SMALL CAP DIVERSIFIED VALUE

MARKET COMMENTARY

The Russell 2000 Index returned +4.9% in the third quarter of 2020 and is now down -8.7% year-to-date. Two-thirds of Russell 2000 companies beat consensus revenue expectations and 70% exceeded earnings expectations. Corporate America's strong showing trumped continued worries about the prevalence of COVID-19 and Congress' stalemate over a new stimulus package. Meanwhile, the Fed continues to signal easy monetary policy for the foreseeable future, maintaining a subdued economic outlook. COVID-19 cases reaccelerated for the first time in months, but hospitalizations and deaths remained downward trending—there was a large jump in tests administered which could explain the mixed developments.

Growth outperformed value across geographies and across market capitalizations. Based on information from the Kenneth French/Dartmouth data library, small value has underperformed growth over the last 10 years by the largest magnitude on record. This has led to a colossal divergence in valuations. The Russell 2000 Value Index trades at 11x normal earnings, which is below its historical average of 13x. The Russell 2000 Growth Index, however, trades at 24x normal earnings, above its historical average of 21x.

Perhaps more important to our clients than the value-growth dichotomy is the equally noteworthy divergence within value, both in terms of trailing performance and future opportunity. The portfolio, for example, trades at 7.9x normal earnings, a considerable discount to the value benchmark. The strongest performers within small cap value have been concentrated in market segments with low correlations to economic growth, like healthcare and consumer staples. The weakest performers within value have been concentrated in market segments where near-term forward earnings estimates have declined meaningfully, in some cases by 30% or more. Financials and energy comprise a disproportionate share of these examples. The positions we have in these areas have underperformed, though we view the forthcoming earnings declines as temporary. While a year or two of depressed earnings modestly reduces our estimate of intrinsic value, the market reaction has been much greater. Companies with good liquidity and strong balance sheets are in position to weather the next year or two of depressed earnings which makes their stocks attractive return opportunities for the long-term investor. We remain selective, however, and recognize that certain market segments and/or individual companies may not recover—we look to avoid businesses with uncertain long-term outlooks or insurmountable secular pressures.

Financials represent the portfolio's largest weight, and banks represent the portfolio's largest exposure within financials. Earnings estimates have declined due to the combination of increased loan loss provisions, a ban on share repurchases, slower asset growth, and lower interest rates. Accounting rules require banks to estimate loan losses upfront based on prevailing economic conditions. The substantial provisions taken during the first half of 2020 could end up being too high as the actual impact of COVID appears to be less economically damaging than what was assumed at the beginning of the crisis. Banks' balance sheets were quite healthy entering 2020, as substantial capital had been built in the previous decade. The provisions already taken combined with the excess capital—not to mention the pre-provision income being generated—provides a meaningful cushion to absorb elevated credit losses. Further, banks' business models are less interest rate sensitive than generally believed. Banks' net interest margin is more closely tied to the yield spread earned on loans than it is from the rate sensitive benefit they get from funding a portion of their earning assets with non-interest bearing liabilities. The banks' benefit of free funding dissipates as rates decline, but the yield spread on loans exhibits countercyclical traits (i.e. the yield spread often widens when rates decline as banks tighten lending standards). This has resulted in relatively stable net interest margins over the past decade despite persistently falling interest rates over that period.

The dichotomy between growth and value is significant and pervasive, but so too are the opportunities within value. The portfolio's valuation discount to the value benchmark is considerably wider than normal. This reflects our conviction that select opportunities are exceptionally attractive. The recent environment has not been conducive to our approach, but we are confident that patient investors will be rewarded by the rarely observed risk-adjusted potential of the current portfolio.

ATTRIBUTION – 3Q20

The Hotchkis & Wiley Small Cap Diversified Value portfolio (gross and net of management fees) underperformed the Russell 2000 Value Index in the third quarter of 2020. The portfolio's value-focused approach hurt relative performance as the most deeply discounted stocks underperformed. For example, index stocks trading at a discount to book value lagged the overall index by about 10 percentage points in the quarter; the portfolio had 44% of the portfolio invested in such stocks compared to 32% percent for the Russell 2000 Value. The overweight position and stock selection in financials, along with stock selection in industrials detracted from performance. The underweight in real estate and the overweight in consumer discretionary helped.

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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. Equity performance attribution is an analysis of the portfolio's return relative to a selected benchmark (interaction effect is combined with stock selection), is calculated using daily holding information and does not reflect management fees and other transaction costs and expenses. 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 indexes 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 Characteristics 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.

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. Growth investing tends to work well during speculative, momentum-driven markets, while value investing tends to work well following recessionary periods. Value stocks following a recession may start from a lower market value than growth stocks which can contribute to their outperformance. Past recessions and recoveries cannot predict future performance due to different factors and circumstances.

Market Disruption: The recent global coronavirus pandemic has caused and continues to cause 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, depending on the severity and the length of the outbreak, has the potential to negatively impact the firm's investment strategies and reduce available 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. Portfolio managers' opinions and data included in this commentary are as of September 30, 2020 and are subject to change without notice. Any forecasts made cannot be guaranteed. Information obtained from independent sources is considered reliable, but H&W cannot guarantee its accuracy or completeness. Certain information presented is based on proprietary or third-party estimates, which are subject to change and cannot be guaranteed. 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. Past performance is no guarantee of future results.