Value Investor INSIGHT
The Leading Authority on Value Investing
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On Course

The challenge in any investing strategy based on mean reversion is getting right exactly what the "mean" is, a skill at which Stan Majcher has proven quite adept.

INVESTOR INSIGHT

Stan Majcher
Hotchkis & Wiley

Investment Focus: Seeks companies for which he can with conviction envision a normalized earnings power that is much higher than the current status quo.

Starting out as an investment-banking trainee at Merrill Lynch in 1993, Stan Majcher kept getting projects involving industries under high stress. "Part of it was probably giving the less-glamorous work to the new guy," he says, "but it actually fit well with my contrarian nature."

Now responsible for some $3.8 billion in mid-cap assets at Los Angeles-based Hotchkis & Wiley, Majcher's penchant for the out of favor has served him quite well. The Mid-Cap Value fund he's co-managed since inception in 1997 has earned a net annualized 12.4%, vs. 10.0% for the Russell Midcap Index. Mining pockets of still-high market negativity, he's finding value today in such areas as energy, telecom equipment, banking and tires.

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Investor Insight: Stan Majcher

Stan Majcher of Hotchkis & Wiley explains how stock investing is like wagering on football games, how he deals with – and prepares for – being out of sync with the market, which recently favored sector has become decidedly less so, and why he sees unrecognized value in Ophir Energy, Whiting Petroleum, Ericsson, Popular and Goodyear Tire & Rubber.

Your firm has built a thriving franchise focused on trying to take advantage of mean reversion. Describe what that means in practice.

Stan Majcher: The basic idea is that investors typically expect current conditions to persist into the future, but in reality markets revert toward normal equilibrium conditions. When oil prices are high, investors expect them to stay high and vice versa. When real estate prices are weak, investors expect them stay weak and vice versa. When things are good investors expect more of the same and when things are bad it's hard for investors to think they could get better.

Empirical evidence demonstrates that returns on capital are mean-reverting. When business is unusually good and profitability high, substitutes multiply, competitors surface and financing becomes easily accessible. This puts pressure on profitability to revert toward normal levels. When returns on capital are unusually poor, the process works in reverse and profitability improves toward the mean. But because investors tend to project the recent environment into the future and value companies accordingly, share prices may not always represent a reasonable assessment of business value. We look to take advantage of the mispricings.

Our research is focused on determining a company's long-run normal earnings power, which is its sustainable cash earnings under equilibrium economic and competitive-market conditions. At the industry level we have to understand well the competitive environment and the factors that most influence supply and demand. At the company level we need to understand the competitive strengths and weaknesses and how the business model, capital intensity and financial leverage translate revenue into free cash flow over a full cycle.

Anyone can do what we do, but few employ the necessary discipline throughout the cycle. There are periods when our style seems to have stopped working and it can be hard as an investor to stick it out through that. Of course it's often darkest before the dawn and remaining disciplined through a down period can lead to a long period of outperformance.

ON MEAN REVERSION:

When investors project the recent past into the future we try to take advantage of the mispricings that result.

How would you characterize today's market environment on the darkness-versus-dawn spectrum?

SM: Had you asked me three months ago I would have explained how we were deep into the third extended period where we were out of sync since I joined Hotchkis & Wiley 20 years ago. The market seemed to love things like REITs, consumer staples and utilities, areas we thought were considerably overvalued. We were finding opportunity in areas like energy and financials, which until recently the market overlooked. At the end of June the year-to-date returns for our Mid-Cap Value fund were off by 1,000 basis points from our mid-cap benchmark and the gap between our portfolio's average P/E on normalized earnings and the same measure for the benchmark was at an all-time high.

We're now 300 basis points ahead of our benchmark for the year. And the portfolio is still trading at an extremely low multiple – just over 7x – of our estimate of normalized earnings, versus around 15x for the benchmark. Historically when the P/E multiple has been that low and the valuation gap to the benchmark that high, it has usually meant good things for our performance.

One technical question before going on: How do you arrive at a normalized earnings estimate for your Russell benchmark?

SM: If it's not a company for which we've done our own fundamental work to estimate normalized earnings, there are quantitative methodologies that utilize relevant historical financial data as well as consensus estimates.

The scourge of the mean-reversion investor would appear to be timing, borne out by your being heavily exposed to energy in the past couple years well before any reversion started. How do you try to mitigate damage from that?

