

Small Cap Diversified Value 3Q 2017 Commentary



September 30, 2017

MARKET COMMENTARY

The Russell 2000 Index returned +5.7% in the third quarter; the Russell 2000 Growth and Value Indexes returned +6.2% and +5.1%, respectively. The S&P 500 Index returned +4.5%, its 8th consecutive positive quarter. Dating back to 2013, this 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, for example, the Russell 2000 Value Index traded at 1.3x 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, small cap growth stocks have outperformed small cap value stocks by nearly more than 11 percentage points. Much of this performance difference is attributable to the growth index's large overweight in healthcare and technology and underweight in financials and energy. The more expensive sectors outperformed the less expensive sectors this year which has led to a wide valuation discrepancy between the value and growth indexes. We continue to find value opportunities selectively, though it is more difficult today than it was 5 years ago. Financials, consumer discretionary, and industrials represent the portfolio's largest weights; we have limited exposure to telecom, REITs, utilities, and consumer staples. 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 minimal.

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 12x normal earnings compared to 16x for the Russell 2000 Value.

ATTRIBUTION: 3Q 2017

The Hotchkis & Wiley Small Cap Diversified Value portfolio (gross and net of management fees) outperformed the Russell 2000 Value Index in the third quarter. Positive stock selection in 9 of the 11 GICS sectors drove the outperformance. Stock selection was particularly strong in financials, industrials, and materials. The underweight and stock selection in healthcare detracted from performance during the quarter.

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.

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