MID-CAP VALUE

MARKET COMMENTARY

The Russell Midcap Index increased 9.2% in the fourth quarter of 2022. The Russell Midcap Value Index outperformed for the quarter, returning +10.5% vs. +6.9% for the Russell Midcap Growth Index.

In calendar year 2022, the economy and capital markets experienced numerous milestones that had not been observed for quite some time. The S&P 500 declined -18.1%. Since the Great Depression, only three years have been worse: 1974 (oil crisis), 2002 (tech bubble burst), and 2008 (financial crisis). Value stocks declined but held up much better than growth stocks. The Russell Midcap Value declined -12.0% compared to the Russell Midcap Growth's -26.7% decline. Considering the still wide valuation gap and value's significant outperformance in periods of elevated/rising inflation and interest rates, we are optimistic that value's outperformance can persist.

Inflation peaked midyear at 9.1%, the highest reading in more than 40 years[1]. To combat rising prices, the FOMC increased the Fed Funds rate by more than 400 basis points over the course 2022, from 0.25% to 4.5% (upper bounds). This was the largest rate hike in any calendar year since 1973, and the current 4.5% level is its highest in more than 15 years. Other interest rates followed suit. 10-year treasury yields peaked above 4% for the first time in more than a decade; 30-year mortgage rates peaked above 7% for the first time in more than 2 decades. Yields on corporate credit also increased significantly. The treasury yield curve remains significantly inverted, which has been a harbinger of recessions historically. The tight labor market exhibited strong contrasting signals, however, with the unemployment rate reaching a 50-year low. Expectations for future corporate earnings are roughly flat, thus the stock market's decline was entirely due to a compression in valuation multiples as opposed to an actual or expected decline in earnings.

Forecasting economic growth and/or predicting recessions is not our expertise. We do, however, fully acknowledge current warnings signs, e.g., continued Fed tightening and the yield curve. 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 S&P 500 Energy sector returned +65% in 2022, the best-performing sector by a substantial margin. The only other S&P 500 sector with a return above zero was Utilities, which was up about +2%. Crude oil is a depleting resource/commodity. Wells produce less oil as they age, the pace of which is called its *decline rate*. To maintain flat production, companies must invest considerable sums in new projects to offset declining production elsewhere. To *increase* production, these investments need to be substantial. In recent years, however, energy companies have spent considerably less on new production than they have historically, instead using cash flows to pay down debt and/or return capital to shareholders. Our view has been, and continues to be, that this lack of investment will create a situation where supply is unable to keep pace with global demand. This imbalance should keep the price of oil elevated and facilitates strong free cash flows for energy companies. Much of this cash flow is earmarked for share repurchases, which is accretive to earnings per share. Capital expenditures have increased recently but spending on long lead time projects appears insufficient to oversupply the market. 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 significant overweight.

Financials represents the portfolio's largest weight, and second largest overweight relative 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. Our positions are focused on companies with difficult-to-replicate franchises that should earn returns well above their cost of capital.

ATTRIBUTION – 4Q22 & 2022

The Hotchkis & Wiley Mid-Cap Value portfolio (gross and net of management fees). outperformed the Russell Midcap Value Index by a considerable margin in the fourth quarter of 2022. Stock selection in Industrials was particularly strong. Stock selection and the overweight in Energy, along with stock selection in Financials, Health Care, and Consumer Discretionary also contributed positively to performance. Stock selection in Consumer Staples and Utilities detracted from relative performance during the quarter, as did the underweights in Materials and Health Care. The largest positive contributors to relative performance in the quarter were Fluor Corp., APA Corp., Universal Health Services, Kosmos Energy, and AIG; the largest detractors were Popular, Warner Bros. Discovery, First Citizens Bancshares, Herbalife, and F5 Inc.

(continued)

[1]US CPI Urban Consumer year-over-year, not seasonally adjusted.

The portfolio also outperformed the benchmark by a wide margin over calendar year 2022 (gross and net of management fees). The overweight and stock selection in Energy contributed most to outperformance. Stock selection in Industrials and Financials also contributed positively. Stock selection and the underweight in Consumer Staples, Utilities, and Materials detracted for the year.

LARGEST NEW PURCHASES – 4Q22

No new purchases.

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. For the portfolio's total performance attribution, 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 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.

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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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