International Value
1Q 2017 Commentary

Hotchkis & Wiley

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MARKET COMMENTARY

The Russell Developed ex-US Index increased +7.2% in the first quarter of 2017 (in US Dollar terms), continuing an impressive rise over the past four-plus years. The rise in equity prices across international markets has triggered debate about current valuations. Most traditional valuation measures are above historical averages; however, these metrics are below historical averages after adjusting for the low interest rate environment globally. Our general view is that the broad international equity market is fully valued. Often overlooked, however, is that some market segments contain bargains while others are richly valued. Finding such opportunities has become more difficult in recent years but we continue to observe a large valuation discrepancy between cyclical market segments and those viewed as bond surrogates. Today's popular international 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, slow-growing market segments, and paying 20-25x earnings is a risky proposition in our view. Investing in passive ETFs that track common equity indices is the other preferred strategy of the day, pouring still more investor capital into overvalued stocks and exacerbating the situation. Meanwhile, some market segments that have been shunned 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 European banks and insurers that trade at discounts to tangible book value; it would cost more to replicate the asset base than to simply buy the company. These businesses continue to have a stigma from the global financial crisis, which is in part why current valuations remain attractive. The fact remains, however, that these companies provide essential services to the economies in which they operate (low obsolescence risk) and have capital ratios/liquidity metrics at the highest levels in many decades. Regulatory uncertainty abroad always represents a 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 for the risks at hand. We own a mix of attractively-valued companies that trade at bargain prices; in most cases the stocks have been shunned or overlooked because the underlying businesses are cyclical. Technology is another sector that offers attractive valuation opportunities for the risks at hand. We own a mix of attractively-valued global equipment and manufacturing 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 capital stewards.

Because we have identified attractive pockets of opportunity within a fully valued market, the portfolio trades at a large discount to the market. The portfolio trades at 1.2x book value and 8.6x normal earnings compared to 1.7x and 14.4x, respectively, for the Russell Developed ex-US Index.

ATTRIBUTION: 1Q 2017

The Hotchkis & Wiley International Value portfolio (gross and net of management fees) underperformed the Russell Developed ex-US Index in the first quarter of 2017. Relative to the benchmark, the portfolio was negatively impacted by stock selection in Consumer Staples, Financials, and Technology. These negatives were offset in part the positive selection in Energy and Consumer Discretionary. 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 ARRIS, Royal Mail, Ophir, Tesco, and Enstar, while the largest contributors were WorleyParsons, Ericsson, Adient, BAE Systems, and Masonite.

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 International 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 ex-US 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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