# SMALL CAP DIVERSIFIED VALUE FUND

**3Q23 MANAGER REVIEW & ECONOMIC OUTLOOK**

HWVIX | HWVAX | HWVZX

## PERFORMANCE (%) as of September 30, 2023

| | QTR | YTD | 1 Yr | 3 Yr | 5 Yr | Since 6/30/14 |
|---|---|---|---|---|---|---|
| Small Cap Diversified Value Fund – I Shares | -1.96 | 2.21 | 16.43 | 21.21 | 4.97 | 7.47 |
| Russell 2000 Value | -2.96 | -0.53 | 7.84 | 13.32 | 2.59 | 5.22 |

*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.*

The Fund's total annual operating gross expense ratio as of the most current prospectus is 0.87% for I Shares; 0.80% net expense ratio. The Advisor has contractually agreed to waive advisory fees and/or reimburse expenses through August 29, 2024. Expense ratio shown is gross of any fee waivers or expense reimbursements. 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.

## MARKET COMMENTARY

The Russell 2000 Index declined -5.1% in the third quarter and is now up just +2.5% since the beginning of the year. The Russell 2000 Value Index declined less than the Russell 2000 Growth Index in the quarter (-3.0% vs. -7.3%), though small growth remains ahead year-to-date (+5.2% vs. -0.6%). Nine of the eleven Russell 2000 GICS sectors declined in the quarter, with energy and financials the exceptions. Energy was the top performing sector, returning +18.6% for the quarter, while financials returned +1.2%. Healthcare and utilities were the worst performing sectors, declining -15.1% and -11.8%, respectively.

The FOMC raised the Federal Funds target rate another 25 basis points in its July meeting to 5.5% (upper bound), its highest level in more than 20 years. Treasury yields rose accordingly, especially on the long end of the curve, which flattened the still-inverted yield curve. Historically, inverted yield curves have been efficacious harbingers for recessions, but the strong labor market is a conflicting signal. Should a recession transpire, we view a mild/modest slowdown as most likely considering fewer excesses in the system and conservative balance sheets for businesses and consumers alike. Nonetheless, we focus on companies with resilient businesses, financial strength, and prudent management because these factors function as effective defenses in recessionary periods. Our proprietary Fundamental Risk Ratings are designed to measure and manage these factors. We do not necessarily expect to benefit from this part of our investment process during times of market exuberance, but rather during times of market stress.

The performance difference between value and growth in 2023 has been puzzling. In calendar year 2022, interest rates rose and the equity market sold off, which is intuitive because higher rates are generally bad for equities as the cost of capital increases. Small growth stocks sold off significantly more than small value stocks, which is also logical for two primary reasons. First, growth stocks are longer duration securities and thus should be more sensitive changes in interest rates. Second, financials comprise much larger portions of small cap value portfolios and represent the one segment of the market that stands to benefit from higher interest rates. In calendar year 2023, interest rates have continued to rise in a meaningful way, yet the Russell 2000 Growth is up +5.2% compared to the Russell 2000 Value at -0.5%. At the beginning of the year, the price-to-earnings ratio[1] of the growth index was about 8 multiple points higher than the value index. Today, it is 10.6 multiple points higher—the growth multiple has expanded while the value multiple contracted. Current valuation spreads are difficult to justify, and we believe they are unlikely to persist. A reversion toward more normal valuation relationships would benefit value relative to growth and be highly conductive to our value-focused approach.

Financials, a prototypical value sector, represents the portfolio's largest exposure. The portfolio is well-diversified across banks, capital markets, and insurance companies. Our investment thesis remains largely unchanged. Financials, particularly banks, trade at a larger-than-normal discount to the market—near record levels, in fact. Since pre-COVID, bank earnings have increased, albeit slightly, but the price multiples have cratered by more than 30%. Notwithstanding economic and regulatory risks, at high single-digit multiples of earnings and discounts to book value, we view the upside potential as attractive. Alternatively, we find fewer attractive valuation opportunities in small cap real estate and healthcare.

*(continued)*

[1]Source: Bloomberg - all numbers reflect price-to-FY2 consensus earnings

## ATTRIBUTION ANALYSIS

The Hotchkis & Wiley Small Cap Diversified Value Fund outperformed the Russell 2000 Value Index in the third quarter of 2023. The largest positive contributor to relative performance came from the underweight in healthcare—the market's worst-performing sector. The overweight position in financials also helped relative performance, as did stock selection in consumer discretionary and energy. The overweight in technology detracted from relative performance during the quarter. Stock selection in materials and consumer staples also detracted modestly.

*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. Read carefully before you invest.*

*Investing in smaller and/or newer companies involves greater risks than those associated with investing in larger companies. Please read the fund prospectus for a full list of fund risks.* All investments contain risk and may lose value. Equities, bonds, and other asset classes have different risk profiles, which should be considered when investing.

Fund holdings and/or sector allocations are subject to change and are not buy/sell recommendations. Current and future portfolio holdings are subject to risk. Attribution is an analysis of the portfolio's return relative to a selected benchmark, is calculated using daily holdings information and does not reflect the payment of transaction costs, fees and expenses of the Fund. Certain information presented based on proprietary or third-party estimates are subject to change and cannot be guaranteed. Information obtained from independent sources is considered reliable, but H&W cannot guarantee its accuracy or completeness.



**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 indices 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. **Yield curve** plots interest rates of bonds of equal credit and different maturities.

**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.

**Market Disruption**: The global coronavirus pandemic has caused disruption in the global economy and extreme fluctuations in global capital and financial markets. H&W is unable to predict the impact caused by coronavirus pandemic, which has the potential to negatively impact the firm's investment strategies and investment opportunities.