Large Cap Diversified Value
1Q 2018 Commentary

Hotchkis & Wiley

March 31, 2018

MARKET COMMENTARY

In the first quarter of 2018, the S&P 500 Index fell -0.8%. The Russell 1000 Growth Index returned +1.4% while the Russell 1000 Value Index fell -2.8%, extending growth's recent performance advantage. Over the last 10 years, the value index has returned +111% cumulatively compared to +193% for the growth index (+7.8% and +11.3% annualized, respectively). The only other period that favored growth to such an extent was the internet bubble of the late 1990s. While the broad market's valuation today is much less extreme than it was in 1999, a number of popular stocks exhibit exorbitant valuation multiples akin to internet bubble levels. We believe this poses risks for passive investors because they are, either consciously or naively, allocating capital to excessively valued securities. Very few people would buy a new house, car, or even a meal without regard to price, but this frame of mind seems to breakdown at times when buying stocks. In our view, to justify the current valuations of today's most richly valued stocks, many things have to go perfectly right for a very long period. In our experience, such unbridled optimism rarely materializes.

Fortunately for active investors, some segments of the market offer attractive valuations for the risks at hand. In recent years we have been partial to technology even though parts of the sector are overvalued. Our focus has been on attractively valued, well-managed companies with sticky customers, strong balance sheets, and good prospects for growth. Technology represents the portfolio's largest relative weight compared to the index, even though we have been taking capital out of the sector as it has outperformed. As the adoption of cloud technology proliferates, the mix of IT spending is likely to shift with some competitors gaining share at the expense of others. In our view, several of our large tech holdings stand to benefit from this transition. These companies offer cloud products that have been well-received by the marketplace, and as existing customers transition to the cloud they become more valuable to the company. Customers are sticky because switching costs are onerous. Many customers store critical business data in, and have built business processes around these products. Additionally, these companies have great balance sheets, are good stewards of capital, and are growing.

Financials continue to represent the largest sector weight in the portfolio, though our exposure is close to that of the benchmark. Despite healthy stock price appreciation in recent years, banks continue to trade at valuations well below their historical averages. Critics argue that lower valuations are justified because banks will be unable to earn the same returns on capital they have earned in the past due to more stringent capital requirements. We agree, but competitively advantaged banks like the ones we own should be able to earn above cost-of-capital returns. Accordingly, we view 11x normal earnings and a small premium to book value as compelling valuations, particularly considering that the excess capital on their balance sheets reduce the risk profiles dramatically.

We remain underweight consumer staples because valuations appear a bit rich, but less so than in recent years. As a result, we have increased our weight recently. The new positions possess great brands that are among the market share leaders, which enable them to earn good returns on capital. We have also increased energy, and are now modestly overweight relative to the index. We have a strong preference for companies with good balance sheets so that we are not exposed to shareholder dilution in the event the reversion in oil prices takes longer than we anticipate.

Over long periods, value has outperformed growth, and we have no reason to believe we have entered a paradigm shift that would change this going forward. Style shifts can occur quickly and powerfully, and we believe we are well positioned for such a reversion. We continue to be encouraged by the portfolio's valuation discount relative to the value benchmark and the broad benchmark. The portfolio trades at 9.5x normal earnings and 1.6x book value, a notable discount to the Russell 1000 Value Index (14.6x and 2.0x, respectively) and an even larger discount to the S&P 500 Index (17.4x and 3.1x, respectively). We remain committed to maintaining our unwavering dedication to the principals of long-term, fundamental value investing, and that while fads can drive short term performance fundamentals prevail in the long run.

ATTRIBUTION: 1Q 2018

The Hotchkis & Wiley Large Cap Diversified Value portfolio (gross and net of management fees) lagged the Russell 1000 Value Index in the first quarter of 2018. The underperformance of value relative to growth was a performance headwind for our valuation-focused approach. Stock selection in financials, consumer discretionary, and telecommunications also hurt performance. The overweight position in technology, along with positive stock selection in consumer staples and energy helped relative performance. The five largest individual detractors to relative performance in the quarter were AIG, Vodafone, Corning, Murphy Oil, and Wells Fargo; the largest positive contributors were Hewlett-Packard Enterprise, Microsoft, Hess, GlaxoSmithKline, and Unilever.

LARGEST NEW PURCHASES: 1Q 2018

General Electric has leading positions in power turbines, jet engines, diesel locomotives, and diagnostic imaging systems with $120B in sales of which about 60% is international. The stock now trades at an attractive valuation considering it has a high quality set of businesses with interesting future prospects. Shares have underperformed due to shrinking capital and power earnings, combined with weak cash flow in power and declining cash from dispositions in capital, which led to a dividend cut. We believe the power business will be challenged but most of its earnings decline is priced in today. Also, what the market misses is GE's businesses have #1 or #2 market share in virtually every business and has a dominant installed base to service and sell new equipment. GE trades at an attractive multiple of normal earnings with a majority of businesses that earn high long-term returns on capital.

Interpublic Group is an advertising agency holding company with about 15% of the worldwide ad-agency market. It is an above average business selling at an interesting valuation using conservative assumptions regarding its margins relative to the overall industry. It is returning capital to shareholders through dividends and share buybacks.

Unilever is one of the leading suppliers of consumer goods in the food, home care, and personal care product categories. Leveraging its brand strength, Unilever has attained #1 or #2 market share across 85% of its business. It is attractively valued and management has implemented plans to expand margins in the coming years while returning capital to shareholders.

Composite performance is available at www.hwcm.com, located on the strategy's Performance tab. Returns discussed can differ from actual portfolio returns due to data differences, cash flows, trading, and other activity. Portfolio attribution is based on a representative Large Cap Diversified Value portfolio. Certain client portfolio(s) may or may not hold the securities discussed due to each account's guideline restrictions, cash flow, tax and other relevant considerations. Equity performance attribution is an analysis of the portfolio's return relative to a selected benchmark, is calculated using daily holding information and does not reflect management fees and other transaction costs and expenses. For the portfolio's total performance attribution, interaction effect is combined with stock selection. Specific securities identified are the largest contributors (or detractors) to the portfolio's performance relative to the Russell 1000 Value Index. Other securities may have been the best and worst performers on an absolute basis. The "Largest New Purchases" section includes the three largest new security positions during the year based on the security's year-end weight adjusted for its relative return contribution; does not include any security received as a result of a corporate action; if fewer than three new security positions at year-end, all new security positions are included. Securities identified do not represent all of the securities purchased or sold for advisory clients, and are not indicative of current or future holdings or trading activity. H&W has no obligation to disclose purchases or sales of the securities. No assurance is made that any securities identified, or all investment decisions by H&W were or will be profitable. Quarterly characteristics and portfolio holdings are available at www.hwcm.com, located on the strategy's Characteristics and Literature tabs. For a list showing every holding's contribution to the overall account's performance and portfolio activity for a given time period, please contact H&W at hotchkisandwiley@hwcm.com. Portfolio information is subject to the firm's portfolio holdings disclosure policy.

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