SM: Our difficult periods of underperformance have predominantly come from being too early. I've come to the conclusion that we probably can't avoid that. If you believe a business is going to normalize and that it will happen on a timetable that makes investing today at a given price and valuation attractive, you should invest. Being early is generally what makes the risk/reward so compelling, because the market is focused on the next three months, maybe a year.

A key point here is that we should only own companies that can handle a long period of under-earning. We thought oil prices would normalize more quickly than they have but that hasn't materially threatened the long-term prospects of any of the companies we own. If we're right that prices will normalize and that they'll do so at the level we expect – which is really at the heart of our analysis – our energy holdings should have a significant positive impact on the portfolio.

You actively screen for new ideas. What are you looking for?

SM: We don't rely exclusively on screens, but we use them to narrow down the approximately 800 stocks in our mid-cap universe to the much smaller number that are most likely to make it into the portfolio because they trade inexpensively to normalized earnings. Metrics that might signal interesting opportunities are kind of what you'd expect: low price-to-earnings, low total-enterprise-value-to-EBIT, low price-to-book. As I mentioned, we avoid companies with balance sheets that could threaten their viability in an extended downturn.

We've been fortunate as a firm to have very low turnover of personnel so our research team is composed of analysts who are sector experts and who have been at Hotchkis & Wiley for a long time. The combination of experience and continuity provides a historical perspective and the necessary industry contacts that allow our analysts to process what comes out of screens fairly quickly and zero in on what might be a good investment opportunity versus a value trap.

What's typically going on that makes something cheap?

SM: As evidenced by our energy exposure [15% of the portfolio at 9/30], there's often a cyclical component. But cycles impact all businesses. For example, Corning [GLW] is a high-quality business in an oligopoly market for the glass used in products such as cellphones, TVs and computers. We believe it has a sustainable margin advantage over its peers in a secularly growing market, but because of pricing cycles it can experience earnings volatility that impacts the share price. That allows us from time to time to buy in at low multiples of normalized earnings.

Another example would be Ericsson [ERIC], the #1 global player in the highly consolidated market for telecom network equipment, where it competes primarily with Huawei and Nokia. It's a business we like because underlying demand is growing very quickly and customer relationships tend to be deep and sticky. Once your equipment is in place, it's highly likely that the network operator uses you as it expands capacity and to provide ongoing service and repair. The service side of the business accounts for more than 40% of company revenues.

It's important to understand the distinction between coverage and capacity in this business. The first step in building out a mobile network involves providing coverage in a geographic area, even if rather thinly. As demand picks up network operators then add capacity. From an equipment-supply perspective, an Ericsson will discount heavily from listed prices to get its foot in the door by providing coverage, growing its installed base and anticipating much higher-margin sales to expand capacity and for service and repair. At times the company's sales mix can shift around between coverage and capacity, causing earnings to fluctuate from what we consider normal. That provides opportunity: at the company's share price today we're paying only 7x normalized earnings.

ON EXPERIENCE:

We process what comes out of screens fairly quickly to zero in on the good opportunity versus the value trap.

Talk more about making sure your companies can outlast long periods of underperformance. How do you do that?

SM: Our risk assessment looks at financial and non-financial factors. We review balance-sheet leverage, cash-flow volatility, available liquidity, access to capital, unusual profit concentrations and exposure to extreme events. We have also developed a "red-flags" analysis based on investing mistakes we've made or that we've seen others make. Is cash-flow generation commensurate with earnings? Are inventories or receivables building? What new competition is on the horizon? If there are bonds, does their pricing indicate greater risk than you think? With any new idea you can get excited and want to be optimistic – this analysis is meant to control that and make sure no stone goes unturned.

Describe generally how you think about valuation.

SM: Like most value investors we're highly attuned to the fact that the price you pay is central to your returns. That gets lost sometimes in all the discussion about business quality, which we agree is important but it isn't enough. It's like gambling on football games. It would be much easier to pick winners if there wasn't a point spread, but that's not the way it works. The "point spread" is built into a stock's price – sometimes it's a bargain, sometimes it's not.

In the mid-1990s when we were investing in oil tankers, which were extremely out of favor, one CEO said if he invested in a tanker at the right price there's almost nothing he could do wrong. If he invested at the wrong price there's almost nothing he could do right. We feel the same way. If we're getting a great price relative to the risk and the quality of the asset, a lot of things can work in our favor. If we pay too much there's very little chance it will work out.

To quantify return potential we primarily value companies on a multiple of normal earnings and complement that with a dividend discount model or looking at price to replacement cost. There's no static hurdle to meet. In our long-only portfolios we're always fully invested and are constantly comparing available opportunities in order to upgrade the return potential of the portfolio.

