ValueInvestor INSIGHT

The Leading Authority on Value Investing

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Chasing the Narrative

Hotchkis & Wiley's Stan Majcher and Hunter Doble describe their underlying investment rationale for being contrarian, why they don't believe in value traps, why they have the exposure they do to energy and financials, and what they think the market is missing today in Kosmos Energy, Popular, Fluor, CNH Industrial and American International Group.

INVESTOR INSIGHT

Hotchkis & Wiley
Stan Majcher *(l)*, Hunter Doble *(r)*

Investment Focus: Seek companies whose current underperformance is likely to mean-revert to something materially better than what the market currently expects.

Ask Hunter Doble and Stan Majcher of Hotchkis & Wiley if they find the market expensive and the answer is basically "yes and no." Stocks in the Mid Cap Value Strategy they co-manage appear cheap, collectively trading at only 7x their estimates of "normal" earnings. The Russell mid-cap benchmark they follow, however, is relatively dear, trading at 17.5x such earnings. "The wider the spread between undervalued and overvalued," says Doble, "the more excited we tend to be about the opportunity set."

Since Majcher launched the strategy in 1997 it has earned a net annualized 11.4%, vs. 9.6% for the S&P 500. Today he and Doble are finding particular opportunity in such diverse areas as engineering and construction, energy, banking, agricultural equipment and insurance.

Gravitating to what's out of favor is pretty central to your – or any value investor's – approach. After a fairly long period where what's been in favor in the market has done particularly well, describe your underlying rationale for being contrarian.

Stan Majcher: Think about what the market does. It's not only a place for investors to invest, but it also provides a signal for how management should be allocating capital. That works well in theory if markets are efficient and asset prices accurately reflect future profitability. But emotions and basic human nature lead investors to often mistakenly extrapolate the current environment into the future. As it relates to the stock market, if profitability is currently high, stock prices go up, and both of those things cause capital to flow into the business. That process goes too far, supply exceeds demand, and profitability reverts to what is a more normal level. The same dynamic works in reverse: capital leaves the business, supply comes into better balance with demand, and profitability reverts – up in this case – to a more normal level.

We're trying to take advantage of that mean-reverting dynamic by focusing on ideas where there might be temporary issues with profitability – cyclical or unique to a business – and then through proprietary research estimate long-run normal levels of earnings. Our opportunity comes from paying a low price relative to that normal earnings power. If you can buy a stock at a low multiple of depressed earnings, we think that gives you a margin of safety and allows you to win in two ways – from the increase in the underlying earnings and from a higher valuation.

What we don't want to do is extrapolate high levels of profitability that are unsustainable and will be competed down. If you pay a high multiple for earnings that are above normal, that's a recipe for disaster. Earnings fall short of expectations and the valuation the market places on those earnings also comes down.

Some would argue that disruptive technologies across industry sectors make mean reversion less reliable than it once was. How do you think about that?

Hunter Doble: There are certainly industries where technological change can alter the composition of the industry structure going forward. We as investors always have to be careful in assessing the extent to which fundamental changes permanently impair past capital investment. But we believe most industries still reflect the economic reality that high returns attract a crowd, low returns drive capital away, and that profits normalize over time.

A Hotchkis & Wiley analyst will often follow the same industry for much of their career. The goal is to gain the deepest understanding of the fundamental drivers of returns and profitability in the particular industry. That's critical when you're trying to determine the profitability of any given business in a normal or mid-cycle environment and the time horizon around that. Without that deep level of industry knowledge, we wouldn't have the confidence we need in our estimates of normal to invest against.

SM: We tend to increasingly hear questions about the reliability of mean reversion at the bottom of value cycles. They were common, for example, near the end of the dot-com bubble. But if we look at the data on the mean reversion of returns and profitability over time, we don't see a significant difference between today and the last 20, 30 or 50 years. And it makes sense. That high profitability and high returns attract capital is an efficient mechanism for allocating that capital and is conducive to long-term economic growth. What's not great for the economy is when capital is allocated to the wrong places for non-fundamental reasons. The extreme example of that today would be some of the meme stocks. Does anyone really believe there's a shortage of videogame retailers or movie theaters and that capital should be flowing into those markets?

Morningstar's analyst speaks favorably of your strategy but says it's "prone to value traps." How would you respond to that?

