INVESTMENT STRATEGY
The Hotchkis & Wiley Capital Income portfolio invests in both value equity securities and high yielding fixed income securities with an emphasis on income generation. The long-term allocation target between value equities and high yielding fixed income securities is 50/50. The portfolio has two benchmarks, the S&P 500 Index (“the equity benchmark”) and the BofA Merrill Lynch US Corporate, Government & Mortgage Index (“the fixed income benchmark”). These benchmarks are averaged, using the portfolio’s long-term allocation targets, to produce a “50/50 blended benchmark” to help assess performance.

MARKET COMMENTARY
The S&P 500 Index increased +6.1% and the BofA Merrill Lynch US High Yield Index returned +2.7% in the first quarter of 2017. The rise in equities has triggered debate about the equity market’s current valuation. Most traditional valuation measures are above historical averages; however, these metrics are below historical averages after adjusting for the low interest rate environment. Our general view is that the broad market, as defined by the S&P 500, is fully valued. Often overlooked, however, is that some market segments contain bargains while others are richly valued. Finding such opportunities has become more difficult in recent years but we continue to observe a large valuation discrepancy between cyclical market segments and those viewed as bond surrogates. Today’s popular stocks are those that have relatively stable earnings and high dividend payouts, like REITs, consumer staples, and regulated utilities. While the underlying businesses are stable, these are mature, slow-growing market segments, and paying 20-25x earnings is a risky proposition in our view. Investing in passive ETFs that track common equity indices is the other preferred strategy of the day, pouring still more investor capital into overvalued stocks and exacerbating the situation. Meanwhile, some market segments that have been shunned trade for half the valuation levels of the more favored areas of the market, and in select circumstances, even trade at a discount to the replacement cost of the business.

As an example, we own several banks and insurers that trade at discounts to tangible book value; it would cost more to replicate the asset base than to simply buy the company. These businesses continue to have a stigma from the financial crisis, which is in part why current valuations remain attractive. The fact remains, however, that these companies provide essential services to the economy (low obsolescence risk) and have capital ratios/liquidity metrics at the highest levels since the 1930s. Regulatory uncertainty always represents a risk, but this also acts as a barrier to entry as leading franchises are difficult and costly to displace—an often overlooked benefit. The industrials sector also offers attractive valuation opportunities for the risks at hand. We own a mix of attractively-valued companies that trade at bargain prices; in most cases the stocks have been shunned or overlooked because the underlying businesses are cyclical. Technology is another sector that offers attractive valuation opportunities for the risks at hand. We own a mix of attractively-valued software, hardware, and equipment companies with businesses that we view as more predictable than most technology companies. These businesses have relatively sticky customers, strong balance sheets, and are prudent capital stewards.

In credit markets, the high yield index ended the quarter with a yield-to-worst of 5.9% and spread over treasuries of 391 basis points. With spreads both tight and narrowly distributed, it is not the most compelling environment we have ever observed based on valuations alone. Nonetheless, high yield valuations appear more attractive than fixed income alternatives, even after adjusting for differences in risk. Strong market fundamentals are the primary cause of the tight high yield market. The trailing 12 month default rate has fallen well below average (~2.5%), and is poised to decline
further as early-to-mid 2016 defaults roll off. Defaults outside the commodity sectors have been nearly non-existent, persisting at less 1% over the past year. Default increases are most often preceded by revenue and margin declines coupled with increases in financial leverage. Revenues and margins have recently improved; however, and leverage has come down.

We have been able to identify attractive individual opportunities on a highly selective basis. Our penchant for small and mid cap issuers expands our investable universe beyond what is accessible to our largest peers and ETF investors. Such investors are limited to only the most liquid high yield credits, and are compelled to overlook an important segment of the high yield market where opportunities abound. In the current environment, we have identified the most attractive risk-adjusted opportunities in basic industry, energy, and consumer goods credits. Our exposures are predicated on our bottom-up analysis of the individual credits, many of which are misunderstood or ignored by the largest high yield investors. We believe this approach is a considerable advantage in all markets, but disproportionately so in environments where obvious opportunities are hard to find. The portfolio maintains a notable spread advantage relative to the market without assuming undue risk. Going forward, we will maintain our commitment to this time-tested approach and are optimistic about the long-term risk/return prospects of the portfolio.

ATTRIBUTION AND MANAGEMENT DISCUSSION: 1Q 2017
The Hotchkis & Wiley Capital Income portfolio (gross and net of management fees) outperformed the 50/50 blended benchmark in the first quarter of 2017. The equity portion averaged 57% of the portfolio over the year with the balance allocated to high yield bonds. The overweight to equities helped as equities outperformed high yield bonds. The high yield bond exposure, as opposed to investment grade fixed income, also helped relative performance as high yield outperformed high grade bonds by a considerable margin.

The equity portion of the portfolio underperformed the S&P 500 Index. The overweight position in financials and energy detracted from performance as these were among the worst performing sectors in the quarter. Stock selection in financials and technology also detracted from performance. On the positive side, stock selection in energy, real estate, healthcare, and industrials helped relative performance. The largest individual detractors to relative performance were Fifth Street Asset Management, Cobalt, ARRIS, AIG, and Popular; the largest positive contributors were Bowleven, NRG, GEO Group, WorleyParsons, and Oracle.

The high yield bond portion of the portfolio outperformed the BofA Merrill Lynch US Corporate, Government & Mortgage Index but underperformed the BofA Merrill Lynch US High Yield Index. Relative to the high yield index, performance was hurt by credit selection in energy. This was partly offset by positive credit selection in consumer goods and media.

Unless otherwise noted, the high yield market refers to the BofA Merrill Lynch US High Yield Index.

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 intraday trades, cash flows, corporate actions, accrued/miscellaneous income, and trade price and closing price difference of any given security. Portfolio attribution is based on a representative Capital Income 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. Fixed Income performance attribution is an analysis of the portfolio’s return relative to the BofA Merrill Lynch US High Yield Index and is calculated using trade information, does not reflect cash flow transactions and the payment of transaction costs, fees and expenses. 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. Specific securities identified are the largest contributors (or detractors) to the portfolio’s performance relative to the S&P 500 Index. Other securities may have been the best and worst performers on an absolute basis. Securities identified do not
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