

SMALL CAP DIVERSIFIED VALUE

MARKET COMMENTARY

The Russell 2000 Index increased 2.7% in the first quarter of 2023, a welcomed rebound from last year's -20.4% decline. Inflation fears appear to have lessened as the CPI decelerated to 6% year-over-year, a far cry from its mid-2022 peak of more than 9%. The FOMC increased the Fed Funds rate twice during the quarter, both 25 basis point hikes. The important benchmark rate now stands at 5.0% (upper bound), the first time it has reached this level in more than 15 years. The market implied probability of another small rate hike at the next meeting is about 50/50.

After outperforming growth by 12% in 2022 (by declining less), small value underperformed small growth in the first quarter of 2023 by 6.7% (-0.7% vs. +6.0%). The Russell 2000 technology sector was up about 14% in the quarter. Technology comprises a much larger portion of the Russell 2000 Growth than the Russell 2000 Value (18% vs. 6%). Conversely, the financials sector declined -9%. This sector comprises a much larger portion of the Russell 2000 Value than the Russell 2000 Growth (26% vs. 7%). As a result, value spreads widened over the course of the quarter.

We remain partial to financials, with banks representing the portfolio's largest absolute and relative weight. The banking industry has been in the crosshairs of skeptics since the early March failure of Silicon Valley Bank ("SVB"). SVB failed due to a combination of unique characteristics and mismanagement. It had an unusually concentrated depositor base composed of large corporate depositors; 97% of its deposits exceeded the \$250,000 FDIC insurance limit, and thus were uninsured. This makes it more susceptible to a bank run because it takes significantly fewer customers withdrawing their money compared to a bank with a more diversified customer base. Further, SVB invested in long duration securities much more heavily than it should have, creating a risky asset/liability mismatch. Several other regional banks have similar problems, albeit nothing to the extreme of SVB. Nonetheless, well-capitalized, well-managed banks sold off in sympathy, and now trade at attractive valuations for the risks at hand. We have thoroughly assessed widespread bank concerns about declining deposits, an impending recession, and potential regulatory changes. We conclude that these valuations more than compensate us for those risks.

Our energy thesis remains largely unchanged, and it remains our second largest overweight after financials. The portfolio's energy positions trade at attractive valuations and are generating impressive cash flows. Balance sheets have been improved and we believe these companies will continue to reap the benefits of higher oil/gas prices for the foreseeable future, as the lack of investment in new production fails to supply global demand. We recognize these are not the most spectacular businesses, but attractive valuations and unusual industry tailwinds make for a convincing investment opportunity.

Technology is the portfolio's third-largest overweight relative to the index. In tech, we do own some quality businesses, and we are willing to pay higher valuation multiples accordingly. Common traits among our tech holdings are strong balance sheets, sticky customers that generate recurring/predictable cash flow, and promising prospects for growth. We view these businesses as less cyclical than generally understood and prefer this exposure to other non-cyclical parts of the market that trade at rich valuations and grow modestly. This exposure is much different than the exposure to energy and financials, thus acting as an effective offset/complement.

ATTRIBUTION – 1Q23

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 2023. The overweight and positive stock selection in Industrials was the largest positive contributor to relative performance in the quarter. The overweight position in Information Technology and underweight position in Health Care also helped. Conversely, the overweight in Financials and stock selection in Real Estate detracted from relative performance during the quarter.

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Net of fee composite performance as of 3/31/23: -5.50%, 6.65% and 10.23% for 1-, 5-, and 10-year, respectively. Net performance results are presented after management fees and all trading expenses but before custodial fees. **Past performance is no guarantee of future results.**

Portfolio managers' opinions and data included in this commentary are as of March 31, 2023, and subject to change without notice. Information based on forecasts, proprietary or third-party estimates cannot be guaranteed and are subject to change. Information obtained from independent sources is considered reliable, but H&W cannot guarantee its accuracy or completeness.

Portfolio characteristics and attribution are based on a representative Small Cap Diversified Value portfolio. 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. Returns can differ from certain client portfolio(s) due to data differences, cash flows, trading, and other activity. The securities reflected herein are intended for illustrative purposes only and not a recommendation to buy or sell specific securities.

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. Composite performance is available at www.hwcm.com, located on the strategy's Performance tab along with important disclosures included in the strategy's [GIPS Report](#); quarterly characteristics and portfolio holdings are located on the 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.

The Russell 2000® Index measures the performance of the 2,000 smallest companies in the Russell 3000® Index. The Russell 2000® Value Index measures the performance of those Russell 2000® companies with lower price-to-book ratios and lower forecasted growth values. The Russell

2000® Growth Index measures the performance of those Russell 2000® Index companies with higher price-to-book ratios and higher forecasted growth values. The Russell Investment Group is the source and owner of the Russell Index data contained herein (and all trademarks related thereto), which may not be redistributed. The information herein is not approved by Russell. H&W and Russell sectors are based on GICS by MSCI and S&P.

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.

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 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.

All investments contain risk and may lose value. The commentary is for information purposes only and should not be considered as investment advice or a recommendation of any particular security, strategy or investment product.