

Value Opportunities 1Q 2017 Commentary



March 31, 2017

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. For example, the current market price-to-consensus earnings multiple is 18.3x versus the historical average of 16.6x since 1990. However, interest rates are well below historical averages. One valuation method we consider is earnings yield (inverse of P/E) less treasury yield. This provides a net equity yield. Based on this metric, the equity markets continue to be undervalued relative to history (currently 3.1% vs. the historical average of 1.5%). 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. 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 stewards of capital.

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 the S&P 500 at 3.0x book value and 17.3x normal earnings, respectively.

ATTRIBUTION: 1Q 2017

The Hotchkis & Wiley Value Opportunities portfolio (gross and net of management fees) underperformed the S&P 500 Index in the first quarter of 2017. Security selection in materials and technology detracted from performance along with the overweight exposure to energy. This was partially offset by positive security selection in healthcare and real estate. The five largest individual detractors to relative performance were Iracore bonds, ARRIS, AIG, Royal Mail, and Real Industry; the five largest positive contributors were Ericsson, Oracle, GEO Group, WorleyParsons, and Energy XXI.

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 Value Opportunities 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 S&P 500 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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