SM: I actually don't believe value traps exist. If we are correct about the underlying earnings of a business, we will be rewarded. If we are incorrect about the underlying earnings, we won't. That's true for fundamental value investors, growth investors, and anything in between.

The theory behind the value trap is that an inexpensive stock will stay that way because the market never realizes it. I don't think that's true. If a stock is undervalued and you're right about its earnings power, either the market will realize it, a competitor will realize it and make an offer, or management will realize it and buy back shares. Again, I'm not saying we won't be wrong about a stock, but it won't be because we fell into some mysterious "trap."

Starting with the recent example of Credit Suisse [CS], what tends to be going on at a company that attracts your interest?

HD: The company in the spring of this year suffered a number of management fiascos, notably around the blow-ups of hedge fund Archegos Capital and finance company Greenshill Capital. These were clear and significant operational mistakes that produced meaningful losses. Our basic view is that faults in the company's risk-management processes can be fixed with manageable cost and time commitments, and that the underlying franchise value and profitability of the business remains intact. The market doesn't seem to believe that, and the stock today [at around $9.60] trades at less than 7.5x what the company earned in 2019. If we're right about the underlying earnings power, as the focus of the market shifts from past errors of the past management team toward ongoing earnings generation and franchise value, there's considerable upside from today's share price.

ON ATTRACTIVE SECTORS:

Energy and financials provide us with insurance against things most investors probably have a lot of exposure to.

Similarly, what's the setup for you in media company Discovery [DISCA]?

HD: There's obviously a big transition going on in the way people buy and access video programming, and there's much uncertainty around how that all plays out for a company like Discovery. It has a huge U.S. audience, representing over 12% of the total hours spent watching TV, but its ability to monetize that has not kept pace. Its total domestic revenue represents something like 5% of the market.

The earnings power today for the existing business is around $4.50 per share in free cash flow. At today's stock price [of $24.50] the multiple on that is only 5.4x. That in itself is interesting, but we believe there's a good chance the transition to direct-to-consumer offerings of their content could dramatically increase Discovery's monetization of its viewership. Today it makes about 3x more per domestic "ad-light" direct-to-consumer viewer than from a pay-TV viewer. Higher monetization goes straight to the bottom line and would dramatically improve earnings.

I would add that our confidence in what the future holds isn't as high here as it is in other cases. We address that both by trying to be more conservative in our estimate of normal and by allocating a smaller-than-average weight in the portfolio to the stock.

How would you characterize the general attractiveness of your mid-cap opportunity set today?

SM: It's true across market caps, but we're more than usual finding things today either very, very expensive or very, very inexpensive. Our mid-cap universe overall – which tracks the Russell Mid-cap Value Index and includes market caps from around $4 billion to $45 billion – is trading at an historically high valuation, but our portfolio trades at only about 7x our estimate of normal earnings. So, we're finding a lot of opportunities at significant discounts to the market.

I'd make a plug here for mid-caps. There are a lot of them, so when markets are distorted like today there are plenty of potentially good ideas to choose from. We also think it's a sweet spot of the market. Mid-caps have a somewhat greater potential of being mispriced than large-caps, while generally having less overall business risk and greater trading liquidity than small-caps. When you're looking at out-of-favor stocks, that's all important.

Your portfolio today is heavy both on energy and financial stocks. Explain generally what's behind that and then let's talk about some representative examples.

SM: Both energy and financials provide us with insurance against things investors probably have a lot of exposure to. Given what's been working, most portfolios today are likely quite exposed to low interest rates and low inflation. If you believe there's a reasonable case for mean reversion in both of those areas, as we do,

energy and financials should provide protection against the negative impacts higher inflation and interest rates could have on overall stock prices.

With energy, we basically believe that market sentiment has shifted too far and too fast against traditional energy producers. That's not a claim that renewable energy doesn't continue to inexorably take share from oil and gas. But it does reflect our view that that transition will take a very long time and that some traditional oil and gas producers will generate far more earnings and cash flow than would seem to be priced into their shares today.

