

SMALL CAP VALUE

MARKET COMMENTARY

The Russell 2000 Index finished a challenging 2023 on a positive note, increasing +14.0% in the fourth quarter. The Russell 2000 Value Index outperformed the Russell 2000 Growth Index for the quarter, returning +15.3% vs. +12.8%. The strong fourth quarter helped lift the Russell 2000 calendar year 2023 return to +16.9%.

Throughout much of 2023, small cap stocks trailed behind their larger counterparts before staging a robust rebound in the year's final months. Over the last two years, the fear of an economic recession sparked by the Fed's efforts to tame rising inflation cast a cloud over small cap stocks, especially those in cyclical and interest rate sensitive sectors. Adding to economic uncertainty, a regional banking crisis in early 2023 further weighed on investors. While predicting the timing and magnitude of recessions as well as their impact on stock prices is fraught with estimation error, our analysis of past impacts showed that small cap value stocks were priced for a typical recession and the market was not appreciating the recovery potential of these stocks.

Meanwhile, broad market returns were dominated by a narrow group of mega cap tech stocks. Labeled the "Magnificent 7", these giant companies¹ now represent about 28% of the S&P 500 and they represented about 60% of the index return. On the other end of the cap spectrum, small cap stocks are typically more economically sensitive than their large cap counterparts. By the end of 2023, the economic consensus shifted from recession to "soft landing" which sparked a rally in small cap value stocks. We continue to see historically wide valuation differentials between growth and value as well as large and small cap stocks which suggest the small cap value rally should continue.

In addition, as interest rates continue on a path of normalization, we expect investor sentiment will experience positive adjustments, primarily in relation to the cost of capital. This shift in sentiment holds significant implications for companies, especially those of smaller scale. As the cost of capital becomes more favorable, businesses can anticipate a more conducive financial environment for growth and investment.

Historical evidence reinforces the notion that during transformative economic landscapes, the small cap value asset class can embark on a significant and lasting period of outperformance. A pertinent example is the aftermath of the tech bubble, where the Russell 2000 Value Index nearly tripled over the subsequent seven years, in stark contrast to a slight decline in the Russell 2000 Growth Index. Our enduring lesson underscores that patience emerges as a rewarding virtue for those steadfastly focused on fundamentals and valuation principles.

ATTRIBUTION ANALYSIS – 4Q23 & 2023

The Hotchkis & Wiley Small Cap Value portfolio (gross and net of management fees) underperformed the Russell 2000 Value Index in the fourth quarter of 2023. On a sector basis, the largest detractor from relative performance came from stock selection and the overweight in energy. Stock selection in technology, materials, industrials, and consumer discretionary also detracted in the quarter. Conversely, stock selection in communication services contributed positively to relative performance, as did stock selection in utilities and real estate.

The portfolio delivered another year of strong relative performance in 2023 (gross and net of management fees). The balance of the excess return came from stock selection in financials. Stock selection in communication services also helped. In addition, the overweight in technology contributed to outperformance, as did the underweight in healthcare. Stock selection in industrials, real estate, energy, and technology detracted from relative performance in the year.

¹"Magnificent 7" constituents: Apple, Microsoft, Amazon, Alphabet, Meta Platforms, Nvidia, and Tesla.

Net of fee composite performance as of 12/31/23: 19.48%, 14.62%, and 8.63% for 1-, 5-, and 10-year, respectively. Net performance results are presented after management fees and all trading expenses but before custodial fees. Past performance is no guarantee of future results.

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Portfolio characteristics and attribution are based on a representative Small Cap 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 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. 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 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.

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Past performance is no guarantee of future results

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