

## Hotchkis & Wiley: Exploiting the Inefficiencies in Small-Cap Stocks

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by Robert Huebscher

*Judd Peters, CFA, is a portfolio manager of the Hotchkis & Wiley Small Cap Diversified Value Fund (HWVIX). Along with co-manager Ryan Thomes, he coordinates the day-to-day management of the fund, as well as represents the strategy to current and prospective clients.*

*He has been with Hotchkis & Wiley for 18 years. Prior to joining the firm, he was an analyst in the investment banking division of Wedbush Morgan Securities. He received his BA in mathematics and a BS in biochemistry from University of California, San Diego.*

*As of April 30, since its inception (6/30/2014), the fund's annualized return has been 9.45%, resulting in a 232 basis point outperformance versus Russell 2000 Value Index, which returned 7.13%. The fund is rated five stars by Morningstar and is in the top 7th percentile of its Morningstar peer group over the three years ending March 31, 2018.*

*I interviewed Judd last week.*

**Bob: Tell us about your investment process. Specifically, how do you find value in the small-cap space?**

**Judd:** We use a two-step process to construct the portfolio. In the first step, we use proprietary valuation models to narrow down a universe of around 3,000 small-cap stocks to a group of 500-600 stocks that our models indicate are attractive investments. In the second step, we distribute these 500-600 stocks to our team of 22 investment analysts based on their industry coverage. These an-

alysts perform a fundamental review of each stock and based on their recommendations, we build a portfolio of 350-400 undervalued stocks. We typically find opportunities in companies that are temporarily under-earning relative to their long-term potential, either due to industry cyclicality or company-specific situations.

**Bob: How do you seek to capitalize on overreactions by investors in small caps?**

**Judd** Investors often overreact both positively and negatively to short-term financial results. The market has a tendency to extrapolate short-term performance into the future. For example, we might find a company that has a 2% operating income margin this year, but earned an average margin of 10% over the last decade. Because the market tends to project the current low margin into the future, this valuation is likely to be a reasonable or even low multiple of this year's depressed earnings. If our research indicates that the company can improve its margins toward to the historical average, then we are investing at a very attractive valuation relative to the long-term potential earnings.

**Bob: What is your view on valuations today in small cap and more generally? How do you compare the current era of outperformance of growth stocks to the dot-com era?**

**Judd:** There are certainly lofty valuations in parts of the U.S. equity market today, particularly in large-cap technology stocks. We've also seen valuations in small-cap growth run far ahead of small-cap



Judd Peters

value. Based on 10-year rolling returns, the Russell 2000 growth index has outperformed the Russell 2000 value index by more than 2 percentage points annualized. The last time the Russell 2000 growth got this far ahead of the Russell 2000 value was early 2000, after which value outperformed growth by a large margin.

**Bob: How do the valuations in your fund compare to that of the Russell 2000 value index, in terms of P/E and P/B ratios?**

**Judd:** The P/B of the portfolio is 1.3, compared to the Russell 2000 value index at 1.5. The 2018 P/E of the portfolio is 13.3 compared to the Russell 2000 value index at 15.0. We are more focused on normalized earnings, and on that metric our normalized P/E is 10.1 compared to the Russell 2000 value index at 14.9.

**Bob:** As of March 31, the strategy had \$412 million in assets (of which \$27 million was in the mutual fund). How big can it be before you consider closing it?

**Judd:** We estimate that we can manage \$4 billion in total-strategy assets without compromising the integrity of the portfolio. However, we will close the fund if trading becomes a challenge. Hotchkis and Wiley has a track record of closing funds at conservative levels to preserve trading liquidity and protect existing shareholders.

**Bob:** How are you managing risk in the current market?

**Judd:** At the company level, the two most important risk controls are balance sheet strength and valuation support. Balance sheet strength is critical because we are often investing in companies with temporarily depressed profitability. The company needs to have sufficient time to repair its margins and operations without the need for a dilutive capital raise. Valuation support is critical because owning the assets and earnings power of a business at a discount provide you with an anchor, regardless of short-term volatility in the stock price.

At the portfolio level, the large number of holdings diversifies a substantial amount of risk. However, we constantly monitor the portfolio to ensure we are not assuming any unintended risks. For example, there are a large number of small-cap retail stocks that appear statistically undervalued at the moment, but the retail business model is facing secular headwinds via online competition. We own some retailers, but maintain a lower weight relative to the index than the valuations alone would suggest, due to the sector's uncertainty and challenges.

**Bob:** How do you manage trading liquidity in the small- and micro-cap end of the market?

**Judd:** Our Small Cap Diversified Value Fund benefits by holding a large number of stocks. We hold 350-400 stocks in our portfolio and the largest individual weight is capped at 0.4%. This allows us to continue to access the smaller end of the market-cap range, where the opportunities to find mispriced stocks are the greatest.

**Bob:** In which areas and sectors are you finding the most opportunities in today?

**Judd:** It's all based on where we are finding the most attractive individual stock opportunities. We don't set out to overweight or underweight a sector based on a top-down theme. With that said, we are currently finding the most opportunities in consumer discretionary, industrials and energy.

**Bob:** You have a large allocation to financials, specifically banks. What risks are posed by the flattening of the yield curve?

**Judd:** When the yield curve flattens due to rising short rates, banks will generally benefit. Large portions of the loans held on bank balance sheets pay interest rates that float with short rates. Longer duration fixed-interest loans tend to be sold off. So rising short rates increase banks' interest income and the value of the loan portfolio does not drop significantly. On the deposit side, the rates that banks must pay to attract deposits lags the increase in short rates and also increases slowly. This is because customer deposits are sticky - people tend to stay with the same bank rather than switch to save a few basis points. The overall effect as short rates rise is an increase in net-interest margin.

