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 an 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 continue to find opportunities because there is a 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 (9.3x consensus earnings and 8.1x normal earnings) with a payout yield of 10% (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 3000 Growth Index outperformed the Russell 3000 Value Index in the quarter by about 4 percentage points (+16% vs. +12%); since the beginning of 2017, growth has outperformed value by about 31 percentage points (+47% vs. +16%). 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 9%. 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 7.4x compared to 14.1x and 23.3x for the Russell 3000 Value and Russell 3000 Growth, respectively. 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 Value Opportunities portfolio (gross and net of management fees) outperformed the Russell 3000 Value Index in the first quarter of 2019. The overweight position in industrials and underweight position in healthcare were positive contributors to relative performance in the quarter. Positive security selection REITs, energy, and consumer staples also helped. Security selection in materials, healthcare, and communication services detracted from performance. The largest positive contributors to relative performance in the quarter were General Electric (equity and preferred), Seritage Growth Properties, Apache, Goldman Sachs, and Hewlett Packard Enterprise; the largest detractors were Iracore bonds, Royal Mail, National Oilwell Varco, Vodafone, and Wells Fargo.

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LARGEST NEW PURCHASES

Medtronic PLC is one of the world's largest medical technology companies with operations in over 150 countries and a highly diversified product portfolio. Medtronic boasts a #1 or #2 market position in 75% of its businesses and its significant scale provides substantial benefits in negotiations with a consolidating healthcare industry. The company benefits from numerous secular trends, including an aging population in developed markets and increasing healthcare spend in fast-growing emerging markets. Medtronic also has a strong new device pipeline which should underpin the company's ability to deliver mid single digit top line growth for years to come. Medtronic trades at a compelling valuation of normal earnings given the company's growth profile.

The GEO Group is a diversified owner and operator of state and federal penitentiaries, immigration detention, reentry services and electronic monitoring. The GEO 5 7/8 2024 bond fell in price due to political commentary to a point that the bond yield was comparable to GEO's equity dividend yield. The GEO bonds trade at very attractive multiples of current cash flow, a significant discount to replacement cost and has lease terms that extend beyond the maturity of the bond.

JC Penney Corp. operates over 800 department stores in the US and Puerto Rico including 400 stores that are owned. The JCP 5 7/8 2023 bond is secured by over 280 stores and distribution centers with an appraised value that well exceeds debt at our bond level. The market continues to discount department store assets due to more sales moving online to the point that we are able to buy security in real estate assets that provide strong downside protection and equity like returns.