GLOBAL VALUE

MARKET COMMENTARY

The MSCI World Index returned +7.9% in the third quarter of 2020 and is now in positive territory year-to-date (+1.7%). More than 60% of MSCI World companies beat consensus revenue expectations and nearly 75% exceeded earnings expectations. A strong corporate showing trumped continued worries about the prevalence of COVID-19. Meanwhile, the largest central banks continue to signal easy monetary policy for the foreseeable future, maintaining a subdued economic outlook. COVID-19 cases reaccelerated for the first time in months, but hospitalizations and deaths remained downward trending—there was a large jump in tests administered which could explain the mixed developments.

Growth outperformed value across geographies and across market capitalizations. Based on information from the Kenneth French/Dartmouth data library, value has underperformed growth over the last 10 years by the largest magnitude on record. Also, for the first time in the nearly 100-year old dataset, growth has outperformed value over a 20-year period. This has led to a colossal divergence in valuations. Apple, for example, is a very good business, with a great balance sheet, an iconic brand, and a loyal customer base. For *half* the price of Apple, however, you could buy *all* 18 banks in the S&P 500. The bank group (again, at half the price) generated more than twice the revenue and twice the earnings of Apple. For the price of Tesla, you could buy the next four largest global auto manufacturers and have money left over. Tesla generated revenue last year of $25 billion and the other four autos generated revenue of $743 billion; Tesla's earnings were negative while the other four autos generated $38 billion in earnings. $38 billion in *earnings* compared to $25 billion in *revenue* seems like a better option at the same price, let alone a discount (all numbers were quoted in US Dollars).

Perhaps more important to our client base than the value-growth dichotomy is the equally noteworthy divergence within value, both in terms of trailing performance and future opportunity. The strongest performers within global value have been concentrated in market segments with low correlations to economic growth, like healthcare and consumer staples. The weakest performers within value have been concentrated in market segments where near-term forward earnings estimates have declined meaningfully, in some cases by 30% or more. Financials, energy, and cyclical industrials comprise a disproportionate share of these examples. The positions we have in these areas have underperformed, though we view the forthcoming earnings declines as temporary. A year or two of depressed earnings reduces our intrinsic value estimate, but this impairment of value is certainly not commensurate with actual share price declines. We are unwilling to take meaningful balance sheet risk because a weak balance sheet can significantly impair capital via shareholder dilution or worse. This steadfast risk aversion allows us to tolerate temporary earnings volatility and take advantage when market values decline more than intrinsic values. We remain selective, however, and recognize that certain market segments and/or individual companies may not recover—we look to avoid businesses with uncertain long-term outlooks or insurmountable secular pressures.

Financials represent the portfolio's largest absolute weight, largest relative weight, and largest detractor to relative performance. Banks represent the portfolio's largest exposure within financials. Earnings estimates have declined due to the combination of increased loan loss provisions, a ban on share repurchases, slower asset growth, and lower interest rates. Accounting rules typically require banks to estimate loan losses upfront based on prevailing economic conditions. The substantial provisions taken during the first half of 2020 could end up being too high considering the severity of the economic outlook at the time. Banks' balance sheets were quite healthy entering 2020, as substantial capital had been built in the previous decade. The provisions already taken combined with the excess capital—not to mention the pre-provision income being generated—provides a meaningful cushion to absorb elevated credit losses. Further, banks' business models are less interest rate sensitive than generally believed. The large money center banks have diverse revenue streams, some of which have little/no interest rate sensitivity. For less-diversified banks, the net interest margin is more closely tied to the yield spread earned on loans than it is from the rate sensitive benefit they get from funding a portion of their earning assets with non-interest bearing liabilities. The banks' benefit of free funding dissipates as rates decline, but the yield spread on loans exhibits countercyclical traits (i.e. the yield spread often widens when rates decline as banks tighten lending standards). This has resulted in relatively stable net interest margins over the past decade despite persistently falling interest rates over that period.

The dichotomy between growth and value is significant and pervasive, but so too are the opportunities within global value. The portfolio's valuation discount to the benchmark is near record levels, reflecting our view that select opportunities are exceptionally attractive. The recent environment has not been conducive to our approach, but we are confident that patient investors will be rewarded by the rarely observed risk-adjusted potential of the current portfolio.

ATTRIBUTION – 3Q20

The Hotchkis & Wiley Global Value portfolio (gross and net of management fees) underperformed the MSCI World Index in the third quarter of 2020. The portfolio's value-focused approach hurt relative performance as the most deeply discounted stocks underperformed. For example, index stocks trading at a discount to book value lagged the overall index by about 12 percentage points in the quarter; the portfolio had about 40% of the portfolio invested in such stocks compared to just 10% for the MSCI World Index. The overweight position and stock selection in both financials and energy, along with stock selection in consumer discretionary detracted from performance. The overweight position in industrials along with stock selection in real estate helped relative performance. The largest detractors to relative performance in the quarter were AIG, General Electric, National Oilwell Varco, Vodafone, and Citigroup; the largest positive contributors were Royal Mail, News Corp, Corning, TE Connectivity, and Navistar International.

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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 data differences, cash flows, trading, and other activity. Portfolio characteristics and attribution based on representative Global 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 holdings 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 MSCI World Index. Other securities may have been the best and worst performers on an absolute basis. The "Largest New Purchases" section includes the three largest new security positions during the quarter/year based on the security's quarter/year-end weight adjusted for its relative return contribution; does not include any security received as a result of a corporate action; if fewer than three new security positions during the quarter/year, all new security positions are included. 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. The value discipline used in managing accounts in the Global Value strategy may prevent or limit investment in major stocks in the MSCI World and returns may not be correlated to the index.

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. MSCI makes no express or implied warranties or representations and shall have no liability whatsoever with respect to any MSCI data contained herein. The MSCI data may not be further redistributed or used as a basis for other indices or any securities or financial products. This report is not approved, reviewed, or produced by MSCI. See www.hwcm.com / *Index definitions* for full disclaimer.

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. Growth investing tends to work well during speculative, momentum-driven markets, while value investing tends to work well following recessionary periods. Past recessions and recoveries cannot predict future performance due to different factors and circumstances, including differences in US and international financial markets. Companies identified are for illustrative purposes and should not be considered investment advice.

Market Disruption: The recent global coronavirus pandemic has caused and continues to cause disruption in the global economy, unprecedented business and travel disruption and extreme fluctuations in global capital and financial markets. H&W is unable to predict the consequences of the upheaval caused by coronavirus pandemic, which, depending on the severity and the length of the outbreak, has the potential to negatively impact the firm's investment strategies and reduce available investment opportunities.

All investments contain risk and may lose value. 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 September 30, 2020 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. The strategy invests in foreign securities which involve greater volatility and political, economic and currency risks and differences in accounting methods. Past performance is no guarantee of future results.