MARKET COMMENTARY
The Russell 2000 Index increased +2.5% in the first quarter of 2017, continuing a nearly unbroken string of quarterly gains since mid-2012. The rise in equities has triggered debate about the US 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 small cap market 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 small cap stocks are those that have relatively stable earnings and high dividend payouts, like 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 because the underlying businesses are cyclical.

Because we have identified attractive pockets of opportunity within a fully valued market, the portfolio trades at a large discount to the market. The portfolio trades at 1.3x book value and 8.7x normal earnings compared to 1.6x and 16.3x, respectively, for the Russell 2000 Value. Compared to the Russell 2000, the portfolio’s valuation discount is even more pronounced, as the broad index trades 2.2x book value and 18.7x normal earnings.

ATTRIBUTION: 1Q 2017
The Hotchkis & Wiley Small Cap Value portfolio (gross and net of management fees) outperformed the Russell 2000 Value Index in the first quarter of 2017. Positive stock selection in Real Estate, Consumer Discretionary, and Industrials were the primary performance contributors during the quarter. This was partly offset by stock selection in Materials and Financials. The largest individual contributors to relative performance were GEO Group, MDC Partners, Extreme Networks, Masonite, and NRG, while the largest detractors were Real Industry, ARRIS, Sonic Automotive, Whiting Petroleum, and KBR.

PORTFOLIO ACTIVITY: 1Q 2017
We added six new positions and fully exited five during the quarter, closing with 63 holdings. We increased the weight in Industrials and Real Estate, primarily by adding a new position in WestJet Airline and increasing the position in Seritage Growth Properties. We decreased the weight in Financials and Technology.
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 Small Cap 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. Specific securities identified are the largest contributors (or detractors) to the portfolio’s performance relative to the Russell 2000 Value Index. Other securities may have been the best and worst performers on an absolute basis. 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.

The commentary is for information purposes only and should not be considered as investment advice or a recommendation of any particular security, strategy or investment product. Portfolio managers’ opinions and data included in this commentary are as of March 31, 2017 and are subject to change without notice. Any forecasts made cannot be guaranteed. Information obtained from independent sources is considered reliable, but H&W cannot guarantee its accuracy or completeness. Certain information presented is based on proprietary or third-party estimates, which are subject to change and cannot be guaranteed. Equity securities may have greater risks and price volatility than U.S. Treasuries and bonds, where the price of these securities may decline due to various company, industry and market factors. Investing in value stocks presents the risk that value stocks may fall out of favor with investors and underperform growth stocks during given periods. All investments contain risk and may lose value. Investing in smaller and/or newer companies involves greater risks than those associated with investing in larger companies, such as business risk, significant stock price fluctuations and illiquidity. Past performance is no guarantee of future results.

©2017 Hotchkis & Wiley. All rights reserved. Any unauthorized use or disclosure is prohibited.