INTERNATIONAL SMALL CAP DIVERSIFIED VALUE

MARKET COMMENTARY

In calendar year 2022, the global economy and capital markets experienced numerous milestones that had not been observed for quite some time. Despite returning +15.2% in the fourth quarter, the MSCI World ex-USA Small Cap Index declined -20.6% over the full year, its worst annual performance since 2011. Value stocks declined but held up much better than growth stocks. The MSCI World ex-USA Small Cap Value Index declined -14.0% compared to the MSCI World ex-USA Small Cap Growth's -27.0% decline. Considering value's significant outperformance in periods of elevated/rising inflation and interest rates, and its outperformance coming out of economic slowdowns, we are optimistic that value's outperformance can persist.

Forecasting economic growth and/or predicting recessions is not our expertise. We do, however, fully acknowledge current warnings signs, e.g., continued central bank tightening and inverted yield curves. Two things providing solace in the event of an economic slowdown are modest financial leverage and attractive valuations. There are fewer excesses in the system compared to prior recessionary periods like 2008. Unlike then, balance sheets of both consumers and financial institutions are quite strong today. Further, equity valuations are reasonable, and in select market segments, unusually attractive. A strong argument could be made that a recession is already priced into equity markets, at least in certain market segments, which is different compared to recessionary periods like 2002. While several signs point to an economic slowdown, several others suggest that the severity would be manageable and/or much of the pain has already been felt.

The MSCI World ex-USA Small Cap Energy sector returned +27% in 2022, the best-performing sector by substantial margin. All other MSCI World ex-USA Small Cap sectors were negative for the year. Crude oil is a depleting resource/commodity. Put simply, when oil is extracted from a well, that well now contains less oil, and what remains is increasingly difficult to extract. As a result, wells produce less oil as they age, the pace of which is called its *decline rate*. To maintain flat production, therefore, companies must invest considerable sums in new projects to replace these wells' declining production. To *increase* production, these investments need to be substantial. In recent years, however, energy companies have spent unusually little on new production, instead using cash flows to pay down debt and/or return to shareholders. Our view has been, and continues to be, that this lack of investment will create a situation where supply, i.e., production, is unable to keep pace with global demand. This imbalance keeps the price of oil elevated and facilitates strong free cash flows for energy companies. Much of the cash flow is earmarked for share repurchases, which is accretive to earnings per share. Capital expenditures, i.e., new investments, have increased recently, but it takes a long time for such investments to result in actual production. Thus, this imbalance could persist for some time. Meanwhile, energy stocks' valuations remain compelling even after the impressive performance because they are coming from such a low base. Free cash flow yields are well into the teens, hence our continued overweight.

Financials represents the portfolio's largest absolute weight and relative weight to the index. Our thesis on Financials is straightforward—it is the most attractively valued sector in the portfolio. The sector trades at notable discounts to other parts of the market and relative to its own history, despite balance sheets that are well positioned to withstand a potential economic slowdown.

ATTRIBUTION – 4Q22 & 2022

The Hotchkis & Wiley International Small Cap Diversified Value portfolio (gross and net of management fees) outperformed the MSCI World ex-USA Small Cap Index in the fourth quarter of 2022. The overweight in Financials, along with stock selection in Consumer Discretionary, Industrials, and Energy resulted in the bulk of the performance advantage. The underweight in Real Estate also helped. Stock selection in Consumer Staples and Materials modestly detracted during the quarter.

The portfolio significantly outperformed the benchmark over calendar year 2022 (gross and net of management fees). Stock selection was positive in 10 of the 11 GICS sectors, with stock selection strongest in Information Technology, Industrials, Consumer Discretionary, and Financials. The overweight positions in Financials and Energy also worked well. Conversely, stock selection and the underweight in Utilities modestly detracted from relative performance in 2022.

Past performance is no guarantee of future results

INTERNATIONAL SMALL CAP DIVERSIFIED VALUE

Portfolio characteristics and attribution based on representative International Small Cap Diversified 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. Performance 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. 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 International Small Cap Diversified Value strategy may prevent or limit investment in major stocks in the MSCI World ex-USA Small Cap, MSCI World ex-USA Small Cap Value and MSCI World ex-USA Small Cap Growth and returns may not be correlated to the indexes. Index returns include reinvestment of dividends, net foreign withholding taxes. Quarterly characteristics and portfolio holdings are available at www.hwcm.com, located on the strategy's 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.

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. 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 strategy invests in foreign securities which involve greater volatility and political, economic and currency risks and differences in accounting methods.

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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.

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.

Portfolio managers' opinions and data included in this commentary are as of December 31, 2022, and subject to change without notice. Information based on forecasts, proprietary or third-party estimates cannot be guaranteed and are subject to change. Information obtained from independent sources is considered reliable, but H&W cannot guarantee its accuracy or completeness.

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