SMALL CAP DIVERSIFIED VALUE

MARKET COMMENTARY

The Russell 2000 Index finished a challenging 2022 on a positive note, increasing +6.2% in the fourth quarter. The Russell 2000 Value Index outperformed the Russell 2000 Growth Index for the quarter, returning +8.4% vs. +4.1%.

In calendar year 2022, the economy and capital markets experienced numerous milestones that had not been observed for quite some time. The Russell 2000 declined -20.4%, its worst year since the Great Financial Crisis. Value stocks declined but held up much better than growth stocks. The Russell 2000 Value declined -14.5% compared to the Russell 2000 Growth's -26.4% decline. Considering value's significant outperformance in periods of elevated/rising inflation and interest rates, and its outperformance coming out of economic slowdowns, we are optimistic that value's outperformance can persist.

Inflation peaked midyear at 9.1%, the highest reading in more than 40 years[1]. To combat rising prices, the FOMC increased the Fed Funds rate by more than 400 basis points over the course 2022, from 0.25% to 4.5% (upper bounds). This was the largest rate hike in any calendar year since 1973, and the current 4.5% level is its highest in more than 15 years. Other interest rates followed suit. 10-year treasury yields peaked above 4% for the first time in more than a decade; 30-year mortgage rates peaked above 7% for the first time in more than 2 decades. Yields on corporate credit also increased significantly. The treasury yield curve remains significantly inverted, which has been a harbinger of recessions historically. The tight labor market exhibited strong contrasting signals, however, with the unemployment rate reaching a 50-year low. Expectations for future corporate earnings are roughly flat, thus the stock market's decline was entirely due to a compression in valuation multiples as opposed to an actual or expected decline in earnings.

Forecasting economic growth and/or predicting recessions is not our expertise. We do, however, fully acknowledge current warnings signs, e.g., continued Fed tightening and the yield curve. Two things providing solace in the event of an economic slowdown are modest financial leverage and attractive valuations. There are fewer excesses in the system compared to prior recessionary periods like 2008. Unlike then, balance sheets of both consumers and financial institutions are quite strong today. Further, equity valuations are reasonable, and in select market segments, unusually attractive. A strong argument could be made that a recession is already priced into equity markets, at least in certain market segments, which is different compared to recessionary periods like 2002. While several signs point to an economic slowdown, several others suggest that the severity would be manageable and/or much of the pain has already been felt.

The Russell 2000 Value Energy sector returned +60% in 2022, the best-performing sector by substantial margin. The only other Russell 2000 Value sector with a return above zero was Utilities, which was up just +0.4%. Crude oil is a depleting resource/commodity. Put simply, when oil is extracted from a well, that well now contains less oil, and what remains is increasingly difficult to extract. As a result, wells produce less oil as they age, the pace of which is called its *decline rate*. To maintain flat production, therefore, companies must invest considerable sums in new projects to replace these wells' declining production. To *increase* production, these investments need to be substantial. In recent years, however, energy companies have spent unusually little on new production, instead using cash flows to pay down debt and/or return to shareholders. Our view has been, and continues to be, that this lack of investment will create a situation where supply, i.e., production, is unable to keep pace with global demand. This imbalance keeps the price of oil elevated and facilitates strong free cash flows for energy companies. Much of the cash flow is earmarked for share repurchases, which is accretive to earnings per share. Capital expenditures, i.e., new investments, have increased recently, but it takes a long time for such investments to result in actual production. Thus, this imbalance could persist for some time. Meanwhile, energy stocks' valuations remain compelling even after the impressive performance because they are coming from such a low base. Free cash flow yields are well into the teens, hence our continued overweight.

Financials represents the portfolio's largest weight, and second largest overweight relative to the index. Our thesis on Financials is straightforward—it is the most attractively valued sector in the portfolio. The sector trades at notable discounts to other parts of the market and relative to its own history, despite balance sheets that are well positioned to withstand a potential economic slowdown.

ATTRIBUTION – 4Q22 & 2022

The Hotchkis & Wiley Small Cap Diversified Value portfolio (gross and net of management fees) outperformed the Russell 2000 Value Index in the fourth quarter of 2022. The largest positive contributor to relative performance was the underweight in Health Care. Stock selection in Financials, Information Technology, and Energy also helped relative performance. Conversely, stock selection in Consumer Staples and the overweight in Information Technology detracted from relative performance during the quarter modestly.

The portfolio also outperformed the benchmark over calendar year 2022 (gross and net of management fees). The overweight in Energy was the largest contributor to relative performance. Stock selection in Financials and Information Technology also helped relative performance, along with underweights to Health Care, Communication Services, and Real Estate. The overweight in Consumer Discretionary detracted from relative performance, as did stock selection in Consumer Staples and Energy.

[1]US CPI Urban Consumer year-over-year, not seasonally adjusted

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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.

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.