How does something like Goodyear [GT], which you first bought in 2008, stay in the portfolio for as long as it has?

SM: When we originally took the position it was, of course, trading at a low multiple of normalized earnings, but it was in many respects a very different company. It had a higher cost structure, weaker product mix, less exposure to growing markets, more debt and a larger pension obligation. As we've owned it the normal earnings power of the business has significantly increased as all of those business dimensions have improved. The share price has also significantly increased, but has remained attractive relative to normalized earnings. A key dimension today is the potential for capital return. Goodyear's management projects returning roughly 45% of the company's current market capitalization to shareholders over the coming four years, which given the cash the company generates we believe is a reasonable expectation.

Describe your thought process when something goes against you.

SM: It's pretty straightforward. We take the new information into account and reassess the risks and analyze whether our estimate of normal earnings power has been affected or not. If the stock price goes down but the normal earnings power hasn't changed, that's actually a good thing. It allows us to commit more capital at a better price and improve the prospective return of the portfolio.

Any recent examples?

SM: Earlier this year Office Depot [ODP] fell 40% in one day following the announcement that its merger with Staples fell through. We thought the market's reaction went beyond what was warranted given the flexibility provided by the company's balance sheet and the prospects for the stand-alone business going forward. When that's the case we try to take advantage and add to our position. The stock is still down about 15% this year, but because of opportunistic purchases and some recovery in the share price, it's no longer a meaningful detractor to performance and we still own a significant position at a better valuation than when we first started.

Before diving into some current energy ideas, describe how you're assessing "normal" when it comes to oil prices.

SM: Our view on the marginal cost of production for oil – where supply meets demand over the long term – is $70 to $80 per barrel. That estimate actually hasn't changed from when oil was above $100 per barrel or when it went below $30 per barrel.

We generally believe the world isn't spending enough money on developing oil-production projects in order to satisfy demand over the long run. Exploration budgets have been cut and large oil companies have not been replacing their reserves. Incremental production in recent years from places like Saudi Arabia, Iraq and Iran were largely one-time boosts from spare capacity and that may be difficult to sustain without spending considerable capital and time.

Additionally, while there's a lot of market confidence that U.S. unconventional production can make up the supply shortfall over the next few years, we think that might be overly optimistic. Major U.S. unconventional plays only account for about 5% of global production and the dramatic reduction in the U.S. unconventional rig count isn't something that can be turned around sufficiently fast to satisfy world demand. We believe U.S. unconventionals will eventually grow quickly but that there will be more of a lag than expected.

Drilling down to some specific holdings, how did London-based Ophir Energy [OPHR:LN] get on your radar screen?

INVESTMENT SNAPSHOT

Ophir Energy
(London: OPHR:LN)

Business: U.K.-based energy exploration and development company with producing assets primarily in Asia and funded-to-development pre-production assets located in Africa.

Share Information
(@12/29/16, Exchange Rate: $1 = £0.8156):

Price	**£0.95**
52-Week Range	£0.64 – £1.01
Dividend Yield	0.0%
Market Cap	£669.0 million

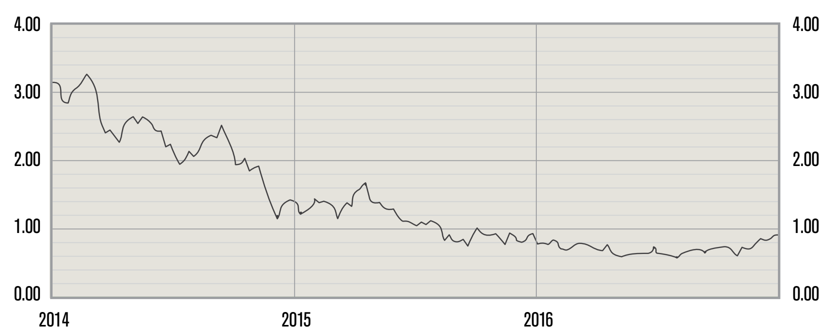
Financials (TTM):

Revenue	£126.7 million
Operating Margin	(-223.4%)
Net Profit Margin	(-189.4%)

Valuation Metrics
(@12/29/16):

	OPHR	S&P 500
P/E (TTM)	n/a	24.9
Forward P/E (Est.)	n/a	19.0

OPHR PRICE HISTORY



THE BOTTOM LINE
While the flow of capital away from energy exploration has dampened investor enthusiasm for companies like this one that specialize in it, says Stan Majcher, it has also improved such companies' prospective returns. Valuing the company's three primary assets in Asia and Africa on a sum-of-the-parts basis, he believes the fair share value exceeds £2.

