

SMALL CAP DIVERSIFIED VALUE

MARKET COMMENTARY

The Russell 2000 Index returned +9.3% in the third quarter and is now up +11.2% since the beginning of the year. The most recent Consumer Price Index report provided further evidence that inflation is decreasing on a sustainable path. Moderate inflation combined with signs of labor market softness prompted the FOMC to cut the Fed Funds rate by 50 basis points to 5.0% (upper bound). While the cut was mostly anticipated, the Fed's outlook and comments reinforced the view of further rate cuts, and equity markets reacted positively. Small caps outperformed large caps in the quarter, narrowing large cap's significant advantage year-to-date (+22.1% vs. +11.2%). Small value outperformed small growth in the quarter (+10.2% vs. +8.4%), though growth maintains its edge year-to-date (+13.2% vs. +9.2%). The energy sector declined amid the drop in crude oil prices, while all other small cap sectors were positive.

Increased expectations for lower interest rates in the future, a notion reinforced by the Fed's actions and comments, helped small caps disproportionately. On average, small cap companies have more debt than large caps, and a larger portion of their debt is rate sensitive. We parsed the small cap market by financial leverage and found a meaningful correlation between 3Q performance and debt levels—companies with high leverage outperformed those with low leverage. We are habitually underweight the former, and find it difficult to keep pace with the benchmark in such environments. We can accept such volatility because we have historically benefited from periods where investors exercise greater discernment for competitively differentiated companies that are financially responsible and well managed—a recipe that has worked over the long term.

Notwithstanding small caps outperformance in the quarter, the Russell 2000's three-year return is +1.8% per annum compared to +11.9% for the S&P 500 (+6% and +40% unannualized, respectively). Over the past ten years, the small cap index is up 8.8%/year compared to +13.4%/year for large caps (+132% and +251% unannualized, respectively). The resulting valuation gap between large

caps and small caps is quite striking. Dating back to 1979, small caps and large caps have traded at the same P/E level on average. Today, however, small caps P/E is about 75% that of large caps, a discount only before encountered during the dot.com bubble.

While we view the broad market as richly valued, small value stocks trade at a modest discount to historical averages. At 10x normal earnings, the portfolio's valuation/upside potential appears consistent with its long-term average, without assuming unnecessary risks. We are optimistic about the portfolio's prospects in the foreseeable future, particularly compared to other equity asset classes and passive alternatives.

ATTRIBUTION ANALYSIS – 3Q24

The Hotchkis & Wiley Small Cap Diversified Value portfolio underperformed the Russell 2000 Value Index in the third quarter of 2024 (gross and net of management fees). Index companies we generally view as risky—those with elevated financial leverage and/or those with little to no earnings—performed well in the quarter. Our significant underweight this group made keeping pace with the benchmark a formidable challenge. Our overweight position in smaller stocks, i.e., less than \$1B in market cap, also hurt relative performance, albeit modestly. We view this as somewhat surprising, considering anything perceived as higher risk/higher beta generally performed well, and as a group microcaps generally fit this description. Not owning Lumen Technologies, an index stock that returned +545% in the quarter, cost the portfolio about 50 basis points of relative performance. Negative stock selection in industrials, consumer staples, and consumer discretionary hurt, along with the underweight position in real estate. The overweight position and positive stock selection in financials helped in the quarter.

Net of fee composite performance as of 9/30/24: 18.98%, 11.09%, and 9.77% for 1-, 5-, and 10-year, respectively. Net performance results are presented after management fees and all trading expenses but before custodial fees. Additional disclosures provided in Endnotes.

Past performance is no guarantee of future results.



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Endnotes:

All investments contain risk and may lose value. This commentary is for general information only and should not be relied on for investment advice or recommendation of any particular security, strategy, or investment product.

Portfolio characteristics and attribution are based on a representative Small Cap Diversified Value portfolio. Attribution is an analysis of the portfolio's return relative to the index, is calculated using daily holdings information and does not reflect management fees and other transaction costs and expenses; interaction effect is combined with stock selection. Returns can differ from certain client portfolio(s) due to data differences, cash flows, trading, and other activity (data source: Bloomberg, Russell).

The value discipline used in managing accounts in the Small Cap Diversified Value strategy may prevent or limit investment in major stocks in the Russell 2000 Value Index and returns may not be correlated to the index. Composite performance is available at www.hwcm.com, located on the strategy's Performance tab along with important disclosures included in the strategy's [GIPS Report](#); quarterly characteristics and portfolio holdings are located on the Portfolio 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, contact H&W at hotchkisandwiley@hwcm.com. Portfolio information is subject to the firm's portfolio holdings disclosure policy.

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 Russell 2000[®] Growth Index measures the performance of those Russell 2000[®] Index companies with higher price-to-book ratios and higher forecasted growth values. The S&P 500[®] Index is a broad-based unmanaged index of 500 stocks, which is widely recognized as representative of the equity market in general.

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A value-oriented investment approach involves the risk that value stocks may remain undervalued or may not appreciate in value as anticipated. Value stocks can perform differently from the market as a whole or from other types of stocks and may be out of favor with investors and underperform growth stocks for varying periods of time. Investment risk disclosures for the firm's strategies are described in Part 2A of Form ADV of H&W.

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