SMALL CAP DIVERSIFIED VALUE

MARKET COMMENTARY

The Russell 2000 Index declined -5.1% in the third quarter and is now up just +2.5% since the beginning of the year. The Russell 2000 Value Index declined less than the Russell 2000 Growth Index in the quarter (-3.0% vs. -7.3%), though small growth remains ahead year-to-date (+5.2% vs. -0.6%). Nine of the eleven Russell 2000 GICS sectors declined in the quarter, with energy and financials the exceptions. Energy was the top performing sector, returning +18.6% for the quarter, while financials returned +1.2%. Healthcare and utilities were the worst performing sectors, declining -15.1% and -11.8%, respectively.

The FOMC raised the Fed Funds target rate another 25 basis points in its July meeting to 5.5% (upper bound), its highest level in more than 20 years. Treasury yields rose accordingly, especially on the long end of the curve, which flattened the still-inverted yield curve. Historically, inverted yield curves have been efficacious harbingers for recessions, but the strong labor market is a conflicting signal. Should a recession transpire, we view a mild/modest slowdown as most likely considering fewer excesses in the system and conservative balance sheets for businesses and consumers alike. Nonetheless, we focus on companies with resilient businesses, financial strength, and prudent management because these factors function as effective defenses in recessionary periods. Our proprietary Fundamental Risk Ratings are designed to measure and manage these factors. We do not necessarily expect to benefit from this part of our investment process during times of market exuberance, but rather during times of market stress.

The performance difference between value and growth in 2023 has been puzzling. In calendar year 2022, interest rates rose and the equity market sold off, which is intuitive because higher rates are generally bad for equities as the cost of capital increases. Small growth stocks sold off significantly more than small value stocks, which is also logical for two primary reasons. First, growth stocks are longer duration securities and thus should be more sensitive changes in interest rates. Second, financials comprise much larger portions of small cap value portfolios and represent the one segment of the market that stands to benefit from higher interest rates. In calendar year 2023, interest rates have continued to rise in a meaningful way, yet the Russell 2000 Growth is up +5.2% compared to the Russell 2000 Value at -0.5%. At the beginning of the year, the price-to-earnings ratio[1] of the growth index was about 8 multiple points higher than the value index. Today, it is 10.6 multiple points higher—the growth multiple has expanded while the value multiple contracted. Current valuation spreads are difficult to justify, and we believe they are unlikely to persist. A reversion toward more normal valuation relationships would benefit value relative to growth and be highly conductive to our value-focused approach.

Financials, a prototypical value sector, represents the portfolio's largest exposure. The portfolio is well-diversified across banks, capital markets, and insurance companies. Our investment thesis remains largely unchanged. Financials, particularly banks, trade at a larger-than-normal discount to the market—near record levels, in fact. Since pre-COVID, bank earnings have increased, albeit slightly, but the price multiples have cratered by more than 30%. Notwithstanding economic and regulatory risks, at high single-digit multiples of earnings and discounts to book value, we view the upside potential as attractive. Alternatively, we find fewer attractive valuation opportunities in small cap real estate and healthcare.

ATTRIBUTION ANALYSIS

The Hotchkis & Wiley Small Cap Diversified Value portfolio (gross and net of management fees) outperformed the Russell 2000 Value Index in the third quarter of 2023. The largest positive contributor to relative performance came from the underweight in healthcare—the market's worst-performing sector. The overweight position in financials also helped relative performance, as did stock selection in consumer discretionary and energy. The overweight in technology detracted from relative performance during the quarter. Stock selection in materials and consumer staples also detracted modestly.

[1]Source: Bloomberg - all numbers reflect price-to-FY2 consensus earnings

SMALL CAP DIVERSIFIED VALUE

All investments contain risk and may lose value. This commentary is for general information only and should not be relied on for investment advice or recommendation of any particular security, strategy, or investment product.

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 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.

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.

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.

Information contained in this material may represent or be based on forward-looking statements. Due to various risks and uncertainties, actual events/results or performance of the strategy may differ materially from those reflected or contemplated in such forward-looking statements. 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 managers' opinions and data included in this commentary are as of September 30, 2023. Any discussion or view of a security, an asset class/segment, industry/sector and/or investment type are not investment recommendations, should not be assumed to be profitable, and are subject to change without notice.