Sources: Company reports, other publicly available information

SM: The flow of capital away from exploration has improved prospective returns for those who specialize in it. For companies that have already made discoveries the go-forward economics are very good because they are not dragged down by the sunk costs of drilling dry holes. Today you can buy companies with attractive exploration assets for prices that are less than the value of what they have already discovered. Many other things are also working in these companies' favor. Acquiring additional exploration acreage and developing existing projects can now be done at dramatically reduced prices.

That's the basis of our interest in Ophir, an exploration-focused company with three valuable assets we don't believe the market is correctly valuing. The first is what they acquired in early 2015 in buying Salamander Energy, consisting of producing or near-production properties in Indonesia, Thailand and Malaysia. Based on our discounted-cash-flow analysis – assuming $70 oil and what we consider a conservative 10% discount rate – we believe these assets are worth $600 million, alone worth more than Ophir's current enterprise value.

The second asset is Fortuna, a liquefied-natural-gas [LNG] project in Equatorial Guinea that's a partnership with the world's largest oil-services firm, Schlumberger, and the world's largest LNG-transport company, Golar. The project uses a cheaper and quicker technology to cool gas to liquid form for shipment, putting the assets at the low end of the production cost curve. Even in a currently oversupplied but improving LNG market, we believe the project economics here are solidly positive. Assuming we're right and that LNG prices continue to normalize from current levels, we value this piece on a discounted-cash-flow basis for Ophir at around $825 million.

The final store of value is natural gas assets in Tanzania. The company sold a half interest in its holdings there for $1.25 billion in 2013, when LNG prices were nearly twice the current level. The continued development will require more confidence in the LNG market, but even at current prices we estimate Ophir's remaining stake is worth around $375 million, heavily discounted from the 2013 transaction.

If we add it all up, include $207 million of net cash and subtract $150 million for overhead, we arrive at an estimated net asset value for the company of around $1.85 billion, or £1.5 billion. That's £2.06 per share, compared with the current share price of 95 pence.

How would you characterize Ophir's staying power?

SM: The $408 million of gross cash on the balance sheet can finance all of the company's development projects and the current cash burn should materially decline as more of the Asian assets come online over the next year. We think that gives the company plenty of cushion if energy prices happen to stay lower for longer than we expect.

Explain your thesis for U.S.-based Whiting Petroleum [WLL].

SM: With the tightening in the crude-oil market that we expect over the next few years, growth in U.S. production will be

INVESTMENT SNAPSHOT

Whiting Petroleum
(NYSE: WLL)

Business: Exploration and development of unconventional oil and gas assets in the U.S., the large majority of which are located in either the Williston Basin or the Niobrara Shale.

Share Information (@12/29/16):

Price	**12.19**
52-Week Range	3.35 – 14.44
Dividend Yield	0.0%
Market Cap	$3.00 billion

Financials (TTM):

Revenue	$1.24 billion
Operating Profit Margin	(-45.4%)
Net Profit Margin	(-101.7%)

Valuation Metrics
(@12/29/16):

	WLL	S&P 500
P/E (TTM)	n/a	24.9
Forward P/E (Est.)	n/a	19.0

Largest Institutional Owners
(@9/30/16):

Company	% Owned
Fidelity Mgmt & Research	7.2%
Vanguard Group	7.2%
Hotchkis & Wiley	4.9%
Fine Capital	4.8%
Key Group	3.7%

Short Interest (as of 12/15/16):

Shares Short/Float	23.2%

WLL PRICE HISTORY

THE BOTTOM LINE

With the tightening of the crude-oil market Stan Majcher expects in coming years, companies like this one that can ramp production quickly and profitably should be well positioned to benefit. Assuming $70-per-barrel oil and that the company spends within cash flow, his present-value estimate of its net assets is $25 per share, twice the current price.

Sources: Company reports, other publicly available information

necessary to satisfy demand. While we're skeptical that U.S. unconventional production grows as rapidly and at the economics many observers expect, we do believe that such U.S. production is advantaged in the current market because of the shorter cycle times to bring on production. A pad of unconventional wells in the U.S. can take six to nine months to come on stream while large international projects can take several years. That's a big advantage in a tightening market. Whiting is a company that owns largely short-cycle, high-return projects in the core of one of the best unconventional plays in the U.S., the Williston Basin.

