MID-CAP VALUE

MARKET COMMENTARY

The Russell Midcap Index rose +7.5%, closing the second quarter of 2021 near an all-time high. It is up +16.3% since the beginning of the year. While the threat of new COVID variants persists, vaccination levels increased and new cases slowed. Consequently, state and local governments continued to ease closures/restrictions spurring renewed economic activity. Manufacturing rose and labor markets improved, highlighting the potential for tight supply conditions. Consumer prices rose 5% year over year, the fastest level in more than a decade. In response, Fed Chairman Powell reiterated his view that inflationary pressures would be transitory. WTI crude oil touched $74/barrel, its highest level in more than two years. Corporate earnings continued to show strength, with 82% of Russell Midcap companies outperforming consensus expectations.

The Russell Midcap Growth Index outperformed the Russell Midcap Value Index (+11.1% vs. +5.7%) in the second quarter. Even so, the value index has outperformed by more than 12 percentage points over the past 9 months (+43.8% vs. +31.5%). According to data from the Ken French/Dartmouth library, which dates to 1926, the average value-led market[1] has lasted for 33 months and outperformed growth by an average of 55 percentage points. The duration and magnitude of the current rally is far short of that. Nearly all prolonged value-led markets, however, contain stints when growth outperforms value. In perhaps the strongest value rally ever, for example, value outperformed growth by 147 percentage points from March 2000 through December 2006. However, growth outperformed value in nearly one-third of those months (24 out of 82 months). Like that value run, we came from extreme valuation spreads in mid/late 2020 and continue to observe spreads that are considerably wider than average. This gives us confidence that value's advantage this time will persist in a powerful way, for a prolonged period, or both.

Interest rates fell during the quarter, particularly for long-dated bonds (the yield curve flattened). The 10-year treasury note declined from 1.74% to 1.47% over the quarter. Energy was the top-performing mid cap sector, rising by more than +15% as WTI crude prices advanced 24%. Healthcare and real estate (the latter often trades inversely to interest rates) were next best, both returning more than +10%. Utilities was the only mid cap sector that declined in the quarter, though consumer staples, consumer discretionary, and industrials also lagged.

As measured by any common valuation metric, the spread between value and growth stocks is wide. So too is the spread between the portfolio and the value benchmark, which means the spread between the portfolio and either the core or growth index is extreme. We believe this bodes well going forward as value relationships normalize. We continue to focus on companies trading at large discounts to intrinsic value but that have strong balance sheets, quality businesses, and employ appropriate corporate governance—a combination that we believe should continue to benefit our clients.

ATTRIBUTION – 2Q21

The Hotchkis & Wiley Mid-Cap Value portfolio (gross and net of management fees) underperformed the Russell Midcap Value Index in the second quarter. Stock selection in financials, industrials, and technology detracted from performance, along with the underweight position in real estate. The overweight allocation to energy and positive stock selection in consumer discretionary helped. The largest individual detractors were Fluor, Cairn Energy, Discovery, F5 Networks, and Hewlett Packard Enterprise; the largest positive contributors were CommScope, Embraer, Bed Bath & Beyond, Royal Mail, and APA Corp.

LARGEST NEW PURCHASES – 2Q21

Credit Suisse Group presents an attractive valuation following large lapses in its risk management (e.g., exposure to Archegos). We expect that fixing its risk management process is well within its ability and doing so will have manageable cost and time commitments. While the potential for punitive regulatory actions and/or litigation exists, this is more than reflected in the current share price. While recent events are a blemish, the underlying franchise value remains intact; Credit Suisse is a high-quality business that should generate attractive returns on capital over time.

Huntsman is a chemicals and materials producer with a focus on polyurethanes. Huntsman has recently sold much of its disparate commodity chemicals portfolio at attractive prices and has used the proceeds to reduce debt and invest downstream. The company's remaining businesses are exposed to end markets that grow faster than GDP with minimal incremental capital needs and produce earnings that should be steadier than in the past. It trades at an attractive valuation and is returning substantial capital to shareholders.

(continued)

[1] A value-led market is defined as one that outperforms growth by at least 10 percentage points.

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PACCAR is one of the world's largest manufacturer of light, medium, and heavy-duty trucks, marketed under the Peterbilt, Kenworth, DAF, and Leyland brands. In addition to industry-leading brands, it has a growing global presence, and strong returns on capital. Its normal earnings power is higher than pre-pandemic results because it has made investments in technology, brand, and capacity expansions in PACCAR's Engine and Parts operations. PACCAR has an unusually high variable cost structure in its North American truck manufacturing operations, and an overly conservative balance sheet. It is structured to weather whatever the pandemic does to the global truck industry. Finally, PACCAR maintains a disciplined strategy of returning capital to its shareholders.