Small Cap Value
2011 Commentary

Hotchkis & Wiley

December 31, 2011

MARKET COMMENTARY

Small cap equity investors endured several bouts of extreme volatility during 2011. After a strong first half of the year, the small caps declined considerably in the late summer until a fourth quarter rally provided some relief. In the end, the Russell 2000 Index returned -4.2% for the year. 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.

The unusually high correlation of stock price movements and changes in macroeconomic expectations has increased the return volatility of our portfolio over the last few years. We see this as a cyclical phenomenon that will eventually subside as the US economy begins to grow and corporate profits continue to improve. Our experience has been that compelling valuations and strong fundamentals are likely to prevail in the long run, particularly in small caps, 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 Russell 2000 Index underperformed the highest-valued quintile by an astounding 25 percentage points; excluding financials this outperformance was 28 percentage points. Utilities and consumer staples were the top-performing small cap sectors for the year, while materials, energy, and telecommunications 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 H&W Small Cap Value portfolio has an earnings yield of 10.1%, and based on the portfolio’s payout yield repays two and a half 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.

---

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 4.6% 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 Small Cap Value portfolio (gross and net of management fees) underperformed the Russell 2000 Value Index for the year. The overweight position in low P/E stocks hurt performance as this group underperformed the market considerably. Valassis Communications (consumer discretionary) was the largest individual 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; Kinetic Concepts, Miller Industries, and Great Plains Energy were the largest individual contributors.