A lot has worked against the company's stock in addition to lower oil prices. As a result of an ill-timed, levered acquisition of Kodiak Oil & Gas in 2014, just before the oil downturn began, Whiting ended up having to sell equity and assets into the downturn at low prices. It converted some debt into mandatorily convertible bonds, which was announced the week of Brexit. That forced the conversion of debt into more shares than anticipated. There was plenty of volume in the stock at depressed prices which gave us the opportunity to create a meaningful position.

How well can it ride out low oil prices?

SM: We estimate the company needs to spend a bit less than $600 million annually to maintain production, which is about what it's spending now. We think we're conservative on that estimate because it assumes 20% higher services costs and 20% more in infrastructure costs than current levels. The company was free-cash-flow positive in the most-recent quarter, so with $1.8 billion of liquidity and the vast majority of its debt due in 2019 and 2020, we believe it can meet its production goals at current prices for a long time.

How cheap do you consider the shares, now trading at around $12.20?

SM: Assuming $70-per-barrel crude oil – the low end of our normal range – and that the company spends within cash flow, our present-value calculation of the net assets is $25 per share, roughly twice the current price.

One protection on the downside here is that Whiting has some 20 years of inventory in high-quality acreage. This acreage could be more valuable to an acquirer that could accelerate drilling and pull forward the cash flows. If oil prices remain at current levels we wouldn't be surprised if Whiting attracted the interest of suitors.

You described earlier what made Ericsson's stock cheap relative to normalized earnings. What causes that to change?

SM: The company's revenues adjusted for currency changes have fallen 8% this year due to the dynamic I mentioned where coverage buys have outweighed capacity additions. That's an issue for the financials when we estimate coverage-related gross margins at approximately 25%, versus 65% or so gross margins on revenues that are capacity-related.

We don't know exactly how long telecom operators can continue with existing infrastructure, but we do know that increasing numbers of connected devices combined with increasing bandwidth usage per device is yielding 50% annual

INVESTMENT SNAPSHOT

Ericsson
(Nasdaq ADR: ERIC)

Business: World's largest provider of telecom network equipment and related services to operators of mobile and fixed networks worldwide; originally founded in Sweden in 1876.

Share Information (@12/29/16):

Price	**5.76**
52-Week Range	4.83 – 10.20
Dividend Yield	7.9%
Market Cap	$19.07 billion

Financials (TTM):

Revenue	$24.69 billion
Operating Profit Margin	9.6%
Net Profit Margin	4.5%

Valuation Metrics
(@12/29/16):

	ERIC	S&P 500
P/E (TTM)	16.9	24.9
Forward P/E (Est.)	17.1	19.0

Largest Institutional Owners
(@9/30/16):

Company	% Owned
Primecap Mgmt	2.4%
Hotchkis & Wiley	1.9%
Cambiar Inv	0.6%
Brandes Inv	0.3%
Invesco	0.3%

Short Interest (as of 12/15/16):

Shares Short/Float	0.6%

ERIC PRICE HISTORY

THE BOTTOM LINE

The inexorable growth in bandwidth demand will require that telecom network providers add significant incremental capacity to their systems, says Stan Majcher, resulting in high-margin business for Ericsson. At the 14x multiple he considers reasonable on his normalized EPS estimate of 85 cents, the company's shares would trade at $11.75.

Sources: Company reports, other publicly available information

growth in bandwidth demand. At some point capacity is going to have to be added in a big way, translating into high-margin business for Ericsson. To us it's a classic mismatch between the short-term outlook priced in by the market and the longer-term outlook we have.

There was a recent management shakeup at the company. What's your take on the new CEO, Börje Ekholm?

SM: He has never run a telecom-equipment business but has been on Ericsson's board for a decade and is very well known by Ericsson's controlling shareholder, Investor AB, where he was CEO for ten years. While we expect him to do a good job, I would say the franchise is built more on scale and installed base than executive talent. We'd argue the prior CEO underperformed on many operating metrics for six years during the "rip-and-replace" 4G-wireless cycle, but Ericsson still grew market share during that period. I'd add that Ericsson has given up some of those market-share gains over the past three years to Chinese vendors Huawei and ZTE, which have received preferential status during a massive upgrade in China.

Are you concerned that Chinese competitors will take market share as the 5G upgrade cycle unfolds in the next few years?

SM: The technological standard for 5G has not yet emerged, but the expectation is that 5G will be deployed through upgrades to existing base stations rather than through completely new infrastructure. That will limit the opportunity for new competition to take share.

How are you looking at normalized earnings and at upside in the U.S.-listed ADRs, now at $5.75?

