Global Value
3Q 2017 Commentary

Hotchkis & Wiley

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MARKET COMMENTARY

In US Dollar terms, the Russell Developed Index returned +5.1% in the three months ended September 30th, its 6th consecutive positive quarter. In local currency, the index was up slightly less as both the Euro and the Pound appreciated relative to the Dollar by about 3%. Dating back to mid-2012, the index has generated a positive return in 18 of the past 21 calendar quarters, reflecting an attractive starting point (in mid-2012, the Russell Developed Index traded at 12x consensus earnings and 1.5x book value), a period of reasonably healthy corporate earnings growth, and what has generally been a supportive global economic environment. Accordingly, we consider much of the performance over this period to represent a justified reversion towards more normal market valuations as opposed to the speculative gains of a market that has overheated dramatically. With most valuation measures above long-term historical averages, the rally may have overshot but not wildly so—we are not alarmed, we are guarded.

Growth stocks have outperformed value stocks over the above-mentioned period, particularly within the United States. The FAANG stocks[1] have led the market, with an average return of +160% since the beginning of 2013, and now represent 4 of the 5 largest stocks in the Russell Developed Index. This has led to a wide valuation discrepancy between the value and growth indexes, and, as we discuss below, between sectors.

We continue to find value opportunities selectively, though it is more difficult today than it was 5 years ago. An important benefit of a global strategy is that the opportunity set to select from is broad. Consequently, we are able to find attractive investments even when the broader global equity market appears to be fully valued, as it does today. Financials, industrials, and technology represent the portfolio's largest weights; consumer staples, materials, and healthcare represent the largest underweights. The former sectors not only trade at considerable valuation discounts but also have higher earnings growth expectations over the next two years compared to the latter sectors. We are always leery of paying high multiples for stocks, particularly when growth prospects are bleak.

While select market segments appear richly valued, others remain quite attractive. Given this dichotomy, our portfolio's composition and its characteristics are vastly different from the index. The valuation discount is particularly striking; the portfolio trades at 8x normal earnings compared to 17x for the Russell Developed Index. The portfolio trades at 1.2x book value compared to 2.2x for the index.

ATTRIBUTION: 3Q 2017

The Hotchkis & Wiley Global Value portfolio (gross and net of management fees) outperformed the Russell Developed Index in the third quarter. The underweight allocation to consumer staples, real estate, and utilities helped relative performance; also, the few positions we have in these sectors outperformed. Positive stock selection in industrials was also a meaningful positive contributor to relative performance. Stock selection in technology, financials, and consumer discretionary detracted from performance in the quarter. The largest individual positive contributors to relative performance were Navistar, Hewlett Packard Enterprise, WestJet Airlines, Kosmos Energy, and Masonite International; the largest individual detractors were Ericsson, Popular, Ophir Energy, Royal Mail, and AIG.

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

PORTFOLIO ACTIVITY: 3Q 2017

The Global Value portfolio added three new positions during the quarter:

National Oilwell Varco (NOV) is a provider of oilfield equipment, drilling consumables and related services. The company produces a diverse portfolio of products that help customers drill, complete and produce from onshore and offshore oil and gas wells. We believe that the company has strong market positions in many of the lines of business in which it competes thanks to scale, technology, and brand. NOV has a good balance sheet and trades at an attractive multiple of normalized earnings. Current earnings are depressed due to the reduction in capital spending that has accompanied the decline in the oil price. We think that market participants are under-estimating the potential for near-term recovery in earnings from those businesses exposed to onshore drilling activity, and assigning little value to the later-cycle rig equipment business.

Masonite (DOOR) is a manufacturer of interior and exterior doors for the residential and non-residential building construction markets, primarily in the United States and Canada. During the US housing recession, Masonite and its primary competitor actively acquired distressed peers, resulting in a more attractive market structure. As volumes have increased with housing starts, the company has benefited from both pricing power and production economies of scale. This has driven meaningful margin expansion and we expect these trends to continue. As the company's cash generation has recovered, they have begun to repurchase stock; the share count has declined by nearly 4% over the past twelve months (as of June 30, 2017). The company's shares sold off sharply in the aftermath of a modestly disappointing Q2'17 earnings report; we took advantage of this volatility to establish a new position.

Johnson Controls (JCI) is a diversified industrial company. The Company is a leading provider of security products and services, lead acid batteries, and products and services related to building and energy management such as HVAC. These businesses have leading market positions protected by durable advantages. We believe that the market is underestimating both the potential for profitable growth from these businesses, as well the tax and operational synergies that may emerge from the Company's 2016 merger with Tyco International.

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 Portfolio Activity section includes the three largest new positions in the period excluding any security received as a result of a corporate action; if fewer than three new positions were purchased, all new purchases 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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