Here's one quick example: We generally think energy equities today price in something below $60 per barrel for West Texas Intermediate crude oil. The market price today is around $70 per barrel, and we use in our models a normal price of about $65. Using $65 per barrel, an exploration and production company like Marathon Oil [MRO], which we own, trades on our estimate of normalized earnings at a free-cash-flow yield of around 16%. Even if that yield stays where it is, if we're right about the normalized oil price – which is lower than today's price – we should have an attractive return on the stock.

What makes things more interesting is that we believe it's possible oil prices go up sharply. Demand for oil and gas is inelastic and alternatives are not likely to have a significant near-term impact even under optimistic assumptions. At the same time, in part due to signaling from investors, there has been a deep cutback in investment. Even with recent higher oil prices we see global productive capacity shrinking. Inelastic demand combined with depleting capacity could put considerable upward pressure on prices. We don't need to bet specifically on that when the market is pricing in a drop in oil prices, but it gives us additional upside optionality.

One other general point to make is that E&P companies today throw off enormous amounts of free cash flow. Historically they have poured the cash into the asset side of the balance sheet to increase production. Today more of it is going to de-levering the liability side of the balance sheet and returning capital to shareholders. This constrains supply and also creates tremendous value for shareholders. If we get normalized oil prices of around $65, at a 16% free cash flow yield Marathon could theoretically buy all of its shares back in just over six years.

Describe in more detail your investment case for Kosmos Energy [KOS].

SM: This is an oil and gas exploration and production company, with assets primarily offshore in the U.S. Gulf of Mexico and in West Africa. The business throws off a tremendous amount of free cash flow – at our normalized $65-per-barrel oil price Kosmos' existing assets would generate about 85 cents per share in free cash flow. At today's share price that's nearly a 25% free-cash-flow yield.

Conventional offshore reservoirs generally are considered more environmentally friendly, have lower decline rates and, once producing, throw off a lot of free cash flow. Not as many companies want to specialize in offshore today, which gives Kosmos interesting acquisition opportunities as others scale back in the area. Last month the company bought additional

INVESTMENT SNAPSHOT

Kosmos Energy
(NYSE: KOS)

Business: Deepwater oil and gas exploration, development and production, with assets located in offshore Ghana, Equatorial Guinea, Mauritania, Senegal and the Gulf of Mexico.

Share Information (@12/30/21):

Price	**3.47**
52-Week Range	1.80 – 4.24
Dividend Yield	0.0%
Market Cap	$1.60 billion

Financials (TTM):

Revenue	$1.03 billion
Operating Profit Margin	(-18.6%)
Net Profit Margin	(-16.3%)

Valuation Metrics
(@12/30/21):

	KOS	S&P 500
P/E (TTM)	n/a	28.8
Forward P/E (Est.)	5.2	22.7

Largest Institutional Owners
(@9/30/21 or latest filing):

Company	% Owned
Fidelity Mgmt & Research	9.9%
GMO	6.3%
Vaughan Nelson Inv Mgmt	5.9%
BlackRock	5.3%
Cobas Asset Mgmt	4.6%

Short Interest (as of 12/15/21):

Shares Short/Float	4.9%

KOS PRICE HISTORY

THE BOTTOM LINE

Market sentiment has shifted too far and too fast against traditional exploration and production companies, says Stan Majcher. In this case, at 10x his estimate of normalized free cash flow the company's stock would trade at $8.50. That includes nothing for its share in an LNG joint venture going live in 2023 that he values at another $3 per share.

Sources: Company reports, other publicly available information

interests in two fields it already had an interest in off the coast of Ghana from Occidental Petroleum, at a price where free cash flow should pay back the acquisition price in less than three years. Management has generally created a lot of value through capital allocation and we think this particular deal will end up being highly accretive.

What makes this idea even more interesting is the company's multistage liquefied natural gas project with BP that is located off Mauritania and Senegal and is scheduled to come on stream at the beginning of 2023. The capital started going into the project well before the market for natural gas tightened considerably and prices have risen sharply, particularly in Europe and Asia. We're not at all counting on the current market staying as hot as it is, but we do believe the demand story for natural gas is generally positive as the world continues to displace coal as an energy resource. Contracts are already in place for the first phase of the project which should result in significant generation of free cash flow from the beginning. At today's share price, we don't think the market is ascribing any value at all to these LNG assets.

How do you assess the various regulatory or other governmental-oversight risks for Kosmos?