SM: We estimate normalized earnings at just under 85 cents per share and believe 14x earnings is a reasonable multiple for a business that has structural advantages in an oligopolistic market. That implies a fair value of around $11.75 per share.

The margin of safety here we think comes from the large installed base, an inefficient cost structure that leaves plenty of room to cut and an extremely conservative balance sheet. Net cash is 20% of the market cap and we think excess working capital is as much as another 30% of market cap. Investors are assuming continued underperformance, but there are levers the company can pull to help change that sentiment.

The stock of Puerto-Rican bank Popular Inc. [BPOP] has been on an excellent run. Describe why you still find it attractive.

SM: The stock was severely depressed as the governments of Puerto Rico and the U.S. worked through the crisis around Puerto Rico's debt. As progress was made on that front Popular's shares appear to have benefitted, but we still think they're mispriced.

The company is the largest bank in Puerto Rico, with a 46% share of deposits. Even in a challenging economic environment it has been able to earn excellent returns – for example, its pre-provision income as a percentage of tangible assets is 1.9%, versus a range of 1.2% to 1.7% for most U.S. regional banks. Its market

INVESTMENT SNAPSHOT

Popular
(Nasdaq: BPOP)

Business: Holding company for Puerto Rico's largest bank, providing banking and financial services through its Banco Popular subsidiary to consumer and corporate customers.

Share Information (@12/29/16):

Price	**43.60**
52-Week Range	22.40 – 44.91
Dividend Yield	1.3%
Market Cap	$4.52 billion

Financials (TTM):

Revenue	$1.72 billion
Operating Profit Margin	32.7%
Net Profit Margin	20.9%

Valuation Metrics
(@12/29/16):

	BPOP	S&P 500
P/E (TTM)	12.7	24.9
Forward P/E (Est.)	12.1	19.0

Largest Institutional Owners
(@9/30/16):

Company	% Owned
Vanguard Group	10.4%
T. Rowe Price	6.6%
Hotchkis & Wiley	5.5%
Fidelity Mgmt & Research	4.5%
Diamond Hill Capital	4.4%

Short Interest (as of 12/15/16):

Shares Short/Float	1.2%

BPOP PRICE HISTORY

THE BOTTOM LINE

Despite the strong recent performance of its shares, Stan Majcher still believes the market is overstating the company's balance-sheet risks and understating its ability to capitalize on normalized market conditions going forward. At the 13-15x P/Es on normalized earnings at which U.S. regional banks typically trade, the shares would be worth $60-70.

Sources: Company reports, other publicly available information

dominance helps, combined with the fact that the competition is relatively well behaved, with three banks controlling 80% of the market.

Many investors seem to think the balance sheet must be challenged but we don't believe that's the case. Banks typically get into trouble from underwriting loans in overheated economies that later go cold, rather than underwriting loans when there's a chill in the economy. The latter is a better description of Popular's case. It has been underwriting loans in a depressed economy and has done so on favorable terms that reflect that. In addition, its exposure to Puerto-Rican municipal debt is relatively small and confined to senior parts of the capital structure.

Is your thesis dependent on a recovery in the Puerto Rican economy?

SM: We estimate normalized earnings at $4.75 per share, which is partly predicated on an economic recovery that will allow credit and operating expenses to normalize. Popular is not as interest-rate sensitive as most regional banks so we assume little in terms of net-interest-margin expansion. One other driver of per-share earnings growth is that we estimate the company has excess capital of about $1 billion, or roughly 20% of the current market cap. We expect that to be returned to shareholders through stock buybacks over the next five years, irrespective of an economic recovery.

Now at $43.60, how inexpensive do you consider the shares?

SM: The shares trade at less than 9.2x our estimate of normalized earnings, while regional banks typically trade at 13-15x normalized P/Es. We believe that valuation gap with peers should eventually close.

Coming back to Goodyear, could one argue that with its margins at 20-year highs some mean reversion is in order?

SM: That's a fair question, Goodyear's profit per tire and returns on invested capital have risen significantly. The company projects further improvements but we're more conservative and are counting only on the sustainability of current earnings. That's a function of changes in the cost structure and the fortuitous industry shift toward larger and more-complex tires. Goodyear is one of only a few manufacturers that OEMs trust to develop and supply the increasingly broad array of low-volume tires designed to meet their needs. With a wider list of niche products and high levels of brand loyalty on aftermarket replacements, we're confident that competitor-driven margin reversion should take a long time to unfold. In the meantime we expect additional efficiency-related initiatives now underway at the company to offset most of any forecasted mix-related profit decline. The net of all this yields an earnings-power estimate near today's levels.

