

Large Cap Fundamental Value 2017 Commentary



December 31, 2017

MARKET COMMENTARY

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 caps outperformed small caps 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, respectively¹. 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.

Several attributes of the portfolio provide reason for optimism as we look to 2018 and beyond. First, despite the market trading at a valuation premium to history, the portfolio's valuation is about in-line with its historical averages; i.e., its discount to the market is wide. We have been able to identify interesting valuation opportunities on a selective basis, particularly in banks, oil & gas, software, and insurance—the portfolio's largest industry exposures. Second, we are reassured by the quality of the businesses across the portfolio. While some holdings may be contending with temporary difficulties—the reason they are undervalued—most are well-capitalized companies with long-term competitive advantages that should translate into improved returns on capital in the future. Third, the correlation among stocks across the market has moved from high (a macro-driven market) to low (a stock-driven market); the latter is a much more conducive environment for a fundamental, bottom-up value investor.

The portfolio trades at 10.2x normal earnings and 1.6x book value, a notable discount to the Russell 1000 Value Index (15.7x and 2.1x, respectively) and an even larger discount to the S&P 500 Index (18.6x and 3.2x, 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.

¹1990 through 2017

ATTRIBUTION: 2017

The Hotchkis & Wiley Large Cap Fundamental Value portfolio (gross and net of management fees) outperformed the Russell 1000 Value Index in 2017; it outperformed the benchmark in each of the four calendar quarters. Positive stock selection contributed to the outperformance, and was particularly favorable in consumer staples, industrials, utilities, and telecommunications. Stock selection in consumer discretionary, financials, and materials were modest detractors. The largest individual contributors to relative performance were Anthem, Microsoft, Boeing, CNH Industrial, and Calpine; the largest detractors were AIG, Discovery Communications, Hess, Bed Bath & Beyond, and Apache.

LARGEST NEW PURCHASES: 2017

Apache Corporation is a global oil & gas exploration and production company. The company is among the largest acreage holders in the Permian, a large oil and natural gas basin in West Texas. The company has recently-discovered assets that could provide years of organic production growth. The company has a strong balance sheet and asset base. We expect the Permian assets to drive corporate returns higher in a normal oil price environment.

Discover Financial Services is a diversified financial services provider primarily focused on credit cards. The company was spun-off from Morgan Stanley in 2007. The share price has been impacted by concerns about the low charge-off environment reverting higher, especially given the recent up-tick in net charge offs across the industry. Even after adjusting for a mid-cycle credit environment, however, the valuation remains attractive. Discover also has significant excess capital that could translate into sizeable share buybacks over the next few years.

PepsiCo, Inc. is a leading snack and beverage company with operations in more than 100 countries, including a strong market position in emerging markets. It has a portfolio of excellent brands and scale advantages, which enable the company to earn attractive returns on invested capital. The company trades at an attractive valuation considering the quality of its business, its growth prospects, and its shareholder-friendly capital allocation.

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 Large Cap Fundamental 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 1000 Value 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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