

SMALL CAP 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.

While the likelihood of a recession increased during the quarter, stock prices are increasingly reflecting this outcome. At 8.3x normal earnings, the portfolio can absorb considerable earnings reduction before its valuation multiple would exceed that of the benchmark index. We note that a recession is not a certainty and if we have a “soft landing” or modest economic growth, our portfolio is attractively valued.

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 Value portfolio (gross and net of management fees) underperformed the Russell 2000 Value Index in the second quarter of 2022. Stock selection in real estate, energy, and industrials were key detractors from relative performance. The underweight in utilities and consumer staples also detracted from performance. Stock selection in consumer discretionary, technology, and communication services contributed positively to performance. The largest positive contributors to relative performance in the quarter were Points.com, Popular, Arrow Electronics, Global Indemnity Group, and Allison Transmission; the largest detractors were Seritage Growth Properties, TrueBlue, Stagwell, Expro Group Holdings, and Adient.

SMALL CAP VALUE

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 Value portfolio. Certain client portfolio(s) may or may not hold the securities discussed due to each account's guideline restrictions, cash flow, tax and other relevant considerations. Performance attribution is an analysis of the portfolio's return relative to an 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. Specific securities identified are the largest contributors (or detractors) to the portfolio's performance relative to the index. Other securities may have been the best and worst performers on an absolute basis. No assurance is made that any securities identified, or all investment decisions by H&W were or will be profitable.

The value discipline used in managing accounts in the Small Cap 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, 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.

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 the Global Industry Classification Standard by MSCI and S&P.

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.

Portfolio managers' opinions and data included in this commentary are as of June 30, 2022, and subject to change without notice. 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.

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.

Past performance is no guarantee of future results.