SMALL CAP DIVERSIFIED VALUE

MARKET COMMENTARY

The Russell 2000 Index declined -31% 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.

Small cap value was the worst performing segment of the US equity market. Owning inexpensive stocks was not a successful strategy in the first quarter. Small cap value index was down -36% in the first quarter and one point it was down nearly -45%. Prior to COVID-19, economically sensitive sectors were trading at significant discounts to traditionally stable sectors. Consequently, value indices and value managers were disproportionately exposed to sectors that were most affected by the sudden and severe contraction in economic activity. While all small cap sectors experienced double digit declines, value sectors such as financials, industrials, and energy felt the most pain. The energy sector was down -62%, almost double the small cap market decline.

In light of both the prevailing and potential adverse economic developments of the quarter, we reviewed portfolio holdings to opportunistically improve business quality and balance sheet strength without sacrificing return potential. We also looked to reduce or eliminate companies that were unlikely to survive the current economic environment. As a result of this review, we added new positions and exited others but ultimately the portfolio continues to maintain exposure to economically sensitive sectors—albeit with better quality businesses and better balance sheets. Also, we now own a handful of companies that were considered large cap just a few months ago. These companies have well established business franchises that are rarely found in the small cap market. While the recent portfolio price declines have been painful, our holdings now trade at values last seen during the 2008 financial crisis.

The Russell 2000 Value Index, however, trades at 9.0x consensus earnings (FY2) and 0.9x book value, both of which fall in the lowest 2% of its own history (i.e. the index traded at higher multiples more than 98% of the time). Historically, when the Russell 2000 Value Index's valuation falls into the lowest quintile, as it clearly does today, its subsequent 3-year annualized return has averaged +13 to +17% compared to +10% over all periods. The portfolio trades at 6.1x normal earnings, 6.7x consensus earnings (FY2), and 0.73x book value, which represent all-time lows. Therefore, despite the value index trading at/near record valuations, the portfolio's discount remains well above average. 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 Small Cap Diversified Value portfolio (gross and net of management fees) underperformed the Russell 2000 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 under $1 billion in market cap was 47% compared to 27% for the index. This smaller cap bias detracted from relative performance considerably. The portfolio had outsized exposure to stocks that began the year trading at less than 10x consensus earnings (26% vs. 16% for the R2000V) and stocks that began the year trading at a discount to book value (32% vs. 23% for the R2000V). The overweight exposure to these deeply discounted stocks was a considerable detractor, as this group underperformed substantially. Energy, industrials, and consumer discretionary detracted from performance which was partially offset by positive stock selection in financials.

SMALL CAP DIVERSIFIED 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 Diversified Value portfolio. Client portfolio holdings may vary due to different restrictions, cash flows, 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 holding information and does not reflect management fees and other transaction costs and expenses. 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 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. 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 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. All investments contain risk and may lose value. Past performance is no guarantee of future results.