Capital Income
3Q 2017 Commentary

Hotchkis & Wiley

September 30, 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 BofAML 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 returned +2.0% in the third quarter of 2017 and is now up +7.0% year-to-date. This marks the 7th consecutive positive quarter for the high yield market. The S&P 500 Index returned +4.5% in the three months ended September 30, its 8th consecutive positive quarter. Dating back to 2013, the index has generated a positive return in 18 of the last 19 calendar quarters—a feat it had not previously accomplished in its 90+ year history. Part of the reason for this impressive run was the market's valuation at the outset of the period. At the beginning of 2013, the S&P 500 Index traded at 12x consensus earnings and 2x book value; the financial crisis' mess had been largely cleaned up but valuations remained in check. Since then, corporate earnings have been strong and the economic environment supportive. Accordingly, we categorize most of the performance over this period as a reversion toward normal market valuations as opposed to a market that has overheated dramatically. Based on most valuation measures, the reversion appears to have overshot historical averages but not wildly so—we are not alarmed, we are guarded.

Growth stocks have outperformed value stocks by 23 percentage points over the above-mentioned period, including a 13 percentage point advantage year-to-date. The FAANG stocks[1] have led the market, with an average return of +160% since the beginning of 2013, and now represent more than 10% of the S&P 500 Index. This has led to a wide valuation discrepancy between the value and growth indexes: the Russell 1000 Value Index trades at 17x forward earnings and 2x book value compared to the Russell 1000 Growth Index at 23x and 7x, respectively. While select market segments appear richly valued, others remain quite attractive.

The high yield market's yield-to-worst fell and spreads tightened by about 20 basis points each and now stand at 5.5% and 355 basis points, respectively. The tightening was consistent across ratings during the quarter, and small cap credits tightened slightly more than large cap credits. Treasury yields were largely unchanged. The energy sector, which was the largest laggard in the previous quarter, was the top-performing high yield sector by a considerable margin. WTI crude prices rose by 12% over the quarter.

Excess spreads, or spreads adjusted for unrecovered defaults, are below long term averages but only slightly so. This is due to low defaults as opposed to wide spreads, of course. Across the entire high yield market, there was only one default in July, no defaults in August, and one default in September. This was the first time in more than 5 years when one or fewer defaults occurred in three consecutive months. The high yield market's default rate declined to 1.3%, well below long-term averages, and less than 1% of the market is priced as distressed. Energy sector defaults had been elevated until recently, but most of the sector's cleansing appears to be in the rear view mirror. Commodity spreads have tightened accordingly, and are now only about 50 basis points wider than the overall market.

[1] Facebook, Apple, Amazon, Netflix, and Google

We have found numerous equity opportunities in financials, industrials, and technology; high yield bond opportunities in basic industry and healthcare; and both equity and high yield bond opportunities in energy. These opportunities are represented by large, medium, and small-sized companies. A primary advantage of this strategy is that it can invest across the capital structure in companies of any size. Because the opportunity set is so vast, we are able to find attractive opportunities even when the overall market appears a bit frothy, as it does today.

ATTRIBUTION AND MANAGEMENT DISCUSSION: 3Q 2017

The Hotchkis & Wiley Capital Income portfolio (gross and net of management fees) underperformed the 50/50 blended benchmark in the third quarter of 2017. The average equity weight was 56% and the average high yield bond weight was 44% during the quarter. The overweight to equities helped as equities outperformed high yield bonds. High yield bonds also outperformed investment grade bonds which benefited performance.

The equity portion of the portfolio underperformed the S&P 500 Index during the quarter. The portfolio’s value focus was a headwind as growth outperformed value over the quarter. Stock selection in technology, financials, and energy detracted from performance. This was partially offset by positive stock selection in consumer staples, utilities, and real estate. The largest individual equity detractors relative to the index were Energy XXI Gulf Coast, Popular, Ericsson, Discovery Communications, and Fifth Street Asset Management; the largest positive contributors were Hewlett Packard Enterprise, WestJet Airlines, Kosmos Energy, Masonite International, and WorleyParsons.

The high yield bond portion of the portfolio outperformed the ICE BofAML US Corporate, Government & Mortgage Index as high yield bonds outpaced investment grade bonds. It also outperformed the high yield index by a small magnitude. Relative to the ICE BofAML US High Yield Index, the portfolio benefited from a large overweight in energy, which was the top-performing high yield sector during the quarter. Positive credit selection in media also helped. On the negative side, credit selection in basic industry, retail, and telecommunications detracted from performance.

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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