Small Cap Diversified Value 2017 Commentary

Hotchkis & Wiley

December 31, 2017

MARKET COMMENTARY

In 2017, the Russell 2000 Index returned +14.6% and the Russell 2000 Value Index returned +7.8%. Large caps outperformed small caps and 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. This benefit is less prominent for small caps than for large caps but the reduction in the corporate tax rate should benefit small caps disproportionately—average effective tax rates for small caps are higher than large caps. Lowering 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, the portfolio trades at a wide valuation discount compared to the market. We have been able to identify interesting valuation opportunities on a selective basis, particularly in financials, industrials, and energy—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 11.5x normal earnings and 1.4x book value, a notable discount to the Russell 2000 Value Index (15.9x and 1.5x, respectively) and an even larger discount to the Russell 2000 Index (18.9x and 2.2x, 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.

ATTRIBUTION: 2017

The Hotchkis & Wiley Small Cap Diversified Value portfolio (gross and net of management fees) outperformed the Russell 2000 Value Index in 2017. Stock selection was positive in all but one sector (telecom detracted about -0.1%), which drove the outperformance in the year. The overweight and stock selection in industrials were particularly helpful, along with positive stock selection in real estate. The overweight position in energy and underweight position in healthcare were modest performance detractors.

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 Small Cap Diversified 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 (Russell 2000 Value Index), is calculated using daily holding information and does not reflect management fees and other transaction costs and expenses. 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. 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 smaller and/or newer companies involves greater risks than those associated with investing in larger companies, such as business risk, significant stock price fluctuations and illiquidity. Past performance is no guarantee of future results.