Value Opportunities
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 has been 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 industrials represent the portfolio's largest weights; healthcare, 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 8x normal earnings compared to 18x for S&P 500. The portfolio trades at 1.2x book value compared to 3.1x for the index.

ATTRIBUTION: 3Q 2017

The Hotchkis & Wiley Value Opportunities portfolio (gross and net of management fees) underperformed the S&P 500 Index in the third quarter. The strategy's value focus hurt relative performance as growth stocks outperformed value stocks. Security selection in healthcare, technology, and consumer discretionary detracted from performance in the quarter. Positive security selection in consumer staples, industrials, and real estate helped relative returns. The largest individual detractors to relative performance were Ericsson, Energy XXI Gulf Coast, Discovery Communications, Bed Bath & Beyond, and Popular; the largest contributors were Hewlett Packard Enterprise, WestJet Airlines, Masonite International, Seritage Growth Properties, and Frank's International.

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

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 Value Opportunities 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 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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