Large Cap Diversified Value 3Q 2017 Commentary

Hotchkis & Wiley

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MARKET COMMENTARY

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.

We continue to find value opportunities selectively, though it is more difficult today than it was 5 years ago. Financials, technology, and energy represent the portfolio's largest weights; REITs, consumer staples, and utilities 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 10x normal earnings compared to 15x and 18x for the Russell 1000 Value and S&P 500, respectively. The portfolio trades at 1.5x book value compared to 2.0x and 3.1x for the two indexes.

ATTRIBUTION: 3Q 2017

The Hotchkis & Wiley Large Cap Diversified Value portfolio (gross and net of management fees) outperformed the Russell 1000 Value Index in the third quarter—overall stock selection was positive. Stock selection in industrials was particularly strong, as the portfolio's holdings returned +8% compared to +1% for the Russell 1000 Value. The underweight in consumer staples, the index's worst-performing sector, helped relative performance; the overweight to technology also helped. Stock selection in consumer discretionary, telecom, and materials detracted from performance. The largest individual contributors to relative performance were Hewlett Packard Enterprise, Marathon Oil, Philips, Rockwell Collins, and Boeing; the largest detractors were Ericsson, Discovery Communications, AIG, Bed Bath & Beyond, and Oracle.

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

PORTFOLIO ACTIVITY: 3Q 2017

We increased the weight in energy by adding a new position in National Oilwell and increasing the position in Apache. National Oilwell is a leading provider of oilfield capital equipment, consumables, and services. Its rig systems business has been under pressure as spending on new rigs has declined amid the decline in oil prices. While it may take time for this business to revert, its aftermarket, wellbore technology, and completion & production business segments appear to be overlooked in the marketplace. We decreased the weight in utilities, primarily by trimming Calpine, which is in the process of being acquired. S&P GICS reclassified Philips from industrials to healthcare during the quarter because the majority of its business is in medical systems/diagnostics and it is in the process of divesting its lighting business. Much of the portfolio's increase in the healthcare sector and decrease in the industrials sector was a result of this reclassification and not from trading.

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 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, 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. 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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