# LARGE CAP DIVERSIFIED VALUE

## MARKET COMMENTARY

The S&P 500 Index declined -20% in the first quarter of 2020 as investors contemplated the economic impact of the COVID-19 pandemic. Shelter-in-place orders, travel bans, layoffs, etc. will have material and widespread effects on global economic activity. In an attempt to combat these effects, governments have taken swift and unprecedented action. Monetary policy responses included the Federal Reserve cutting its Fed Funds rate to near zero and injecting massive amounts of liquidity into an array of government, corporate, and money market credit facilities. Fiscal policy responses included a $2.2 trillion package intended to stimulate the economy, and to provide relief for companies and individuals most affected by the economic consequences of the pandemic. As equities sold off, treasuries rallied—the yield on the 10-year Treasury note declined from 1.9% at the beginning of the year to less than 0.7% at the end of the quarter, reaching an all-time low of 0.5% in early March.

All S&P 500 sectors declined by double digits. Technology, healthcare, consumer staples, and utilities declined the least while energy, financials, and industrials declined the most. Energy was the largest laggard, with the sector falling -50% in the three month period. Government-imposed efforts to mitigate the COVID-19 pandemic, particularly travel/transportation bans, have decreased the global demand for oil. Meanwhile, negotiations between Saudi Arabia and Russia designed to limit oil production reached an impasse. Increased supply of oil, which coupled with the aforementioned decreased demand, sent WTI oil prices plummeting -66%, closing the quarter at close to $20/barrel. Financials was the second worst-performing sector, declining -32%. Banks declined disproportionately, falling more than -40% as interest rates collapsed and investors became concerned with the potential for increased credit defaults.

In light of both the prevailing and potential adverse economic developments of the quarter, we stress-tested the liquidity and cost structure of every holding in our portfolio—essentially an in depth evaluation of both financial and operating leverage. The first objective was to evaluate each business' ability to survive an economic downturn more severe than what seemed conceivable just a few weeks ago. The second objective was to reevaluate weight changes that would result in an improved risk/return profile for the overall portfolio. While the cyclical tilt in portfolio holdings has hurt near-term earnings prospects, it is still, in our judgment, far too costly to shift to non-cyclical sectors given historic disparities in valuation. Fortunately, more than 97% of the portfolio has investment grade balance sheets going into a period of recession. These companies will survive a difficult economy in the weeks and months ahead, and their stock price declines have created enormous opportunity. We have gradually and modestly increased turnover during this quarter, emphasizing high quality companies at extremely attractive prices.

The Russell 1000 Growth Index trades at 17.8x consensus earnings and 6.5x book value, which are above historical averages (17.5x and 5.1x, respectively). The Russell 1000 Value Index, however, trades at 11.3x consensus earnings (FY2) and 1.5x book value, both of which fall in the lowest quintile of its own history (i.e. the index traded at higher multiples more than 80% of the time). Historically, when the Russell 1000 Value Index's valuation falls into the lowest quintile, as it does today, its subsequent 3-year annualized return has averaged +13 to +15% compared to +9.0% over all periods. The portfolio trades at 5.6x normal earnings, 8.1x consensus earnings (FY2), and 0.97x book value, which not only falls in the lowest quintile of its own history but close to all-time lows. Therefore, despite the value index trading at valuations well below average, the portfolio's valuation relative to the index is at/near an all-time discount. Historically, when the portfolio's valuation discount to the market falls into the lowest quintile, its subsequent 3-year return has averaged about +3% above the index, per year. So while the portfolio is composed of companies with business models and balance sheets able to withstand a draconian environment, the valuation potential is highly compelling in both absolute and relative terms.

A stable investment team is an irreplaceable luxury during challenging periods. We have not encountered a global pandemic the likes of which we face today, but we have certainly encountered challenging environments before. While we do not discount the human toll the virus has taken, our clients have charged our team with managing their assets through various investment environments. We take that responsibility in earnest. We speak to experts daily and read research constantly to try and understand COVID-19's potential ramifications on the economy, capital markets, and most importantly, the portfolio. Despite the unusually opaque nature of today's environment, we are confident that the current portfolio will exceed client expectations in the long-term notwithstanding economic activity or market direction in the near-term.

