Mid-Cap Value
2017 Commentary

Hotchkis & Wiley

December 31, 2017

MARKET COMMENTARY

In 2017, the Russell Midcap Index returned +18.5% and the Russell Midcap Value Index returned +13.3%. Large caps outperformed small caps and mid caps fell in between the two; growth outperformed value across the market cap spectrum. 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. 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 at a small discount to its historical average; i.e., its discount to the market is wide. We have been able to identify interesting valuation opportunities on a selective basis, particularly in energy, financials, and tech—the portfolio's largest sector 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 7.8x normal earnings and 1.1x book value, a notable discount to the Russell Midcap Value Index (16.6x and 2.0x, respectively) and an even larger discount to the Russell Midcap Index (19.3x and 2.7x, 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 Mid-Cap Value portfolio (gross and net of management fees) underperformed the Russell Midcap Value Index in 2017. Energy was the biggest detractor by a large magnitude. We are surprised that energy stocks were so weak during the year considering stock valuations were/are low, oil inventories have fallen, and oil prices rose. We believe stock prices will better reflect fundamentals in due course, and have maintained a considerable weight in the sector accordingly. Stock selection in consumer discretionary and technology were more modest detractors. Positive stock selection in utilities, industrials, and REITs contributed to performance during the year. The overweight position in tech and underweight position in REITs also helped performance. The largest individual detractors to relative performance were Whiting Petroleum, Bed Bath & Beyond, Popular, Ophir Energy, and ARRIS International; the largest contributors were NRG Energy, Tri Pointe Group, Calpine, Navistar, and Corning.

LARGEST NEW PURCHASES: 2017

Mallinckrodt is a specialty pharmaceutical company that was spun out of Covidien in 2013. The valuation is compelling because investors are concerned about continued pricing power of a key product as well as pricing pressure on generics. While these concerns are not without merit, it is more than reflected in the stock's valuation.

Weatherford is the fourth largest diversified oilfield services company. It competes across most major service lines and has significant opportunities to improve economic earnings power. Recent management changes and shift in strategic priorities combined with expected normalization in energy prices and services activity should increase both earnings and cash flow. The stock is trading at an attractive normal valuation.

C&J Energy Services is a diversified oilfield services company focused on North America. It has a midsize pressure pumping fleet as well as the largest fleet of high spec workover rigs in North America. Other key service lines include wireline, fluid services, coiled tubing and cementing. The company exited Chapter 11 with a debt free capital structure in early 2017. North American service capacity is likely to tighten as activity returns to North American shale basins. This coming tightness presents an opportunity for pressure pumpers such as CJ. Increased onshore activity should drive earnings and cash flow higher even in a moderate oil price environment. The stock is trading at an attractive normal valuation.

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 Mid-Cap 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 Midcap 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.

The commentary is for information purposes only and should not be considered as investment advice or a recommendation of any particular security, strategy or investment product. Portfolio managers' opinions and data included in this commentary are as of December 31, 2017 and are subject to change without notice. Any forecasts made cannot be guaranteed. Information obtained from independent sources is considered reliable, but H&W cannot guarantee its accuracy or completeness. Certain information presented is based on proprietary or third-party estimates, which are subject to change and cannot be guaranteed. Equity securities may have greater risks and price volatility than U.S.

Treasuries and bonds, where the price of these securities may decline due to various company, industry and market factors. Investing in value stocks presents the risk that value stocks may fall out of favor with investors and underperform growth stocks during a given period. All investments contain risk and may lose value. Investing in small and medium-sized companies involves greater risks than those associated with investing in large company stocks, such as business risk, significant stock price fluctuations and illiquidity. Past performance is no guarantee of future results.