SMALL CAP DIVERSIFIED VALUE

MARKET COMMENTARY

The Russell 2000 Index declined -4.4% in the third quarter of 2021, underperforming large caps which were slightly positive. Economic developments over the quarter were mixed. Real GDP grew an impressive +6.7% in the most recent quarter (seasonally adjusted quarter-over-quarter). The positive momentum in labor markets slowed, however, as many businesses are contending with serious labor shortages. Business owners are hopeful that labor availability will improve due to the expiration of enhanced pandemic unemployment benefits in September, though higher wages and benefits appear likely. This fuels already-tight supply conditions and increases inflationary pressures. Inflation persisted above 5% (year-over-year), its highest level in well over a decade. The Fed voted to keep its target Fed Funds rate near zero until the economy approaches "maximum employment and inflation has risen to 2 percent and is on track to moderately exceed 2 percent for some time."[1] There have been some increasingly hawkish comments from FOMC members, with some suggesting that the economic recovery warrants tapering in the near term. The yield on the 10-year treasury note began and ended the quarter at about 1.5% but fell below 1.2% intra-quarter. Shorter and longer duration treasuries experienced similar moves during the quarter, i.e., there was little change to the yield curve.

Oil prices followed a curiously similar path to interest rates. WTI crude oil began the quarter at about $73/barrel, then declined to nearly $62/barrel intra-quarter, before reverting to $75/barrel by quarter end. Through July and August, energy stocks in the Russell 2000 were down more than -12%, the worst performing sector in the index. This reversed in September. All Russell 2000 sectors declined during September except energy, which was up more than +16% as crude prices rose. For the entire quarter, energy was one of two sectors with a positive return, though it was modest rise (+1.9%). Financials were the other positive group, as banks, consumer finance, and capital markets companies outperformed. Communication services performed worst, largely due to the decline in meme stock AMC Entertainment. Overall, Corporate America continues to perform well as nearly two-thirds of Russell 2000 companies surpassed consensus earnings expectations in the quarter.

Small value outperformed (declined less than) small growth. The Russell 2000 Growth Index declined -5.7% while the Russell 2000 Value Index declined -3.0%. In the recent past, COVID-19 developments appear to have dictated which investing style outperformed—positive developments have favored value, negative developments growth. At the beginning of the year, there were more than 200,000 new confirmed cases per day in the US[2]. Accordingly, the Russell 2000 Growth Index outperformed the Russell 2000 Value Index in the first month and a half of 2021. As cases fell and persisted around or below 100,000/day, small value outperformed considerably. Year-to-date through September, the Russell 2000 Value outperformed the Russell 2000 Growth by more than 20 percentage points (+22.9% vs. +2.8%). We continue to focus on fundamentals and valuation because that is what drives stock prices in the long run; however, we believe the demise of the pandemic through improved inoculation, herd immunity, or both, could provide a welcomed catalyst for a prolonged value rally.

Dating back to 1926, the average value rally has lasted just shy of three years, with an average outperformance of 55 percentage points, cumulatively[3]. Some of the more powerful and long-lasting value rallies have persisted for 7 to 10 years, with value outperforming growth by well over 100 percentage points. Taking a deeper look into these rallies, we observe important similarities between today's environment and the early stages of the strongest and longest value rallies. Specifically, the best value led markets came on the heels of a prolonged period of growth outperformance, and each began with wide valuation spreads. Today, value stocks are coming out of one of the worst periods of underperformance since 1926 and are starting from one of the deepest valuation discounts on record. We see a value-led market being a strong tailwind to our investment approach.

ATTRIBUTION – 3Q21

The Hotchkis & Wiley Small Cap Diversified Value portfolio (gross and net of management fees) outperformed the Russell 2000 Value Index in the third quarter. The overweight position and positive stock selection in financials helped relative performance in the quarter. The underweight and positive stock selection in communication services also helped, though this was largely a function of not owning meme stock AMC Entertainment, which lost one-third of its market value. Positive stock selection in consumer discretionary and technology also contributed to the outperformance. Stock selection in energy, healthcare, and industrials, along with the overweight position in consumer discretionary and underweight position in real estate, detracted from performance.

[1] https://www.federalreserve.gov/monetarypolicy/files/monetary20210922a1.pdf
[2] 7-day moving averages
[3] Statistics in this paragraph reference data from the Kenneth French Dartmouth data library

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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.

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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.

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, 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 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.