SM: Producing hydrocarbons in any country today entails some risks, but generally offshore assets can be more insulated than onshore assets from political issues. The countries in which they operate generally are dependent on the revenues produced and recognize the benefits of partnering with a firm like Kosmos. That's not to say there's little to no risk of political intervention of some kind, but it's not at a level we consider worrisome.

What do you think the shares, now at around $3.50, are more reasonably worth?

SM: We think it's reasonable to value the ongoing business at $8.50 per share, which is 10x our 85-cents-per-share normalized estimate of free cash flow. On top of that, using conservative LNG prices based off of a $65 Brent oil price, we believe the LNG assets are worth another $1.3 billion, or close to $3 per share.

We can try to explain why the market might be offering up an opportunity like this, but we really don't know. What we do know is that in distorted markets it's not uncommon for us to find gaps like this between price and value. It's on us to take advantage of them.

ON ATTRACTIVE SECTORS:

Energy and financials provide us with insurance against things most investors probably have a lot of exposure to.

What's your general case for financials?

HD: The general case is relatively straightforward. The market seems to believe interest-rate-sensitive businesses like banks aren't very profitable when interest rates are low, and that interest rates are likely to stay low forever. That's why we can buy a number of bank stocks today at 10-12x consensus forward estimates, way below the multiples on the broader market. Our view is that those valuations don't reflect the current quality and profitability of the businesses – U.S. banks overall have generated 12% returns on equity over the past ten years, even with low interest rates – and, as we've said, we believe that normal interest rates are higher than rates today.

If we assume a normal rate environment has 0% real yields at the short end of the curve and 50-100 basis points in term spread between overnight rates and 5-year rates – roughly the average of the past twenty years – the average U.S. regional bank would see a 15-25% increase in EPS, taking P/Es from 10-12x to more like 8-10x normal. We think in today's market the opportunity to buy businesses generating consistently good returns on capital at such valuations is very attractive.

Why are you still high on the prospects of Puerto Rico-based bank holding company Popular [BPOP]?

HD: We first invested in Popular back in 2014. The Puerto Rican economy was in a severe recession, and the market was also concerned about the bank's exposure to Puerto Rican municipal debt at a time when the creditworthiness of that debt was very much in question. The stock traded at less than 85% of book value, but the bank was so well capitalized we thought it could ride out any issues related to the municipal debt or the economy with its earnings power fully intact.

The business since then has continually improved. The population of Puerto Rico has been declining at about 1% per year, but Popular has increased its customer base by 1% per year. Its market share of deposits and loans has increased since 2014, from the high-30s to the high-40s. Global banks have exited the market, so that now the top three banks in Puerto Rico control almost the entire market and have generally exhibited rational behavior. Popular generates pre-provision income as a percentage of tangible assets of more than 1.75%, which is higher than the average U.S. regional bank. Tangible book value today is around $68 per share and has compounded at 9% per year since 2014.

Has Popular shown any interest in diversifying beyond Puerto Rico?

HD: We've heard that as a concern of some investors, that the company's fortunes are too tied to such a narrow market. That's not a particular issue for us – we'd probably be more concerned if they were pouring investment capital into markets in which they weren't as well established. The reliance on Puerto Rico is likely to be more of an incremental benefit in the next few years, as some $70 billion in federal relief funds that have been approved to help the island rebuild from Hurricane Maria actually start to be spent at a higher rate. That's an extremely large amount of money for an economy of this

size, and should have a highly positive impact on overall economic growth.

Is the political environment stable?

HD: For the most part, yes. One positive of the territory's financial restructuring is that The Puerto Rico Oversight, Management, and Economic Stability Act passed by Congress in 2016 established a Fiscal Control Board that has control over all budget decisions. That gives us more confidence that the money flowing into the island will be allocated to the right things and spent wisely.

On the regulatory front, we think it's important to point out that Popular is regulated by the Federal Reserve and its deposits guaranteed by the FDIC, just like any other U.S. bank. Popular has to balance what regulators want versus what shareholders want. The company continues to operate with very high levels of excess capital – its common equity Tier 1 ratio is currently 17.4% – but given the profitability of the underlying business it has still been able to return significant capital to shareholders. Over the past two years Popular has reduced its share count by 17% while also paying out a 2-3% dividend yield. There have been times we felt management could have been more aggressive with the capital return, but we generally think they've done a good job of maintaining relations with regulators and can also return increasing amounts of capital in the coming years.

