LARGE CAP FUNDAMENTAL VALUE

MARKET COMMENTARY

The S&P 500 Index declined -16.1% in the second quarter and is now down -20.0% year-to-date. Several economic developments in the quarter sparked fears of a recession. Real GDP was -1.6% quarter-over-quarter (1Q), the war in Ukraine showed little signs of abating, the Consumer Price Index increased 8.6% year-over-year, and an increasingly hawkish FOMC raised the Fed Funds rate by 125 basis points via two hikes (from 0.5% to 1.75%). The Fed signaled further rate increases going forward to combat the highest inflation level in more than 40 years. The futures market implies that investors expect the Fed Funds rate to exceed 3% by year end with more rate hikes expected in 2023. Higher rates are generally bad for equities. It becomes more costly to borrow, increasing the cost of capital, which is the rate used to discount future cash flows. Higher rates impair long-duration equities disproportionately because most of the intrinsic value is derived from a terminal value estimate far into the future. In general, growth stocks are longer duration securities than value stocks. Unsurprisingly, value has outperformed growth in periods of elevated inflation and interest rates historically.

Value held up better than growth in the quarter. Energy and the three least economically sensitive sectors—consumer staples, utilities, and health care—each declined about -5% in the quarter. These sectors comprise a considerably larger portion of the value index. All other sectors declined -15% or more, with consumer discretionary (-26%), communication services (-21%) and technology (-20%) the worst performers. The Russell 1000 Growth's combined weight in these three sectors averaged more than 73% in the quarter, highlighting the index's unusual concentration the likes of which we have not observed since the tech bubble.

The portfolio's largest sector weights relative to the Russell 1000 Value Index are technology, energy, and financials. Within technology, the portfolio's largest exposure is software. While these stocks are not inexpensive on typical valuation metrics like P/E, EV/EBIT, P/B, etc., they represent fantastic businesses that trade at large discounts to our estimate of intrinsic value. Common traits among our positions are high returns on capital, captive customer bases, good balance sheets, and a substantial return of capital to shareholders. The stocks also trade at large discounts to other parts of the market generally viewed as high quality businesses, e.g., consumer staples, though with superior growth prospects.

Within energy, valuations remain uncommonly attractive despite the sector's significant outperformance recently, because valuations are coming off such a low base. Higher commodity prices have translated into strong free cash flow. Historically, elevated cash flows in energy were routinely used to reinvest in new exploration projects. Recently, however, cash has been used to pay down considerable amounts of debt, de-risking the sector significantly. Dividends and share repurchases have also ramped up meaningfully. With balance sheets improved and cash flow still strong, we expect share repurchases to increase even further going forward—an accretive use of capital considering the still attractive valuations. Additionally, energy has been the best inflation hedge of all sectors dating back to the 1970s.

At just over 25%, financials represent the portfolio's largest weight. At just over 10%, banks represent the largest exposure within financials. As a group, the portfolio's banks trade at about 5x our estimate of normal earnings, a 20% earnings yield, which is the most attractively valued part of the portfolio. The group trades at 0.6x book value and has a dividend yield and payout yield substantially higher than the benchmark. The attractive valuations reflect the market's recession worries and the credit losses that typically coincide with economic slowdowns. Yet the capital position in the industry is such that even severe regulatory stress tests (most recently in June) are passed largely without comment. Banks also experience an earnings benefit should interest rates continue to climb—financials have been the best interest rate hedge of all sectors dating back to the 1970s.

The portfolio contains a mix of great businesses with attractive valuations and good businesses with extremely attractive valuations. At 8.3x normal earnings, the portfolio trades below its long-term average (9.0x). This represents a larger-than-normal discount to the index, which trades at a modest premium to its long-term average (15.0x current vs. 13.5x long-term average). Value continues to trade at a large discount to growth, despite its recent outperformance. We view a reversion toward a more normal valuation relationship as more likely than not, which would represent a conducive environment for our long-term fundamental value approach.

ATTRIBUTION – 2Q22

The Hotchkis & Wiley Large Cap Fundamental Value portfolio (gross and net of management fees) underperformed the Russell 1000 Value Index in the second quarter of 2022 but remains ahead of the benchmark since the beginning of the year. In the quarter, the portfolio's underweight exposure to non-cyclical sectors health care, consumer staples, and utilities hurt relative performance as these sectors declined less than the rest of the market. Stock selection in communication services, energy, and consumer discretionary also hurt. Positive stock selection in financials and the overweight position in energy helped performance in the quarter. The largest detractors to relative performance in the quarter were General Electric, Warner Bros. Discovery, F5 Inc., General Motors, and State Street. The largest positive contributors were FedEx, Berkshire Hathaway, Elevance Health (formerly Anthem), Marathon Oil, and Suncor Energy.

LARGEST NEW PURCHASES – 2Q22

Alphabet Inc. is a holding company whose primary subsidiary is Google. Google is the largest media company in the world with about twice the ad revenue as the second largest media company (Facebook). Alphabet's other businesses are its enterprise services, which include the third-largest Cloud platform and a large knowledge worker software business (Workspace), and venture stage companies collectively reported as "Other Bets". Excluding losses in Cloud and Other Bets, Google's current valuation at 16.5x our view of normal earnings is nearly no premium to the market multiple in spite of much better growth prospects, an overcapitalized balance sheet, and significant value in Cloud, Other Bets, & new advertising products.

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Olin Corp. is the largest global producer of chlor alkali chemicals and chlorine derivatives. Olin was incorporated in 1892 and is headquartered in Virginia. In a healthy GDP scenario, Olin's earnings should remain elevated, particularly with structural changes to chlorine pricing and recent cost-cutting efforts. Olin trades at a significant discount to our assessment of normal earnings, has a strong balance sheet, and the business is diversifying to our existing commodity exposure.

Stanley Black & Decker Inc. (SWK) is a leading manufacturer of consumer and professional hand tools and power tools, as well as fasteners and fittings for the automotive, industrial, infrastructure and oil & gas end-markets. SWK has significantly lagged the market since December 2019, as concerns about market share loss, interest rates, inflation and a consumer slowdown has hurt sentiment. We believe that market share loss concerns are overblown, as SWK has, in fact, maintained market share, and that SWK is less exposed to consumer spending than the market believes. In addition, SWK should be able to grow at an above GDP pace over the long term, due to its exposure to the faster growing corded and gas-powered equipment markets and should benefit from industry consolidation as large tools manufacturers take share from smaller ones. SWK has historically compounded earnings at an ~11% rate over the last 20 years, offers an above average dividend yield, and has performed well in previous recessions. SWK currently trades at ~10x our estimate of normal.

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 Large Cap Fundamental 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. Specific securities identified are the largest contributors (or detractors) to the portfolio's performance relative to the index. Other securities may have been the best and worst performers on an absolute basis.

The value discipline used in managing accounts in the Large Cap Fundamental Value strategy may prevent or limit investment in major stocks in the S&P 500, Russell 1000 Value and Russell 1000 Growth and returns may not be correlated to the indexes. 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.

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. The largest new purchases are as of the publication date but may be sold and no longer held in the Large Cap Fundamental Value strategy at any time, for any reason, without notice, subsequent to the publication date. The securities reflected herein are intended to be for illustrative purposes only and are not intended to be, and should not be construed as, investment recommendations or investment advice. Past performance of these securities, or any other investments, is not an indicator of future results. H&W's opinions regarding these securities are subject to change at any time, for any reason, without notice. No assurance is made that any securities identified, or all investment decisions by H&W were or will be profitable.

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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.

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Past performance is no guarantee of future results.