

Mid-Cap 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 multiples¹, the lowest-valued quintile of the Russell Midcap Index underperformed the highest-valued quintile by an astounding 27 percentage points; excluding financials this outperformance was 31 percentage points. Utilities and consumer staples were the top-performing midcap sectors for the year, while telecom, technology, and financials lagged.

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 Mid-Cap Value portfolio has an earnings yield of 10.7%, and based on the portfolio's payout yield repays four times more cash to shareholders than treasuries². 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 high³.

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.

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 8.8% 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 Mid-Cap Value portfolio (gross and net of management fees) underperformed the Russell Midcap Value Index for the year. The overweight position in low P/E stocks hurt performance as this group underperformed the market considerably. Also hurting performance was stock selection in financials and consumer discretionary. Within consumer discretionary, Valassis was the primary detractor over the course of the year. We believe the price decline is a temporary overreaction to a weak environment—the stock trades at a very low multiple of current earnings and an incredibly low multiple of normal earnings. Positive stock selection in energy, healthcare, and technology were the primary performance contributors for the year; Cobalt International Energy, MI Developments, and Stone Energy were the largest individual contributors.

PORTFOLIO ACTIVITY: 2011

We reduced our healthcare exposure during the year as two positions were acquired; King Pharmaceuticals was bought by Pfizer and Kinetic Concepts was bought by a private equity consortium. The weight in materials was eliminated as we exited three positions because each performed well and approached our valuation targets. We also reduced our overweight position in technology; the most notable transaction was the sale of TE Connectivity (former Tyco Electronics), which approached our valuation target. We increased the energy weight by adding to existing positions Cobalt International Energy and Stone Energy, and by taking new positions in Kosmos Energy and Murphy Oil. As a result, the portfolio is now overweight energy relative to the Russell Midcap Value Index (note the index energy weight was also reduced following its mid-year reconstitution). The purchase of Huntington Ingalls Industries increased our weight in the industrials sector. The company was spun from Northrup Grumman. As investors in Northrup Grumman stock, we were already familiar with its various businesses, including the shipbuilding businesses that were spun off. The now-independent company is attractively valued based on its ongoing operational improvements and sticky customer base.

The portfolio attribution in this commentary is based on a representative Mid-Cap 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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