Large Cap Fundamental Value
1Q 2017 Commentary

Hotchkis & Wiley

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MARKET COMMENTARY

The S&P 500 Index increased +6.1% in the first quarter of 2017, continuing a nearly unbroken string of quarterly gains since the beginning of 2013. The rise in equities has triggered debate about the US equity market's current valuation. Most traditional valuation measures are above historical averages; however, these metrics are below historical averages after adjusting for the low interest rate environment. Our general view is that the broad market, as defined by the S&P 500, 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 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 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 financial crisis, which is in part why current valuations remain attractive. The fact remains, however, that these companies provide essential services to the economy (low obsolescence risk) and have capital ratios/liquidity metrics at the highest levels since the 1930s. Regulatory uncertainty 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. Technology is another sector that offers attractive valuation opportunities for the risks at hand. We own a mix of attractively-valued 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 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 1.4x book value and 9.8x normal earnings compared to 2.0x and 14.7x, respectively, for the Russell 1000 Value Index. Compared to the S&P 500, the portfolio's valuation discount is even more pronounced, as the broad index trades 3.0x book value and 17.3x normal earnings.

ATTRIBUTION: 1Q 2017

The Hotchkis & Wiley Large Cap Fundamental Value portfolio (gross and net of management fees) outperformed the Russell 1000 Value Index in the first quarter of 2017. Positive stock selection drove most of the outperformance, and was particularly strong in Industrials, Healthcare, Utilities, and Telecom. The portfolio's largest sector overweight relative to the Russell 1000 Value is Technology. This overweight helped performance as Technology was the best-performing sector for the quarter. The worst-performing sector in the quarter was Energy, as oil prices declined. The portfolio is underweight in Energy but stock selection was negative because our holdings are disproportionately focused in upstream energy, which is more sensitive to commodity price changes—the combined effect had a close to neutral impact on relative returns. The underweight allocation to Consumer Staples and stock selection in Financials detracted from performance. The largest individual positive contributors to relative performance were NRG, Oracle, Anthem, Ericsson, and Corning; the largest detractors were Hess, Marathon, AIG, Murphy, and Calpine.

PORTFOLIO ACTIVITY: 1Q 2017

The majority of turnover in the quarter was due to adding and trimming around existing positions as valuation changes dictated. We added no new positions and fully exited one during the quarter, closing with 51 holdings. We increased the weight in technology, primarily by adding to the existing position in Hewlett-Packard Enterprise ("HPE") which became the portfolio's largest weight by quarter-end. To become a large position, a stock must be attractively valued, have a strong balance sheet, possess a predictable business model, exercise prudent capital allocation, and be liquid. HPE scores well on each of these traits. The company is divesting its software and enterprise services businesses. After adjusting for these transactions the remaining hardware business trades between 5 and 6 times earnings. Energy was the largest sector decrease; the sector underperformed and we opted to not reweight.

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 Large Cap Fundamental 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 1000 Value 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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