Several tire manufacturers are increasing production capacity of high-value-added tires in the U.S. Is overcapacity a concern?

SM: That end of the market is growing fairly rapidly as OEMs are prioritizing fuel efficiency, durability and handling, all

INVESTMENT SNAPSHOT

Goodyear
(Nasdaq: GT)

Business: Global development, manufacture and sale of tires and related products and services for cars, trucks, buses, aircraft, motorcycles and various other applications.

Share Information (@12/29/16):

Price	**31.13**
52-Week Range	24.31 – 33.36
Dividend Yield	1.2%
Market Cap	$8.13 billion

Financials (TTM):

Revenue	$15.48 billion
Operating Profit Margin	10.6%
Net Profit Margin	2.1%

Valuation Metrics
(@12/29/16):

	GT	S&P 500
P/E (TTM)	30.6	24.9
Forward P/E (Est.)	7.2	19.0

Largest Institutional Owners
(@9/30/16):

Company	% Owned
Vanguard Group	9.2%
BlackRock	4.5%
State Street	3.6%
LSV Asset Mgmt	3.5%
Adage Capital	3.2%

Short Interest (as of 12/15/16):

Shares Short/Float	7.1%

GT PRICE HISTORY

THE BOTTOM LINE

Its shares trade at only 7.2x Stan Majcher's estimate of normal earnings power, leading him to believe that the market is highly skeptical of the sustainability of the company's current performance. At the 12x multiple he believes the re-cast company deserves, on his $4.30-per-share estimate of normalized earnings the shares would trade at $52.

Sources: Company reports, other publicly available information

of which are features of higher-value-add tires. Oversupply is a concern, but it takes three to four years for capacity to come on line. Barring a very large economic contraction, the market appears to be relatively balanced if not undersupplied in the medium term.

What upside do you see in the stock price from just over $31 today?

SM: Our estimate of normal earnings is just over $4.30 per share. That puts the P/E at around 7.2x so there's clearly skepticism – which we don't share – about the sustainability of earnings. We think the structural improvements in the business conservatively warrant a 12x multiple of normalized earnings, which would result in a $52 stock price. On the downside I'd refer back to what I mentioned earlier about capital return. At the current market cap we think the implied yield from buybacks and dividends is roughly 11% per year and that that level of disbursement can be sustained for several years.

As the market has turned on a dime in the past several weeks have you found areas to take profits?

SM: I wouldn't say it's because they've become expensive on an absolute basis, but we have been lightening up on financials, particularly banks. As investors on normalized earnings we've had a strong case for financials based on interest rates eventually reverting at least somewhat to the mean. But after the recent run regional banks in the U.S. have arguably gone from our least-expensive holdings relative to the rest of the portfolio to one of our more expensive. We're finding other places to move some of that capital.

How would you characterize your post-election outlook in general?

SM: To me it all comes down to what kind of values we're finding in the market. I don't know that we add a lot of value in trying to assess what catalysts may come out of the election. I go back to the fact that our portfolio trades at around 7x our estimate of normal earnings at a time when the market is at an all-time high and our benchmark is more than twice as expensive on a normalized-P/E basis. That's what informs my outlook. Valuation is always the best catalyst. VII

Hotchkis & Wiley

Value Investor Insight
December 30, 2016
Hotchkis & Wiley Mid-Cap Value Fund

Average Annual Returns as of September 30, 2018

	1 Year	3 Year	5 Year	10 Year	Since 1/2/97
Class I	13.74%	12.40%	8.19%	14.22%	12.29%
Class A	13.44	12.12	7.91	13.93	12.02
Class A (w/ sales charge)	7.47	10.12	6.75	13.32	11.74
Class C	12.60	11.28	7.11	13.15	11.21
Class C (w/ cdsc)	11.60	11.28	7.11	13.15	11.21
Class R	13.17	11.84	7.64	13.65	11.81
Russell Midcap Value Index®	8.81	13.09	10.72	11.29	10.53
Russell Midcap Index®	13.98	14.52	11.65	12.31	10.42

The performance shown represents past performance. Past performance is no guarantee of future results and current performance may be higher or lower than the performance shown. Investment results and principal value will fluctuate so that shares, when redeemed, may be worth more or less than their original cost. To obtain performance data current to the most recent month-end, access our website at www.hwcm.com.

The Fund's total annual operating expense ratio as of the most current prospectus is 0.99% for I Shares, 1.20% for A Shares, 1.95% for C Shares and 1.45% for R shares. Expense ratios shown are gross of any fee waivers or expense reimbursements.

