Manager Review & Economic Outlook

MARKET COMMENTARY

After falling -12.8% in 4Q 2018, the MSCI World ex-USA Index returned +10.4% in the first quarter of 2019. The swift decline and equally rapid recovery appear to have both been triggered by changes in investor sentiment as opposed to changes in underlying economic or business fundamentals. Investor concerns emerged late in 2018 regarding trade tensions and hawkish central bank action/language; this combination created fears of impending global economic recession. These concerns appeared to fade somewhat during the first quarter of 2019 due to positive progress on global trade talks and dovish central bank commentary that moved interest rates lower. All MSCI World ex-USA sectors were positive in the first quarter, with the best returning +16% (technology) and the worst returning +5% (communication services). The MSCI World ex-USA Index's forward P/E ratio increased from 12.7x at the end of 2018 to 13.7x at the end of the first quarter, slightly lower than the index's median valuation over the past ~15 years. While the valuation is now close to average, it is considerably lower than the 16x level where it began 2018.

We view the international equity market as fairly valued, but believe that there is a large valuation disparity between certain segments of the market. Banks in our opinion remain a particularly attractive value. European banks trade at valuation levels not observed since the global financial crisis. Considering that these banks' balance sheets are as strong as they have been in decades, and the majority of earnings are being returned to shareholders via dividends and share repurchases, we view banks' risk/reward tradeoff as especially compelling. The portfolio's banks trade at 7.4x consensus earnings and 5.4x normal earnings with a payout yield of 5% (dividends + share repurchases as a percentage of total equity). Less attractive to us at current prices are utilities. International utilities trade at high multiples, more than double that of banks in many cases, despite modest prospects for growth and high levels of debt. Utilities can support higher debt levels than most other businesses, but paying high multiples for slow growing businesses with increased leverage is not an attractive proposition in our view. Reflecting these considerable valuation dispersion across sectors, the portfolio exhibits large sector deviations from the benchmark.

The MSCI World ex-USA Growth Index outperformed the MSCI World ex-USA Value Index in the quarter by about 4 percentage points (+12.4% vs. +8.5%); since the beginning of 2017, international growth has outperformed international value by 13 percentage points (+25% vs. +12%). Interestingly, the combination of earnings growth plus dividends paid has been similar for the underlying growth and value companies over this period. The performance difference, therefore, is almost entirely explained by changes in price multiples. The P/E ratio for the Value index has contracted by more than 20% while the P/E ratio for the Growth index has contracted by about 10%. This repricing has contributed to not only the large valuation differences across sectors but also to notable spreads within sectors. Given this backdrop, we have been able to build a portfolio that trades at a large discount to the market. The portfolio's price-to-normal earnings ratio is 7.1x compared to 13.5x for the MSCI World ex-USA Index; the portfolio's price-to-book ratio is 1.0x compared to 1.6x for the index. As active investors with a commitment to long-term fundamental valuation, we view this environment as conducive to our approach and we are optimistic about the portfolio's prospects.

ATTRIBUTION

The Hotchkis & Wiley International Value portfolio (gross and net of management fees) underperformed the MSCI World ex-USA Index in the quarter. International value stocks underperformed international growth stocks by about 4 percentage points in the quarter, which was a significant performance headwind relative to the broad benchmark. Stock selection in financials, industrials, and materials also detracted from performance. Positive stock selection in energy and consumer staples helped relative performance. The largest individual detractors to relative performance in the period were Embraer, Societe Generale, Royal Mail, Vodafone, and Global Indemnity; the largest positive contributors were Ophir Energy, Kosmos Energy, Hitachi, Subsea 7, and Tesco.

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LARGEST NEW PURCHASES

Airbus is an OEM of commercial aircraft (the majority of sales and profits), civil and military helicopters, commercial space launch vehicles, missiles, military aircraft, satellites, defense systems and defense electronics. The commercial aircraft industry is enjoying an unprecedented period of prosperity, with higher travel demand, high aircraft utilization rates, new markets/routes, strong airline profitability and record demand for new planes. Airbus also enjoys the benefits from being one of only two global suppliers of large commercial aircraft. Airbus should grow earnings and cash flow from maturing programs, operating leverage on higher rate schedules, rising efficiency, less cyclical production schedules, supplier concessions, rising aftermarket activity, and more. The sum of these factors suggests significant EPS growth in the coming few years.

Bayer produces and markets healthcare and agricultural products. Its attractive valuation reflects a number of issues that concern investors, including a unique conglomerate structure, an unpopular Monsanto brand, high-profile glyphosate litigation, and a mixed capital allocation track record. We believe these concerns are reasonable but manageable, which creates an opportunity to purchase a portfolio of relatively high quality businesses at an inexpensive price. Bayer trades at an attractive multiple of normal earnings under reasonable forecasts and conservative asset value adjustments, and a sum-of-the-parts analysis leaves a healthy margin of safety. Bayer earns sustainably high margins and returns on its patent-protected pharma and agriculture businesses, has a generally shareholder friendly management team, generates healthy free cash flow, and offers diversification to the portfolio.

Medtronic PLC is a diversified medical device company with dominant market positions in several segments. While the Company trades at a higher multiple of normal earnings than much of the portfolio, we believe that Medtronic has superior prospects for growth at high incremental returns. The small position is diversifying to the portfolio, which is meaningfully underweight the healthcare sector.