## ATTRIBUTION – 1Q20

The Hotchkis & Wiley Large Cap Diversified Value portfolio (gross and net of management fees) underperformed the Russell 1000 Value Index in the first quarter of 2020. Two stylistic factors combined to detract from performance in a major way: size and valuation. Mega cap stocks held up better than other areas of the market. The portfolio's average weight to stocks over $200 billion in market cap was 11% compared to 25% for the index; the lack of exposure to this market segment detracted from relative performance. The portfolio had nearly double the benchmark exposure to stocks that began the year trading at less than 10x consensus earnings (20% vs. 11%) and triple the benchmark exposure to stocks that began the year trading at a discount to book value (27% vs. 9%). The outsized exposure to these deeply discounted stocks was a considerable detractor. Financials, energy, and healthcare detracted from performance which was partially offset by the overweight and positive stock selection in technology. The largest individual detractors to relative performance in the period were AIG, Apache, Wells Fargo, Marathon Oil, and Halliburton; the largest positive contributors were Microsoft, Oracle, Alphabet, Unilever, and Ericsson.

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## LARGEST NEW PURCHASES – 1Q20

Boeing was added after the stock price declined in half over the previous month due to concerns regarding COVID-19 related delays in new aircraft purchases and a general worry about economic activity. Issues regarding its 737 MAX software also continue to linger. Boeing is the world's largest aerospace company with well-established commercial and defense businesses. While near-term concerns for the business are merited, Boeing has a great business with excellent long term prospects, a good balance sheet, and a longstanding commitment to return capital to shareholders. It is rare we have the opportunity to invest in Boeing at such an attractive valuation, though near-term issues have caused us to keep the position size small.

The Hartford Financial Services Group is a U.S. based provider of personal and commercial insurance. The Company is well diversified by line of business and end-market exposure, but the crown jewel is its small business insurance franchise, where we believe it possesses strong distribution relationships and earns attractive margins. The Hartford also generates good returns in its group benefits business, where they are the #2 writer of group disability insurance. Its current stock price represents an attractive valuation for this high quality insurer.

Schlumberger is the world's leading diversified provider of oilfield services. In highly technical areas, from reservoir understanding to subsea boosting, Schlumberger's capabilities are unmatched. The business should generate free cash flow despite the near term volatility in oil markets and should earn attractive returns on capital as the market normalizes.

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 Large Cap Diversified 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. Equity performance attribution is an analysis of the portfolio's return relative to a selected benchmark, is calculated using daily holdings information and does not reflect management fees and other transaction costs and expenses. For the portfolio's total performance attribution, interaction effect is combined with stock selection. Specific securities identified are the largest contributors (or detractors) to the portfolio's performance relative to the Russell 1000 Value Index. Other securities may have been the best and worst performers on an absolute basis. The "Largest New Purchases" section includes the three largest new security positions during the quarter/year based on the security's quarter/year-end weight adjusted for its relative return contribution; does not include any security received as a result of a corporate action; if fewer than three new security positions during the quarter/year, all new security positions are included. Securities identified do not represent all of the securities purchased or sold for advisory clients and are not indicative of current or future holdings or trading activity. H&W has no obligation to disclose purchases or sales of the securities. 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 Large Cap Diversified Value strategy may prevent or limit investment in major stocks in the S&P 500, Russell 1000 Value and Russell 1000 Growth indices 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 Characteristics 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.

Market Disruption: The recent global coronavirus pandemic has caused and continues to cause 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, depending on the severity and the length of the outbreak, has the potential to negatively impact the firm's investment strategies and reduce available investment opportunities.

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. Portfolio managers' opinions and data included in this commentary are as of March 31, 2020 and are subject to change without notice. Any forecasts made cannot be guaranteed. Information obtained from independent sources is considered reliable, but H&W cannot guarantee its accuracy or completeness. Certain information presented is based on proprietary or third-party estimates, which are subject to change and cannot be guaranteed. 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 value stocks presents the risk that value stocks may fall out of favor with investors and underperform growth stocks during a given period. All investments contain risk and may lose value. Past performance is no guarantee of future results.