SMALL CAP DIVERSIFIED VALUE

MARKET COMMENTARY

The Russell 2000 Index declined -17.2% in the second quarter of 2022. The Russell 2000 Value Index outperformed for the quarter, declining less than the Russell 2000 Growth (-15.3% vs. -19.3%). All eleven Russell 2000 GICS sectors declined in the quarter.

Several economic developments in the quarter sparked fears of a recession. Real GDP was -1.6% quarter-over-quarter (1Q), the war in Ukraine showed little signs of abating, the Consumer Price Index increased 8.6% year-over-year, and an increasingly hawkish FOMC raised the Fed Funds rate by 125 basis points via two hikes (from 0.5% to 1.75%). The Fed signaled further rate increases going forward to combat the highest inflation level in more than 40 years. The futures market implies that investors expect the Fed Funds rate to exceed 3% by year end with more rate hikes expected in 2023. Higher rates are generally bad for equities. It becomes more costly to borrow, increasing the cost of capital, which is the rate used to discount future cash flows. Higher rates impair long-duration equities disproportionately because most of the intrinsic value is derived from a terminal value estimate far into the future. In general, growth stocks are longer duration securities than value stocks. Unsurprisingly, value has outperformed growth in periods of elevated inflation and interest rates historically.

The least economically sensitive sectors—consumer staples and utilities—each declined less than -5% in the quarter. Small cap financials and energy also declined less than the broad index with returns of -12.5% and -13.0%, respectively. These sectors represent larger portions of the value index than the growth index. All other sectors declined -16% or more, with communication services (-29%), technology (-21%), and consumer discretionary (-22%) the worst performers.

At 8.7x normal earnings, the portfolio trades below its long-term average (10.1x). This represents an attractive discount to the index (11.5x). Value continues to trade at a large discount to growth, despite its recent outperformance. We view a reversion toward a more normal valuation relationship as more likely than not, which would represent a conducive environment for our long-term fundamental value approach.

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 20x. At both a forward and normal P/E of less than 9x, 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 – 2Q22

The Hotchkis & Wiley Small Cap Diversified Value portfolio (gross and net of management fees) outperformed the Russell 2000 Value Index in the second quarter of 2022. On a sector basis, the largest positive contributor to relative performance came from stock selection in industrials. The underweight and stock selection in communication services also worked well, as did stock selection and the overweight in financials. Positive stock selection in technology also helped performance. Stock selection in energy detracted from relative performance during the quarter. The overweight in consumer discretionary and the underweight in consumer staples also detracted.

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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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.

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Past performance is no guarantee of future results.