Returns shown for A, C and R Shares for the periods prior to their inception are derived from the historical performance of I Shares of the Fund during such periods and have been adjusted to reflect the higher total annual operating expenses of each specific Share class (Inception date: I Shares-1/2/97, A and C Shares-1/2/01, R Shares-8/28/03). Returns shown for A Shares and C Shares without sales charge do not reflect the maximum sales load of 5.25% or the Contingent Deferred Sales Charge (CDSC) of 1.00% for the first year; if reflected, performance would be lower than shown. Returns for A and C shares reflect the deduction of the current maximum initial sales charges of 5.25% and 1.00% CDSC. C Shares convert automatically to A Shares approximately eight years after purchase. A Shares are subject to lower annual expenses than C Shares. Class I shares sold to a limited group of investors. Periods over one year are average annual total return. Average annual total returns include reinvestment of dividends and capital gains. Expense limitations may have increased the Fund's total return.

You should consider the Fund's investment objectives, risks, and charges and expenses carefully before you invest. This and other important information is contained in the Fund's summary prospectus and prospectus, which can be obtained by calling 1-800-796-5606 or visiting our website at www.hwcm.com. Read carefully before you invest.

Mutual fund investing involves risk. Principal loss is possible. Investing in small and medium-sized companies involves greater risks than those associated with investing in large company stocks, such as business risk, significant stock price fluctuations and illiquidity. The Fund may invest in foreign securities which involve greater volatility and political, economic and currency risks and differences in accounting methods.

Top 10 holdings as of 9/30/18 as a % of the Fund's net assets: Whiting Petroleum Corp. 5.4%, Popular Inc. 5.0%, Hewlett Packard Enterprise 4.6%, ARRIS International PLC 4.2%, Kosmos Energy Ltd. 3.7%, Discovery Inc. 3.1%, Cairn Energy PLC 3.1%, CIT Group Inc. 3.0%, Citizens Fin'l Group Inc. 2.9%, and Ericsson 2.8%. Portfolio weightings, sector allocations, and/or fund holdings are subject to change and should not be considered a recommendation to buy or sell any security. Opinions expressed are those of the author and are subject to change, are not intended to be a forecast of future events, a guarantee of future results, nor investment advice. References to other products should not be interpreted as an offer of these securities.

Free cash flow is earnings before depreciation, amortization, and non-cash charges minus maintenance capital expenditures. Price-to-Earnings (P/E) is calculated by dividing the current price of a stock by the company's trailing 12 months' earnings per share. Dividend yield is calculated by annualizing the last quarterly dividend paid and dividing it by the current share price. The dividend yield is that of the securities held in the portfolio; it is not reflective of the yield distributed to shareholders. Price-to-Normal Earnings is the current market price per share divided by normalized earnings per share. Earnings Per Share (EPS) is the portion of a company's profit allocated to each outstanding share of common stock. Price-to-book is the price of a stock divided by its book value. Margin of safety is a principle of investing in which an investor only purchases securities when the market price is significantly below its intrinsic value. In other words, when market price is significantly below your estimation of the intrinsic value, the difference is the margin of safety. This difference allows an investment to be made with minimal downside risk. Market Capitalization of a company is calculated by multiplying the number of outstanding shares by the current market price of a share. Basis point is a unit equal to 1/100th of 1% and is used to denote the change in a financial instrument. Total-Enterprise-Value-to-EBIT represents the entire value of a company divided by earnings before interest and tax. Forward P/E (Est.) represents the current market price per share divided by a company's estimated future earnings-per-share. Projected earnings are consensus analyst forecasts; actual P/E ratios may differ from projected P/E ratios. REITS - Real Estate Investment Trusts TTM-Trailing Twelve Months. EBIT-Earnings Before Interest & Tax. **EPS and P/E growth is not representative of the Fund's or underlying securities future performance.**

Mid-cap benchmark refers to the Russell Midcap® Value Index which measures the performance of those Russell Midcap® companies with lower price-to-book value ratios and lower forecasted growth values. The Russell Midcap® Index, an unmanaged index, measures the performance of the 800 smallest companies in the Russell 1000® Index. The S&P 500® Index is a broad based unmanaged index of 500 stocks, which is widely recognized as representative of the equity market in general. The indexes do not reflect the payment of transaction costs, fees and expenses associated with an investment in the Fund. It is not possible to invest directly in an index. The Fund's returns may not correlate with the returns of their benchmark index.