

# SMALL CAP VALUE FUND

## Commentary

Calendar Year 2011



### Manager Review and Economic Outlook

#### 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. 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<sup>a</sup>, 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.

While improved 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. Historically, companies that return capital to shareholders have outperformed those that do not, which is why our process is keenly focused on managements' capital allocation policies. We anticipate this return of cash to grow, creating a situation in which the incremental yield to owning stocks relative to government bonds could reach a 60-year high<sup>b</sup>.

Efforts aimed at reducing volatility have triggered outflows from equities and other volatile asset classes in favor of bonds and cash. This has pressured the "risk free" yield on Government bonds. The nominal yield on

the 10-Year Treasury closed the year below 2%, which is considerably lower than both the historical and current run rate of inflation (3.7% and 3.4%, respectively). Countless studies have demonstrated that herd-like behavior is counterproductive more often than not. We are innately skeptical that the migration away from stocks to bonds and cash 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.

#### Attribution: 2011

The Hotchkis & Wiley Small Cap Value Fund 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 (5.2%)<sup>1</sup> (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 (0.0%)<sup>1</sup>, Miller Industries (2.6%)<sup>1</sup>, and Great Plains Energy (4.7%)<sup>1</sup> were the largest individual contributors.

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

<sup>b</sup> Based on dividend yield and the Equity Risk Premium.

<sup>1</sup>% of total portfolio as of December 31, 2011.

*Mutual fund investing involves risk. Principal loss is possible. Investing in smaller and/or newer companies involves greater risks not 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.*

Fund holdings and/or sector allocations are subject to change and are not buy/sell recommendations. Current and future portfolio holdings are subject to risk. Value stocks may underperform other asset types during a given period. 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. The Fund may not continue to hold the securities mentioned and the Advisor has no obligation to disclose purchases or sales of these securities. Free cash flow is earnings before depreciation, amortization, and non-cash charges minus maintenance capital expenditures. U.S. Treasuries are generally considered "risk free" securities. Correlation is a statistical measure of the degree to which the movements of two variables (stock/option/convertible prices or returns) are related. **Past performance is no guarantee of future results. Diversification does not assure a profit nor protect against loss in a declining market.**



2012 Best Equity Small Company

for the 3-year risk-adjusted performance among 171 fund families for the period ended 11/30/11

**Performance as of December 31, 2011**



	4Q11	1 Year	3 Year	5 Year	10 Year	Since 9/20/85
I Shares	15.16%	-11.38%	28.14%	-0.95%	8.40%	10.85%
A Shares without sales charge	15.13	-11.60	27.84	-1.20	8.15	10.61
A Shares	9.09	-16.24	25.57	-2.25	7.57	10.38
C Shares	14.92	-12.24	26.95	-1.80	7.44	9.81
Russell 2000 Value Index	15.97	-5.50	12.36	-1.87	6.40	n/a

  

Yield	I Shares	A Shares	A Shares (Load)	C Shares
30-Day SEC Yield with expense waiver	0.30%	0.06%	0.05%	0.00%
30-Day SEC Yield without expense waiver	0.30%	0.06%	0.05%	0.00%

**Contributors to Performance: 2011**

Top Five	% of Total Portfolio <sup>1</sup>
Kinetic Concepts Inc.	0.0%
Rent-A-Center Inc.	2.7
Great Plains Energy Inc.	4.7
MI Developments Inc.	4.8
Miller Industries Inc.	2.6

Bottom Five	% of Total Portfolio <sup>1</sup>
Alliant Techsystems Inc.	4.5%
Symetra Financial Corp.	2.9
Noranda Aluminum Hldg	2.4
PHH Corp.	2.3
Valassis Communications	5.2

**Classes & Tickers**

I Shares	HWSIX
A Shares	HWSAX
C Shares	HWSCX

The Fund's total annual operating expense ratio as of the most current prospectus is 1.08% for I Shares, 1.33% for A Shares and 2.08% for C Shares. Expense ratios shown are gross of any fee waivers or expense reimbursements.

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](http://www.hwcm.com).

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](http://www.hwcm.com). Read carefully before you invest.

Returns shown for A and C 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-9/20/85, A Shares-10/6/00, C Shares-2/4/02). Returns shown for A Shares without sales charge does not reflect the maximum sales load of 5.25%; if reflected, performance would be lower than shown. All other returns reflect the deduction of the current maximum initial sales charges of 5.25%. Returns shown for C Shares do not reflect the contingent deferred sales charge of 1% for the first year. C Shares convert automatically to A Shares approximately eight years after purchase. A Shares are subject to lower annual expenses than C Shares. I Shares are 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.

The Russell 2000® Index measures the performance of the 2,000 smallest companies in the Russell 3000® Index. The Russell 2000® Value Index measures the performance of those Russell 2000® companies with lower price-to-book ratios and lower forecasted growth values. The indices do not reflect the payment of transaction costs, fees and expenses associated with an investment in the Fund. The Fund's value disciplines may prevent or restrict investment in major stocks in the benchmark indices. It is not possible to invest directly in an index. The Fund's returns may not correlate with the returns of their benchmark indices.

The 30-day SEC Yield represents net investment income earned by a fund over a 30-day period, expressed as an annual percentage rate based on the Fund's share price at the end of the 30-day period. The SEC Yield should be regarded as an estimate of the Fund's rate of investment income, and it may not equal the Fund's actual income distribution rate, the income paid to a shareholder's account, or the income reported in the Fund's financial statements. 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. Price-to-forward earnings is the projected P/E ratios of the companies invested in the portfolio, which ratios represent 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.

<sup>1</sup> % of total portfolio includes total investments, cash, and accrued investment income on a trade date basis.

Contributors to Performance measures the impact each security has on the portfolio's total return and is calculated using daily holding information within FactSet (does not reflect the payment of transaction costs, fees and expenses of the Fund).

Lipper determined the fund group awards by averaging Lipper's three-year Consistent Return scores for all of the firm's funds within the asset class, and the eligible group with the lowest average decile rank received the award for that asset class. In case of a tie, the group with the lower average percentile rank received the award. Fund groups with at least five equity, five bond, or three mixed equity portfolios that received Consistent Return scores as of November 30, 2011, are eligible for a fund group award in the respective asset class. Lipper Small Company Group Awards are given in four categories – Overall, Equity, Fixed Income and Mixed Asset. Small companies consisted of those fund families with assets under management of less than \$40.0 billion.

**NOT FDIC INSURED  
NO BANK GUARANTEE  
MAY LOSE VALUE**

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