How inexpensive do you consider the shares at today's price of nearly $82?

HD: Over the past 12 months pre-provision income, taking out a non-recurring benefit from PPE-loan forgiveness, was about $940 million. If we apply to that a normal provision for loan losses of 0.8% of loans and the current tax rate, we would arrive at EPS of about $9.50 per share. At that level of earnings power, assuming the current rate environment, the stock trades at an 8.6x P/E.

In management's interest-rate sensitivity disclosures in the most recent 10-Q, they estimate that a 200-basis-point increase in interest rates would add $200 million to net interest income. We think that reasonably reflects the benefit the bank would realize from a normalization of interest rates and that would add another $1.75 per share in earnings. On $11.25 in EPS, the stock today is at only 7.3x.

A reasonable P/E multiple for a business of this quality is easily 12x. With no interest-rate increase, that would put our estimate of fair value at about $115 per share. With higher interest rates, that number would be around $135. Those estimates assume nothing happens with the excess capital on the balance sheet, which we peg at almost $2 billion. Even if we assume only half of that gets paid out, it would materially increase the per-share business value.

Turning to another sector altogether, describe you interest today in Fluor [FLR].

SM: The company was founded 110 years ago and is now one of the largest engineering and construction companies in the world. More than half of its normal revenue comes from relatively cyclical energy, chemicals and mining end markets, with

INVESTMENT SNAPSHOT

Popular
(Nasdaq: BPOP)

Business: Provider of a wide range of banking and financial services, mostly in Puerto Rico through Banco Popular, but also in the U.S. through subsidiary Popular Bank.

Share Information (@12/30/21):

Price	**81.82**
52-Week Range	54.01 – 87.15
Dividend Yield	2.2%
Market Cap	$6.54 billion

Financials (TTM):

Revenue	$2.69 billion
Operating Profit Margin	44.5%
Net Profit Margin	33.6%

Valuation Metrics
(@12/30/21):

	BPOP	S&P 500
P/E (TTM)	7.3	28.8
Forward P/E (Est.)	9.0	22.7

Largest Institutional Owners
(@9/30/21 or latest filing):

Company	% Owned
Vanguard Group	9.3%
T. Rowe Price	6.6%
Wellington Mgmt	5.9%
Dimensional Fund Adv	5.2%
Polaris Capital	4.2%

Short Interest (as of 12/15/21):

Shares Short/Float	1.7%

BPOP PRICE HISTORY

THE BOTTOM LINE

As the leading bank in a Puerto Rican market that has grown more competitively rational and stands to benefit from an influx of disaster-relief funds, Hunter Doble believes the shares are worth more than 8.6x his estimate of normalized earnings. At 12x, they would trade at $115. Using his normal estimate if interest rates rise, they would trade at $135.

Sources: Company reports, other publicly available information

another 30% or so from more stable government and services customers.

The past five years have been the worst period in Fluor's history. Their upstream oil and gas business shrank dramatically after 2014, then a number of their big fixed-price contracts ran over budget, and then Covid hit, postponing a number of projects. Even as business has picked up and new contracts have been awarded, upfront spending on those is hitting the financials before revenue is being generated, further depressing profitability.

There are a few keys to our interest in the company today. First of all, we believe new management – installed on an interim basis in 2019 and led by CEO David Constable since the beginning of this year – has taken a number of productive steps to work through mispriced projects, divest non-core assets, improve the balance sheet and reimpose better discipline in pursuing new business. All of that is focused on restoring earnings power to historic levels.

We see the company's emphasis on energy, chemicals and mining – not a positive over the past five years – being a positive over the next five years and beyond. As I said, we don't expect demand for hydrocarbons to be hurt much at all in the near term, but we do see the energy transition to renewables as a tailwind behind capital spending on renewable production assets and the infrastructure related to them. Hydrocarbons have proven to be an efficient way to deliver energy. As we move away from that, producing a unit of energy is going to be more capital intensive than it has been. We expect that on balance will benefit engineering and construction firms like Fluor with expertise in the sector.

