Global Value
2017 Commentary

Hotchkis & Wiley

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MARKET COMMENTARY

The Russell Developed Index returned +23.0% in 2017 (US dollar terms), generating a positive return in each calendar quarter. The US dollar weakened relative to other major currencies, declining -14% vs. the Euro, -9% vs. the Pound, and -4% vs. the Yen. Globally, growth stocks outperformed value stocks by a wide range. In the US, large caps outperformed small caps; outside the US, small caps led the way. Global equity market performance was driven by strong corporate earnings, an improving economic environment, and accommodative central banks; US equities received an additional boost from the passage of US tax reform. Following the rally, the overall market's valuation appears above normal but not wildly so, considering continued low interest rates and the healthy outlook for earnings growth.

Perhaps the most significant development for global equities in 2017 was US tax reform. 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. Meanwhile, 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.

We are optimistic as we look forward to 2018 and beyond. The portfolio trades at a large valuation discount to the market. We have been able to identify interesting valuation opportunities on a selective basis, particularly in banks, industrial machinery, oil & gas, and insurance—the portfolio's largest industry exposures. Further, the businesses in our portfolio are expected to continue to grow their value per-share. We believe that we own businesses with good balance sheets, led by strong managers that are well-positioned in their end-markets. While some of our companies may be contending with temporary difficulties—the reason they are undervalued—we have identified the paths to improved profitability and we are confident that we have the time to get there.

The portfolio trades at 8.2x normal earnings and 1.1x book value, a notable discount to the Russell Developed Index at 17.1x and 2.3x, respectively. We continue to believe that 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.

ATTRIBUTION: 2017

The Hotchkis & Wiley Global Value portfolio (gross and net of management fees) underperformed the Russell Developed Index in 2017. The portfolio's value approach detracted from performance as growth stocks outperformed value stocks across the globe. Stock selection in technology was the largest detractor relative to the index—the portfolio's positions performed well but lagged the strong performance of several mega cap growth companies that are large index constituents. Stock selection in consumer discretionary and consumer staples also detracted from performance.

Positive stock selection in utilities and telecommunications helped relative performance. The largest individual detractors to relative performance in the year were AIG, Ophir Energy, ARRIS International, Cobalt International Energy, and Popular; the largest contributors were WorleyParsons, Anthem, CNH Industrial, Calpine, and WestJet.

LARGEST NEW PURCHASES: 2017

WestJet is a cost-advantaged Canadian airline in a duopoly market. WestJet stock sells at a modest premium to replacement cost even though the company possesses a strong franchise, with opportunity to invest at high returns. The company also has an investment grade balance sheet. WestJet's valuation is attractive on current earnings, which are below normal due to a cyclically weak Alberta economy.

Seritage Growth Properties is a mall REIT with 230 wholly owned and 23 JV mall anchor properties across the United States. After being spun off from Sears Holdings in 2015, Seritage is focused on redeveloping and re-leasing mall properties to new tenants, or redeveloping them to alternative uses. The company receives high returns on capital for these projects; the current valuation, perhaps impacted by the threat of a potential Sears bankruptcy, does not reflect these attractive reinvestment economics.

Masonite is a manufacturer of doors with significant market share in both the interior and exterior door markets. During the great recession, Masonite consolidated its competitors at distressed multiples, eventually creating a duopolistic industry environment. The company has experienced manufacturing challenges as it grows through the cycle, but they have been transitory. As housing starts continue to rebound, Masonite can earn high incremental margins and grow earnings rapidly.

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 Global Value 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. 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 Russell Developed Index. Other securities may have been the best and worst performers on an absolute basis. The "Largest New Purchases" section includes the three largest new security positions during the year based on the security's year-end weight adjusted for its relative return contribution; does not include any security received as a result of a corporate action; if fewer than three new security positions at year-end, all new security positions are included. 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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