**Bob:** How do you think the growth of passive investment products

has affected active managers?

**Judd:** More and more of the trading volume for any particular stock is now done by passive investment strategies, which may be trading due to inflows and outflows without regard to valuation. Active managers who seek out mispriced stocks have become a smaller part of the market. This means that stocks can become more mispriced and remain mispriced for longer periods than when passive managers played a smaller role in the market. In the short run, this contributes to volatility. In the long run, this inefficiency creates greater opportunities for active managers, particularly valuation-based managers, to outperform.

**Bob:** What guidance would you offer to an advisor who is choosing between a low-cost ETF that tracks the small-cap-value index and an actively managed fund, such as yours?

**Judd:** Our view is there is more pricing inefficiency in the smaller market cap stocks and therefore more opportunity for active value managers to outperform the benchmark, as compared to large-cap stocks. We're biased, of course, but if you're only going to use active managers in select segments of the market, we think small-cap value should be one of those segments.

**Bob:** What role does the Hotchkis & Wiley Small Cap Diversified Value Fund typically play in clients' investment portfolios?

**Judd:** We aim to generate mid-term and long-term investment returns that exceed the Russell 2000 value index, while maintaining a consistent exposure to small-cap-value stocks. A number of advisors have found that our exposure to micro-cap stocks is unique and complementary to the rest of their equity allocation.

## Hotchkis & Wiley Small Cap Diversified Value Fund

### Average Annual Returns as of March 31, 2018

	1 Year	3 Year	Since 6/30/14
Class I Shares	12.34%	10.46%	9.35%
Russell 2000 Value Index <sup>®</sup>	5.13	7.87	6.81
Russell 2000 Index <sup>®</sup>	11.79	8.39	8.34

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).

The Advisor has contractually agreed to waive advisory fees and/or reimburse expenses through October 31, 2018 so the net expense ratio does not exceed 0.90% for I Shares. Over the past 12 months, the Fund invested in business development companies, which produced acquired fund fees and expenses ("AFFE") of 0.17%. The reported net expense ratio is the expense ratio cap plus AFFE, or 1.07% for I Shares. Net expense ratios were applicable to investors. The Fund's total annual operating gross expense ratio as of the most current prospectus is 1.87% for I Shares. Class I shares 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.

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.

Mutual fund investing involves risk. Principal loss is possible. 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. The Fund may invest in foreign securities which involve greater volatility and political, economic and currency risks and differences in accounting methods.

The Russell 2000<sup>®</sup> Value Index measures the performance of those Russell 2000<sup>®</sup> companies with lower price-to-book ratios and lower forecasted growth values. The Russell 2000<sup>®</sup> Index, an unmanaged index, measures the performance of the 2,000 smallest companies in the Russell 3000<sup>®</sup> Index. The Russell 2000<sup>®</sup> Growth Index measures the performance of those Russell 2000<sup>®</sup> Index companies higher price-to-book ratios and higher forecasted growth values. The indexes do not reflect the payment of transaction costs, fees and expenses associated with an investment in the Fund. It is not possible to invest directly in an index. The Fund's returns may not correlate with the returns of their benchmark index.

The Hotchkis and Wiley Small Cap Diversified Value Fund (HWVIX) received a 5-Star Overall Morningstar Rating among 348 Small Value Funds for the period ending 3/31/18 (derived from a weighted average of the Fund's three-, five- and ten-year risk adjusted return measure, if applicable). The Morningstar Rating<sup>™</sup> for funds, or "star rating", is calculated for managed products (including mutual funds, variable annuity and variable life subaccounts, exchange-traded funds, closed-end funds, and separate accounts) with at least a three-year history. Exchange-traded funds and open-ended mutual funds are considered a single population for comparative purposes. It is calculated based on a Morningstar Risk-Adjusted Return measure that accounts for variation in a managed product's monthly excess performance, placing more emphasis on downward variations and rewarding consistent performance. The top 10% of products in each product category receive 5 stars, the next 22.5% receive 4 stars, the next 35% receive 3 stars, the next 22.5% receive 2 stars, and the bottom 10% receive 1 star. The Overall Morningstar Rating<sup>™</sup> for a managed product is derived from a weighted average of the performance figures associated with its three-, five-, and 10-year (if applicable) Morningstar Rating<sup>™</sup> metrics. The weights are: 100% three-year rating for 36-59 months of total returns, 60% five-year rating/40% three-year rating for 60-119 months of total returns, and 50% 10-year rating/30% five-year rating/20% three-year rating for 120 or more months of total returns. While the 10-year overall star rating formula seems to give the most weight to the 10-year period, the most recent three-year period actually has the greatest impact because it is included in all three rating periods. HWVIX received 5 stars for the three-year time period ended 3/31/18 among 348 Small Value Funds, respectively. Ratings for other share classes may vary.

Morningstar Rankings represent a fund's total-return percentile rank relative to all funds that have the same Morningstar Category. The highest percentile rank is 1 and the lowest is 100. It is based on Morningstar total return, which includes both income and capital gains or losses and is not adjusted for sales charges or redemption fees. Morningstar ranked the Hotchkis and Wiley Small Cap Diversified Value Fund Class I in the top 2% and 7% out of 406 and 348 Small Value Funds for the one- and three-year time periods ended 3/31/18, respectively. Ranking is for the share class indicated only. Other share classes will have different rankings. ©2018 Morningstar, Inc. All Rights Reserved. The information contained herein: (1) is proprietary to Morningstar; (2) may not be copied or distributed; and (3) is not warranted to be accurate, complete or timely. Neither Morningstar nor its content providers are responsible for any damages or losses arising from any use of this information. **Past performance is no guarantee of future results.**

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