Large Cap Diversified Value 2011 Commentary

December 31, 2011

MARKET COMMENTARY

The S&P 500 Index started and ended 2011 at nearly the identical price level (1,258); however, the year was anything but uneventful as investors endured several bouts of extreme volatility. Concerns related to the sovereign debt crisis in Europe, the combative political landscape in the US, and the potential economic slowdown in China rattled investors. These concerns have been exacerbated by the lack of confidence in policymakers, world political leaders, and central bankers. Poor (or no) decisions by policymakers could have lasting consequences (particularly in Europe) and undermine the resounding progress made by businesses over the past three years. Since the financial crisis, we have witnessed unprecedented corporate deleveraging which has been accomplished by improved productivity and restricted spending. This has facilitated strong free cash flows and enabled companies to reduce debt levels, thereby lowering financial risk. Earnings have also been impressive despite the absence of robust economic growth. Given these fundamental improvements, with no equity price change, we end the year with valuations that have become even more compressed.

At Hotchkis & Wiley, we share the market's apprehension regarding the geopolitical landscape, but we believe current macroeconomic anxiety is overly discounting equity prices. Our experience has been that compelling valuations and strong fundamentals are likely to prevail in the long run, and thus we welcome 2012 with open arms. Admittedly, we were not sad to see 2011 come to an end as it was a frustrating year for fundamental stock pickers—particularly those of us focused on valuation. Stocks with low valuations underperformed stocks with high valuations. Based on price-to-forward earnings multiples[1], the lowest-valued quintile of the S&P 500 Index underperformed the highest-valued quintile by an astounding 34 percentage points; excluding financials this outperformance was 25 percentage points. In terms of sectors, financials underperformed, non-cyclicals outperformed, and the rest were in-between.

As of year-end, the nominal "risk free" yield on 10-year Treasury bonds was less than 2%, which is considerably lower than both the historical and current run rate of inflation (3.7% and 3.4%, respectively). By comparison, the Hotchkis & Wiley Large Cap Diversified Value portfolio has an earnings yield of 11.2%, and based on the portfolio's payout yield repays four times more cash to shareholders than treasuries[2]. While corporate cash flows have been predominately used to deleverage balance sheets over the past several years, cash has been returned to investors with increased regularity via higher dividends and share repurchases. We anticipate this return of cash to grow, creating a situation in which the incremental yield to owning stocks relative to government bonds is at a 60-year high[3].

Efforts aimed at reducing volatility have triggered outflows from equities and other volatile asset classes in favor of bonds and cash. Countless studies have demonstrated that herd-like behavior is counterproductive more often than not. We are innately skeptical that the migration away from stocks will ultimately benefit investors that have chosen this path. While elevated volatility and market downturns go hand in hand, so do elevated volatility and market rallies. For disciplined long-term investors, volatility can create opportunity, particularly if those investors are supported with diligent research.

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1 Based on FY2 consensus earnings estimates at beginning of year (1/1/2011).

2 Based on FY2 consensus earnings as of end of year (12/31/2011). U.S. Treasuries are generally considered "risk free" securities. Equity securities have greater risks and price volatility than U.S. Treasuries, where the price of equity securities may decline due to various company, industry and market factors. As of 12/31/11, the portfolio's payout yield and the 10-Year Treasury yield were 8.7% and 1.9%, respectively. Yield measures quoted are not guaranteed or indicative of future yields.

3 Based on dividend yield and the Equity Risk Premium.

ATTRIBUTION: 2011

The Hotchkis & Wiley Large Cap Diversified Value portfolio (gross and net of management fees) underperformed the Russell 1000 Value Index for the year. The overweight position in low P/E stocks hurt performance as this group underperformed the market considerably. This caused more than three-fourths of the underperformance over the year. Also hurting performance was stock selection in technology and financials. Within technology, Hewlett-Packard declined as the CEO lowered guidance and announced plans to revamp its business model. Eventually, the board succumbed to shareholder pressure to replace the CEO and refocus on its core businesses. The position in banks also weighed on performance as concerns regarding sovereign debt exposure and continued economic weakness pressured the stocks. Positive stock selection in energy, materials, and telecommunications was the largest performance contributor for the year. Royal Dutch Shell, Lockheed Martin, and Vodafone were the largest individual contributors.

PORTFOLIO ACTIVITY: 2011

We reduced the technology weight slightly by exiting the position in IBM, which approached our valuation target—still the portfolio remains overweight technology. We exited/trimmed our two materials positions, Celanese and PPG Industries, also because they approached our valuation targets. Another major sale during the year was Philip Morris International; it too approached its valuation target. The most notable sector increases over the course of the year were consumer discretionary and utilities. Within consumer discretionary, the only new purchase was Magna International but we also added to the existing positions in Johnson Controls and Gap. These three companies operate in very different businesses but each are attractively valued, conservatively leveraged, and are returning capital to shareholders. Within utilities, we added a new position in PPL Corporation and added to the existing position in Public Service Enterprise Group. Both of these utilities contain a non-regulated generation fleet that is well-positioned to benefit from tightening generation markets as increasingly stringent EPA rules should force some coal-fired capacity to shut down.

The portfolio attribution in this commentary is based on a representative Large Cap Diversified Value portfolio. Certain client portfolio(s) may or may not contain the securities discussed in this commentary due to the account's guideline restrictions, cash flow, tax and other relevant considerations. The commentary is for information purposes only and is not intended to be, and should not be, relied on for investment advice. The opinions expressed are those of the portfolio managers as of 12/31/11 and may not be accurate reflections of their opinions after that date. There is no guarantee that any forecasts made will come to pass. Accounts may not continue to hold the securities mentioned and H&W has no obligation to disclose purchases or sales of these securities.

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