MID-CAP VALUE

MARKET COMMENTARY

The Russell Midcap Index declined -27% 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 Russell Midcap sectors declined by double digits. Healthcare, consumer staples, utilities, and technology declined the least while energy, consumer discretionary, and financials declined the most. Energy was the largest laggard, with the sector falling -62% 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 declined -36%; banks declined disproportionately, falling -45% 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 the portfolio's positions—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. We believe the portfolio's positions will survive a difficult economy in the weeks and months ahead, and their stock price declines have created enormous opportunity.

The Russell Midcap Growth Index trades at 17.5x consensus earnings and 4.3x book value, which are, rather remarkably, close to historical averages (17.0x and 4.4x, respectively). The Russell Midcap Value Index, however, trades at 10.8x consensus earnings (FY2) and 1.3x 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 Midcap Value Index's valuation falls into the lowest quintile, as it does today, its subsequent 3-year annualized return has averaged +18 to +19% compared to +9.2% over all periods. The portfolio trades at 3.4x normal earnings, 6.0x consensus earnings (FY2), and 0.6x book value, which not only falls in the lowest quintile of its own history but 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. 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 Mid-Cap Value portfolio (gross and net of management fees) underperformed the Russell Midcap Value Index in the first quarter of 2020. Two stylistic factors combined to detract from performance in a major way: size and valuation. Larger cap stocks held up better than smaller cap stocks and growth held up better than value. The portfolio's average weight to stocks over $20 billion in market cap was 10% compared to 29% for the index. Conversely, the portfolio's average weight to stocks under $5 billion was 49% compared to 13% for the index. This smaller cap bias detracted from relative performance considerably. The portfolio had more than double the benchmark exposure to stocks that began the year trading at less than 10x consensus earnings (33% vs. 13%) and nearly four times the benchmark exposure to stocks that began the year trading at a discount to book value (43% vs. 11%). The outsized exposure to these deeply discounted stocks was a considerable detractor. Energy, industrials, and financials detracted from performance. The largest individual detractors to relative performance in the period were Kosmos Energy, Cairn Energy, Apache, NexTier Oilfield Solution, and Goodyear Tire & Rubber; the largest positive contributors were Centene, Amerco, Ericsson, Avis Budget, and Enstar Group.

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MID-CAP VALUE

LARGEST NEW PURCHASES – 1Q20

General Motors is one of the world's largest manufacturers of passenger vehicles. The stock declined and qualified for the mid cap universe. GM has made numerous improvements over the past decade. It maintains a highly profitable truck business, strong business in China, an improved global manufacturing base, strong free cash flow generation, a good balance sheet, and a commitment to return large amounts of cash to shareholders. Importantly, it also possesses a vertically integrated autonomous transportation business that offers significant upside over the long term. Considering these factors, the current stock price represents an attractive valuation.

Omnicom is the second largest ad agency holding company with premier agencies DDB, BBDO, and TBWA. Traditional brand advertising earns about half the revenue, with most of the balance from other marketing services such as public relations, direct marketing support, and specialty sectors such as healthcare. Its stock has underperformed the market in the most recent selloff due to concerns about revenue declines in the cyclical downturn. We believe revenue will be volatile, but earnings will be relatively stable because of the cost flexibility inherent in the business.

PDC Energy is an energy E&P company with acreage in the Wattenberg field in Colorado and the Delaware basin in Texas. The company recently completed an all-stock merger with SRC Energy, which consolidated its acreage position and strengthened its balance sheet. We purchased the stock for its high quality asset base, minimal leverage, hedged production, ability to generate FCF at low prices, and significant discount to NAV.

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 Mid-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. Equity performance attribution is an analysis of the portfolio's return relative to a selected benchmark (interaction effect is combined with stock selection), is calculated using daily holdings information and does not reflect management fees and other transaction costs and expenses. Specific securities identified are the largest contributors (or detractors) to the portfolio's performance relative to the Russell Midcap 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 Mid-Cap Value strategy may prevent or limit investment in major stocks in the Russell Midcap, Russell Midcap Value and Russell Midcap 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. Investing in small and medium-sized companies involves greater risks than those associated with investing in large company stocks, such as business risk, significant stock price fluctuations and illiquidity. All investments contain risk and may lose value. Past performance is no guarantee of future results.