What makes Fluor even more attractive is that, like Kosmos Energy, it also has a significant asset that we don't believe is being valued by the market. The company owns a majority stake in NuScale, a leading provider of modular nuclear reactor technology, which is in the process of merging with a SPAC. The new company, to be renamed NuScale Power Corporation when the deal closes, isn't currently profitable but we believe has a great deal of potential as its technology reduces the cost of producing nuclear energy, which can play an important role in addressing hydrocarbon emissions. You can debate the correct value, but at the implied market value for NuScale today, Fluor's stake is worth close to $8 per share.

INVESTMENT SNAPSHOT

Fluor
(NYSE: FLR)

Business: Global provider of engineering, procurement and construction services for large building projects for energy, chemicals, mining, infrastructure and other end markets.

Share Information (@12/30/21):

Price	**24.57**
52-Week Range	14.41 – 25.68
Dividend Yield	0.0%
Market Cap	$3.48 billion

Financials (TTM):

Revenue	$14.06 billion
Operating Profit Margin	0.7%
Net Profit Margin	(-2.3%)

Valuation Metrics
(@12/30/21):

	FLR	S&P 500
P/E (TTM)	n/a	28.8
Forward P/E (Est.)	21.6	22.7

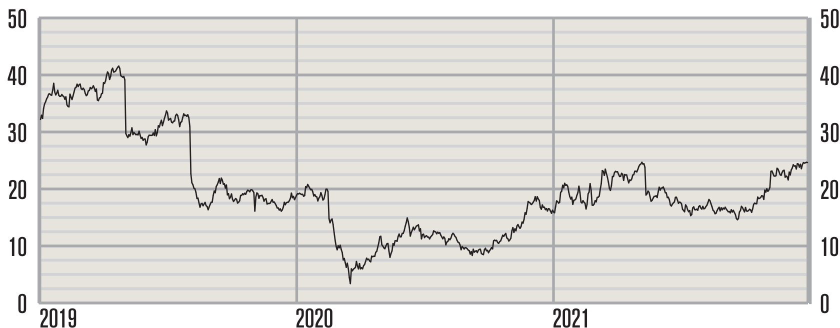
Largest Institutional Owners
(@9/30/21 or latest filing):

Company	% Owned
Wellington Mgmt	11.0%
BlackRock	10.1%
Fidelity Mgmt & Research	9.4%
Vanguard Group	9.1%
Hotchkis & Wiley Capital Mgmt	6.8%

Short Interest (as of 12/15/21):

Shares Short/Float	8.5%

FLR PRICE HISTORY



THE BOTTOM LINE
After a dismal stretch, Stan Majcher believes the company has righted itself operationally entering a period where it should incrementally benefit from its exposure to energy, chemicals and mining end markets. At 12-13x his estimate of normalized EPS the shares would trade at $35-40. Its stake in soon-public NuScale, is worth another $8 per share.

Sources: Company reports, other publicly available information

How attractive do you consider the shares at today's $24.50 price?

SM: As short-term impacts on earnings work themselves out and the industry dynamic improves, we estimate the underlying annual earnings power of the business at about $3 per share. Historically you've seen high multiples for these types of businesses, but the ongoing business would be worth at least $35-40 per share even at only 12-13x earnings. On top of that you have the $8 per share value for NuScale.

Our normal earnings estimate doesn't build in much upside for the energy transition I spoke about earlier. If that has as positive an impact on Fluor as we think it can, earnings could come in well above our current estimate.

From engineering and construction to agricultural equipment, describe the upside you see today in CNH Industrial [CNHI].

SM: Not unlike some of the other ideas we've discussed, this one has both a positive underlying industry story as well company-specific drivers for improved earnings.

CNH's primary business is in heavy farm equipment, where it's one of the three primary global players along with Deere and Agco. Its main brands are Case IH, New Holland and Steyr, which generally inspire strong brand loyalty and are highly regarded for quality, performance and service. Deere in many ways is considered the market leader, but CNH is not far behind.

Farm-equipment manufacturers have played and will continue to play an important role in improving farm productivity through new technology, improved product reliability and increased fuel efficiency. That's all extremely important in order to meet the ever-rising demand for food as global population increases, but also to deliver the more protein-rich diets that usually accompany higher incomes in emerging markets. CNH currently generates roughly one-third of its agriculture-related sales in North America, one-third in Europe, and one-third in developing markets.

