MID-CAP VALUE

MARKET COMMENTARY

The Russell Midcap Index declined a modest -0.9% in the third quarter of 2021. The index reached an all-time high in early September, up more than +4% for the quarter, before declining throughout the remainder of the month. Economic developments over the quarter were mixed. Real GDP grew an impressive +6.7% in the most recent quarter (seasonally adjusted quarter-over-quarter). The positive momentum in labor markets slowed, however, as many businesses are contending with serious labor shortages. Business owners are hopeful that labor availability will improve due to the expiration of enhanced pandemic unemployment benefits in September, though higher wages and benefits appear likely. This fuels already-tight supply conditions and increases inflationary pressures. Inflation persisted above 5% (year-over-year), its highest level in well over a decade. The Fed voted to keep its target Fed Funds rate near zero until the economy approaches "maximum employment and inflation has risen to 2 percent and is on track to moderately exceed 2 percent for some time."[1] There have been some increasingly hawkish comments from FOMC members, with some suggesting that the economic recovery warrants tapering in the near term. The yield on the 10-year treasury note began and ended the quarter at about 1.5% but fell below 1.2% intra-quarter. Shorter and longer duration treasuries experienced similar moves during the quarter, i.e., there was little change to the yield curve.

Oil prices followed a curiously similar path to interest rates. WTI crude oil began the quarter at about $73/barrel, then declined to nearly $62/barrel intra-quarter, before reverting to $75/barrel by quarter end. Through July and August, the mid cap index was up more than +3% but the energy sector was down -9%. This reversed in September. All Russell Midcap sectors declined during September except energy, which was up more than 10% as crude prices rose. For the entire quarter, energy was about flat (+0.2%), which was slightly better than the overall index (-0.9%). Financials performed best, as banks, consumer finance, capital markets, and insurance all outperformed. Communication services and consumer staples were the largest mid cap laggards. Overall, Corporate America continues to perform well as more than 80% of Russell Midcap companies surpassed consensus earnings expectations in the quarter.

Growth outperformed (i.e., declined less than) value slightly. The Russell Midcap Growth Index declined -0.8% while the Russell Midcap Value Index declined -1.0%. In the recent past, COVID-19 developments appear to have dictated which investing style outperformed—positive developments have favored value, negative developments growth. At the beginning of the quarter, there were about 12,000 to 15,000 new confirmed cases per day[2]. As the Delta variant spread, this number increased to more than 150,000 by mid-September, before retreating to about 110,000 by quarter end. The performance difference between value and growth largely moved in tandem with COVID's progression. At the peak of new cases in mid-September, mid growth led mid value by more than 3 percentage points quarter-to-date. This gap narrowed almost entirely by September's end, as new cases subsided. We continue to focus on fundamentals and valuation because that is what drives stock prices in the long run; however, we believe the demise of the pandemic through improved inoculation, herd immunity, or both, could provide a welcomed catalyst for a prolonged value rally.

Dating back to 1926, the average value rally has lasted just shy of three years, with an average outperformance of 55 percentage points, cumulatively[3]. Some of the more powerful and long-lasting value rallies have persisted for 7 to 10 years, with value outperforming growth by well over 100 percentage points. The common trait among these most formidable value-led markets is that each came on the heels of a prolonged period of growth outperformance, and each began with wide valuation spreads. The similarities between today's environment and the early stages of those strong value rallies are palpable. Because the portfolio trades at a valuation discount to the Russell Midcap Value, we believe a value-led market would be highly conducive to our investment approach, even relative to the value benchmark. We continue to focus on companies that trade at significant discounts to intrinsic value, but also possess quality businesses, strong balance sheets, and prudent corporate governance.

ATTRIBUTION – 3Q21

The Hotchkis & Wiley Mid-Cap Value portfolio (gross and net of management fees) underperformed the Russell Midcap Value Index in the third quarter of 2021. Stock selection in consumer discretionary, technology and industrials detracted from performance, along with the underweight exposure to real estate. The overweight and stock selection in energy was a positive contributor, along with the overweight position in financials. The largest detractors to relative performance in the quarter were Royal Mail, ODP Corp., CommScope, Discovery, and Magna International; the largest positive contributors were Cairn Energy, AIG, Range Resources, Popular, and AMERCO.

[1] https://www.federalreserve.gov/monetarypolicy/files/monetary20210922a1.pdf
[2] 7-day moving averages
[3] Statistics in this paragraph reference data from the Kenneth French Dartmouth data library

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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 Mid-Cap 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. No assurance is made that any securities identified, or all investment decisions by H&W were or will be profitable.

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The value discipline used in managing accounts in the Mid-Cap Value strategy may prevent or limit investment in major stocks in the Russell Midcap, Russell Midcap Value and Russell Midcap 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. Investing in small and medium-sized companies involves greater risks than those associated with investing in large company stocks, such as business risk, significant stock price fluctuations and illiquidity.

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, 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 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.