Global Value
1Q 2017 Commentary

Hotchkis & Wiley

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MARKET COMMENTARY

The Russell Developed Index increased +6.3% in the first quarter of 2017, continuing a nearly unbroken string of quarterly gains since mid-2012. The rise in equity prices across the globe has triggered debate about current valuations. Our view is that the broad global equity market is fully valued. Often overlooked, however, is that bargains can still be found in some market segments. For example, we continue to observe a large valuation discrepancy between cyclical industries and those businesses more likely to be viewed as bond surrogates. Today's popular stocks are those that have relatively stable earnings and high dividend payouts, like REITs, consumer staples, and regulated utilities. While the underlying businesses are stable, these are mature industries; paying 20-25x earnings for these slow-growing businesses is a risky proposition in our view. Investing in passive ETFs that track common equity indices is the other preferred strategy of the day, resulting in yet more investor capital chasing overvalued stocks. Meanwhile, some out-of-favor market segments trade for half the valuation levels of the more favored areas of the market, and in select circumstances, even trade at a discount to the replacement cost of the business.

As an example, we own several banks and insurers that trade at discounts to tangible book value; in each of these cases it would cost more to replicate the asset base than to simply buy the company. These companies provide essential services to the economies in which they operate (in other words, face low obsolescence risk) and have capital ratios/liquidity metrics at the highest levels in many decades. Regulatory uncertainty both inside the US and abroad is an ever-present risk, but this also acts as a barrier to entry as leading franchises are difficult and costly to displace—an often overlooked benefit. The industrials sector also offers attractive valuation opportunities. We own a mix of attractively-valued companies that trade at bargain prices relative to their earnings power; in most cases the stocks have been shunned or overlooked simply because the underlying businesses are cyclical and short-term results somewhat less predictable. Finally, we have found that parts of the technology sector are attractively priced today. We own a mix of global software, hardware, and equipment companies with businesses that we view as more predictable than most technology companies. These businesses have relatively sticky customers, strong balance sheets, and are prudent stewards of their shareholders' capital.

Because we have identified these – and other - attractive pockets of opportunity within a fully valued market, the Hotchkis & Wiley Global Value portfolio trades at a large discount to the market. The portfolio trades at 1.1x book value and 7.7x normal earnings compared to 2.2x and 16.1x, respectively, for the Russell Developed Index.

ATTRIBUTION: 1Q 2017

The Hotchkis & Wiley Global Value portfolio (gross and net of management fees) underperformed the Russell Developed Index in the first quarter of 2017. Relative to the benchmark, the portfolio was negatively impacted by stock selection in Consumer Staples and Technology as well as the portfolio's overweight position in Energy. These negatives were offset in part the positive selection in Telecom and Healthcare. Currency was a modest detractor as the portfolio is underweight the Japanese Yen, which appreciated by about 5% relative to the US Dollar. The largest individual detractors to relative performance were AIG, ARRIS, Royal Mail, Cobalt, and Ophir Energy while the largest contributors were NRG, WorleyParsons, Ericsson, Oracle, and Corning.

PORTFOLIO ACTIVITY: 1Q 2017

We added two new positions in the quarter – WestJet Airlines Ltd. and Seritage Growth Properties. WestJet is a low-cost Canadian airline with a history of earning returns above its cost-of-capital. The company is modestly under-earning today due to economic softness in its home Alberta market. Seritage manages a portfolio of real estate properties in the United States. The enterprise trades at discount to the replacement value of its real estate; we expect many of the company's under-performing properties to be profitably re-developed in the years ahead.

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. 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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