Manager Review & Economic Outlook

MARKET COMMENTARY

After falling -13.5% in 4Q 2018, the S&P 500 Index returned +13.7% in the first quarter of 2019. The swift decline and equally rapid recovery were both 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 a hawkish Fed; this combination created fears of impending global economic recession. These concerns appeared to fade during the first quarter of 2019 due to positive progress on US/China trade talks and dovish comments from the Federal Reserve. Throughout this period we have witnessed a significant decline in longer maturity Treasury yields and a flattening of the yield curve. After reaching 3.2% in late 2018, the 10-year note yield fell below 2.4% in March, its lowest level in more than a year despite the Fed's four 2018 rate hikes. In response to these changes, all S&P 500 sectors were positive in the first quarter, with the best returning +20% (technology) and the worst returning +7% (healthcare). The S&P 500's forward P/E ratio increased from 15.4x at the end of 2018 to 17.1x at the end of the first quarter. The index's median valuation over the past ~30 years is 16.4x; while it is now slightly above median, it is considerably lower than the 20x level where it began 2018.

While the overall market appears fairly valued, we find solace in the large valuation disparity between certain segments of the market—some are attractively valued, some richly valued. The S&P Banks Industry Group trades at 9.9x forward earnings. The median multiple for banks over the last 30 years is 12.0x, so the group currently trades at about 80% of its historical average. Considering that banks' balance sheets are as strong as they have been in decades, and nearly 80% 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 an even lower valuation (9.0x consensus earnings and 8.2x normal earnings) with a payout yield of 11% (dividends + share repurchases as a percentage of total equity). Conversely, the S&P Utilities Industry Group trades at 18.8x forward earnings, or double the valuation of banks. The median multiple for utilities over the last 30 years is 14.4x, so the group currently trades at about 130% of its historical average. Opposite of banks, utilities have added financial leverage, increasing net debt to EBITDA by 50% over the past decade from 3.4x to 5.1x. 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. Recognizing the considerable valuation dispersion across sectors, the portfolio exhibits larger-than-normal sector deviations from the benchmark.

The Russell 1000 Growth Index outperformed the Russell 1000 Value Index in the quarter by about 4 percentage points (+16% vs. +12%); since the beginning of 2017, growth has outperformed value by 32 percentage points (+49% vs. +17%). 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 expanded by about 8%. This repricing has contributed to not only the large valuation differences across sectors but also to notable spreads within sectors. In response to this backdrop our Value approach leads to a portfolio that trades at a large discount to the Value index and an exceptional discount to the Growth index. The portfolio's price-to-normal earnings ratio is just 58% of the Russell 1000 Value's P/E compared to the long term average of 71%; the portfolio's price-to-normal earnings ratio is just 35% of the Russell 1000 Growth's P/E compared to the long term average of 49%. 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 Large Cap Diversified Value portfolio (gross and net of management fees) outperformed the Russell 1000 Value Index in the first quarter of 2019. Positive stock selection drove more than 80% of the outperformance in the quarter, with the balance coming from favorable sector allocation. Positive stock selection in financials and energy were the largest contributors. The underweight position in healthcare and overweight position in technology were more modest positive contributors. On the negative side, the overweight in financials and underweight in real estate detracted from performance along with stock selection in consumer discretionary and technology. The largest positive contributors to relative performance in the quarter were Hess, General Electric, Apache, Hewlett Packard Enterprise, and Citigroup; the largest detractors were Vodafone, Biogen, Goodyear Tire, Wells Fargo, and Adient.

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LARGEST NEW PURCHASES

Fluor Corp. is one of the largest E&C companies in the world, with global scale in engineering, construction, and fabrication. More than half of its normal revenue is in the relatively cyclical Energy, Chemicals, & Mining (ECM) segment, while ~30% of normal revenue is from the stable Government and Services businesses. Fluor is a high-quality professional services company with a medium-risk business model that grows with no reinvested capital in an industry with few threats of disruption. Valuation is good on cyclically depressed earnings that should improve with spending cycles in Oil & Gas and mining. Volatility from recent projects execution has depressed current margins thus created an attractive entry point.