Small Cap Diversified Value
1Q 2017 Commentary

Hotchkis & Wiley

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MARKET COMMENTARY

The Russell 2000 Index increased +2.5% in the first quarter of 2017, continuing a nearly unbroken string of quarterly gains since mid-2012. 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 small cap 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 small cap stocks are those that have relatively stable earnings and high dividend payouts, like 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 financials 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. 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 because the underlying businesses are cyclical.

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 11.4x normal earnings compared to 16.3x and 18.7x for the Russell 2000 Value and the Russell 2000, respectively.

ATTRIBUTION: 1Q 2017

The Hotchkis & Wiley Small Cap Diversified Value portfolio (gross and net of management fees) underperformed the Russell 2000 Value Index in the first quarter of 2017. Positive stock selection in Real Estate and Industrials helped relative performance during the quarter. Stock selection in Financials and Utilities was a detractor.

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 Small Cap Diversified 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 (Russell 2000 Value Index), is calculated using daily holding information and does not reflect management fees and other transaction costs and expenses. 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. Portfolio information is subject to the firm's portfolio holdings disclosure policy.

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