bonds outperformed investment grade bonds, which also worked in the strategy's favor.

The equity portion of the portfolio underperformed the S&P 500 Index during the year. Growth stocks outperformed value stocks by more than 16 percentage points in the year, which is a major headwind for our value investment approach and the primary cause of the portfolio's equity underperformance. The overweight and stock selection in energy along with stock selection in technology and financials also detracted from performance. This was partially offset by positive stock selection in utilities and telecommunications, and the underweight position in consumer staples. The largest individual detractors to relative performance over the year were Energy XXI, AIG, Popular, Fifth Street Asset Management, and Cobalt International Energy; the largest contributors were Bowleven, WorleyParsons, NRG Energy, Vodafone, and Anthem.

The high yield bond portion of the portfolio outperformed the ICE BofAML US Corporate, Government & Mortgage Index during the year as high yield bonds outperformed investment grade bonds. The portfolio also outperformed the ICE BofAML US High Yield Index due to positive credit selection. Credit selection was positive or neutral in 14 of the 18 BofAML sectors, and was particularly positive in basic industry, energy, and media credits. This was partially offset by credit selection in retail and healthcare.

The ICE BofAML Indices were known as the BofA Merrill Lynch Indices prior to October 23, 2017.

Composite performance is available at www.hwcm.com, located on the strategy's Performance tab. Returns discussed can differ from actual portfolio returns due to intraday trades, cash flows, corporate actions, accrued/miscellaneous income, and trade price and closing price difference of any given security. Portfolio attribution is based on a representative Capital Income portfolio. Certain client portfolio(s) may or may not hold the securities discussed due to each account's guideline restrictions, cash flow, tax and other relevant considerations. Fixed Income performance attribution is an analysis of the portfolio's return relative to the ICE BofAML US High Yield Index and is calculated using trade information, does not reflect cash flow transactions and the payment of transaction costs, fees and expenses. Equity performance attribution is an analysis of the portfolio's return relative to a selected benchmark, is calculated using daily holding information and does not reflect management fees and other transaction costs and expenses. Specific securities identified are the largest contributors (or detractors) to the portfolio's performance relative to the S&P 500 Index. Other securities may have been the best and worst performers on an absolute basis. Securities identified do not represent all of *the securities purchased or sold for advisory clients, and are not indicative of current or future holdings or trading activity. H&W has no obligation to disclose purchases or sales of the securities. No assurance is made that any securities identified, or all investment decisions by H&W were or will be profitable. Quarterly characteristics and portfolio holdings are available at www.hwcm.com, located on the strategy's Characteristics and Literature tabs. For a list showing every holding's contribution to the overall account's performance and portfolio activity for a given time period, please contact H&W at hotchkisandwiley@hwcm.com. Portfolio information is subject to the firm's portfolio holdings disclosure policy.*

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