Mid-Cap Value
3Q 2017 Commentary

Hotchkis & Wiley

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MARKET COMMENTARY

The Russell Midcap Index returned +3.5% in the third quarter; the equivalent growth and value indices returned +5.3% and +2.1%, respectively. The S&P 500 Index returned +4.5%, 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 Russell Midcap Index traded at 13x 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.

Thus far in 2017, mid cap growth stocks have outperformed mid cap value stocks by nearly 10 percentage points. This has led to a wide valuation discrepancy between the value and growth indexes: the Russell Midcap Value Index trades at 19x forward earnings and 2x book value compared to the Russell Midcap Growth Index at 24x and 6x, respectively. We continue to find value opportunities selectively, though it is more difficult today than it was 5 years ago. Energy, financials, and consumer discretionary represent the portfolio's largest weights; REITs 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 7x normal earnings compared to 16x for the Russell Midcap Value. The portfolio trades at 1.1x book value compared to 1.9x for the index.

ATTRIBUTION: 3Q 2017

The Hotchkis & Wiley Mid-Cap Value portfolio (gross and net of management fees) outperformed the Russell Midcap Value Index in the third quarter. Overall stock selection was positive, with utilities and industrials leading the way. The overweight in energy and underweight in both healthcare and real estate also helped. On the negative side, stock selection in real estate, consumer discretionary, and healthcare were the largest detractors. The largest individual contributors to relative performance were Navistar, NRG Energy, Kosmos Energy, Hewlett Packard Enterprise, and Calpine; the largest detractors were Popular, Ericsson, Bed Bath & Beyond, Office Depot, and Ophir Energy.

PORTFOLIO ACTIVITY: 3Q 2017

We increased the weight in energy modestly by adding to the positions in Whiting Petroleum and C&J Energy Services, both among the most attractively-valued stocks in the portfolio. We also increased the technology weight by adding to Hewlett Packard Enterprise, which became the portfolio's largest position by quarter-end. After adjusting for the recent spinoff of its software business and the net cash on its balance sheet, the remaining enterprise trades at an attractive multiple of its operating income. We reduced the weight in utilities by trimming the position in Calpine, which is in the process of being acquired.

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. 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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