SMALL CAP DIVERSIFIED VALUE

MARKET COMMENTARY

The Russell 2000 Index declined -7.5% in the first quarter of 2022. The Russell 2000 Value Index declined a more modest -2.4% while the Russell 2000 Growth Index declined -12.6%. Nine of the eleven Russell 2000 GICS sectors declined in the quarter. Utilities was one exception, returning +3%. Energy was the other, returning an impressive +42%.

The Consumer Price Index reached 7.9% year-over-year, its highest level in 40 years, raising the threat of tightening monetary policy. Russia's invasion of Ukraine fueled inflation worries further. Sanctions and trade disruption create supply shocks, putting inflationary pressures on significant Russian exports like oil, natural gas, and metals—each experienced meaningful price increases in the period. WTI crude oil increased by 33%, finishing the quarter at $100/barrel; natural gas rose +51%, finishing the quarter at $5.64/MMBtu. Our view has been that the lack of investment in new energy projects/production would create an imbalance once demand recovered to pre-pandemic levels; the resulting supply shortage would put upward pressure on energy prices. While this continues to be our view, Russia's invasion of Ukraine has exacerbated the situation. Russia is the world's 11th largest economy, representing just 2% of global GDP. It is the world's largest exporter of natural gas; however, and the third largest exporter of crude oil. Russia provides more than 40% of Europe's natural gas and more than 25% of its oil. The rise in energy prices has increased energy companies' cash flows significantly. Many have used the cash to pay down debt, de-risking the sector extensively. Share repurchases have been another popular use of capital, which is accretive to shareholders because valuations remain compelling. M&A activity has also increased, which can also be positive for shareholders in the right situation, e.g., paying a good price, removing redundant costs. Each company is in a different situation but there are numerous opportunities for management teams to benefit shareholders. Consequently, energy remains a modest sector overweight in the portfolio notwithstanding the strong recent performance.

The number of job openings continues to hover around its highest level in at least 20 years, increasing the risk of further wage inflation. To combat these inflationary threats, the FOMC increased the Fed Funds rate by 0.25% and signaled more aggressive rate increases in the coming year. Higher interest rates are generally bad for equities because it increases the cost of capital and makes fixed income investments a more appealing alternative. It is typically less bad for value than growth for two primary reasons. First, financials represent the lone sector that benefits from rising rates (higher earnings), and financials comprise significantly larger portions of value portfolios/indexes. Second, value equities are shorter duration securities than growth equities. In a discounted cash flow analysis, the terminal value estimate represents the lion's share of a conventional growth stock's value, whereas a conventional value stock will generate meaningful cash flows sooner.

Despite value's recent outperformance, the valuation spread between growth and value remains wide because the spread at the period's outset was extreme. The Russell 2000 Value trades at 14x forward P/E (consensus FY1) compared to the Russell 2000 Growth at 44x. This equates to a gap of 30x, which is much wider than the historical median of 18x. The gap has been wider than current levels only 20% of the time dating back to the mid-1990s, using monthly data. At both a forward and normal P/E of 10x, the portfolio trades at an even larger discount. We believe these large spreads and the macroeconomic backdrop should continue to benefit value relative to growth, which should be a conducive environment for our investment approach.

ATTRIBUTION – 1Q22

The Hotchkis & Wiley Small Cap Diversified Value portfolio (gross and net of management fees) outperformed the Russell 2000 Value Index in the first quarter of 2022. The overweight position in energy, the best-performing sector by far, was a positive contributor to relative performance. The underweight position in healthcare, among the worst-performing sectors, also helped. Stock selection in financials and materials was also positive. The overweight position and stock selection in consumer discretionary detracted from performance. Stock selection in energy and industrials also hurt.

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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 Small Cap Diversified Value portfolio. Client portfolio holdings may vary due to different restrictions, cash flows, 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 holdings, or all investment decisions by H&W were or will be profitable.

The value discipline used in managing accounts in the Small Cap Diversified Value strategy may prevent or limit investment in major stocks in the Russell 2000, Russell 2000 Value and Russell 2000 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, please 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.

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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.