

# SMALL CAP VALUE

## MARKET COMMENTARY

The Russell 2000 Index increased 5.2% in the first quarter of 2024. Small value stocks underperformed small growth stocks in the quarter (+2.9% vs. +7.6%). Performance was mixed across the Russell 2000 GICs sectors in the quarter, with the information technology, energy, industrials, and consumer discretionary sectors performing best. Communication services, utilities, real estate and financials declined slightly in the quarter.

Despite a respectable return in the first quarter of 2024, small-cap stocks underperformed their larger counterparts by a wide margin. The Russell 1000 Index returned +10.3%, while the Russell 2000 Index returned +5.2%, largely on the back of a few mega cap companies that exhibited robust earnings. We believe the recent performance disparity has created a compelling opportunity for small-cap investors. Since the end of 2005, the average forward price-to-earnings ratio (P/E) of the Russell 1000 Index is 15.5x. The forward P/E of the large-cap index was 19.2x at the end of Q1. By comparison, the forward P/E of the Russell 2000 at the end of the quarter was 20.9x, just above its average P/E of 19.3x since 2005. The Russell 2000 Value Index, where our expertise lies, trades at a more respectable P/E of 15.2x, which is below its longer-term average of 16.7x.

Much of the market action in Q1 hinged on released economic data and expectations for interest rate cuts by the Federal Reserve (Fed). Economic data in the U.S. has been resilient, leading to the timing of interest rate cuts being pushed further into 2024. Concern about the increasing cost of capital, which is the rate used to discount future cash flows, weighed disproportionately on smaller companies. In our view, this concern appears to be an overreaction, as the market has unfairly mispriced many companies in the cyclical sectors in which we invest.

It's worth noting that information technology represents the portfolio's largest overweight relative to the index. In tech, we do own some quality businesses, and we are willing to pay higher valuation multiples accordingly. Common traits among our tech holdings are strong balance sheets, sticky

customers that generate recurring/predictable cash flow, and promising prospects for growth. We view these businesses as less cyclical than generally understood and offer attractive diversification to complement other cyclical positions.

We continue to view the current economic backdrop as particularly compelling for high quality small cap companies, which we define as companies that are able to sustain high returns relative to cost of capital, grow faster than the economy, appropriately leveraged, and adhere to good governance. These traits do not always apply to a passive index fund such as the Russell 2000 Index where many companies are unprofitable and/or exhibit a high degree of financial leverage. With a resilient economy, moderating inflation, the potential for interest rate cuts by the Fed later this year, and continued government investment (the Bipartisan Infrastructure Law and CHIPS Act), we believe smaller companies may be poised for a sustained period of strong performance on both an absolute and relative basis.

## ATTRIBUTION ANALYSIS – 1Q24

The Hotchkis & Wiley Small Cap Value portfolio outperformed the Russell 2000 Value Index in the first quarter of 2024 (gross and net of management fees). Stock selection in the financials sector was robust in the quarter, with many of our holdings performing quite well across sub-industries. Stock selection in industrials and information technology also contributed to outperformance, as did the underweight in real estate and overweight in energy. Conversely, stock selection in consumer discretionary was challenging in the quarter. The underweight in healthcare (lack of exposure to biotechnology), stock selection in energy, and overweight in communication services also detracted.

Net of fee composite performance as of 3/31/24: 22.41%, 13.29%, and 8.97% for 1-, 5-, and 10-year, respectively. Net performance results are presented after management fees and all trading expenses but before custodial fees. Past performance is no guarantee of future results.



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**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 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.

The value discipline used in managing accounts in the Small Cap Value strategy may prevent or limit investment in major stocks in the Russell 2000, Russell 2000 Value and Russell 2000 Growth and returns may not be correlated to the indexes. Composite performance is available at [www.hwcm.com](http://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](mailto: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.

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**Style Risk:** 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.

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Past performance is no guarantee of future results

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