The company is also going through a long-running reorganization and operating overhaul, culminating in the spinoff of its Iveco commercial-truck business as a standalone company starting on January 1. The remaining CNH business will continue to be run by CEO Scott Wine, who joined the company from Polaris Inc. a year ago with a reputation as a very strong operator, and he's been focused on taking costs out and improving margins across the enterprise. That process is still ongoing, but we expect it to further fuel earnings improvement over time.

The shares at today's price of $19.20 have roughly doubled since before the pandemic. How do they trade today relative to your estimate of normalized earnings?

SM: We believe that the earnings power of CNH and Iveco, after accounting for post-spin stand-alone costs, exceeds $1.65 per share. At today's share price you're paying only 11.6x that number for a leading market player with strong brands and scale economies in manufacturing, marketing and distribution. We'd expect a business like this to earn at least a 15-16x P/E, which would translate into a roughly $25 share price on our estimate of normal.

As for additional potential upside, the benefits from the recent acquisition of precision-agriculture company Raven Industries, which closed in November, have yet to be reflected in consensus earnings estimates. It has also been several years since the last pronounced upcycle in demand for agricultural equipment. We're not counting on a boom, but to the extent strong current industry conditions persist, it's very possible CNH can earn well in excess of our normal estimate.

We're surprised to see the next idea to discuss, American International Group [AIG], in a mid-cap portfolio.

HD: This speaks to why we find mid-cap to be such an interesting part of the market. As a firm we've invested in AIG for many years in our large-cap strategies, but the decline in its stock price was so steep

INVESTMENT SNAPSHOT

CNH Industrial
(NYSE: CNHI)

Business: Designs, manufactures and sells tractors, agricultural machinery and heavy construction equipment, primarily under the Case, New Holland and Steyr brand names.

Share Information (@12/30/21):

Price	**19.20**
52-Week Range	12.46 – 19.69
Dividend Yield	0.7%
Market Cap	$26.35 billion

Financials (TTM):

Revenue	$32.86 billion
Operating Profit Margin	8.3%
Net Profit Margin	4.8%

Valuation Metrics
(@12/30/21):

	CNHI	S&P 500
P/E (TTM)	16.5	28.8
Forward P/E (Est.)	13.1	22.7

Largest Institutional Owners
(@9/30/21 or latest filing):

Company	% Owned
Harris Associates	8.9%
Hotchkis & Wiley Capital Mgmt	2.3%
Amundi Asset Mgmt	2.1%
Vanguard Group	1.8%
Acadian Asset Mgmt	1.5%

Short Interest (as of 12/15/21):

Shares Short/Float	0.7%

CNHI PRICE HISTORY

THE BOTTOM LINE

After an extended reorganization and operational overhaul, the company is poised to benefit from a positive demand cycle for agricultural equipment, says Stan Majcher. At the 15-16x multiple of normalized earnings he believes a company with such strong brands and scale economies should earn, the stock would trade at around $25 per share.

Sources: Company reports, other publicly available information

when the pandemic arrived that it came comfortably into our mid-cap universe. The company had been working through a significant turnaround and restructuring of its general insurance business, as well as the winding down of legacy assets. By late 2019 there were signs that the fundamentals of the business, specifically around underwriting profitability and capital efficiency, were finally starting to improve. Then Covid comes along and the stock falls to around 30% of book value and less than 4x our estimate of normal earnings power. We already knew the business well and had a clear sense of the strength of the balance sheet and of normalized earnings. We used the steep selloff in the shares to establish a full position quickly.

Rolling forward to today, we see a re-establishment of the positive trends in underwriting quality, a mix shift to focus on more profitable and capital-efficient lines of business, and continued progress in running off non-core assets. With less emphasis necessary on correcting past mistakes and more directed to growing healthy existing franchises, we believe earned premiums can grow at a double-digit annual rate over the next few years. Assuming the return on equity for the property/casualty side of the business improves from a current 8-9% to the 11-12% most peers earn, we think normal earnings power is around $7.50 per share.

The shares are back to pre-Covid levels. At today's $56.75, how are you looking at upside from here?

HD: The stock still trades below the $60 per share in book value, which doesn't include deferred tax assets of another $8-9 per share. In a business this competitive, capital intensive and slow growing you're unlikely to see high earnings multiples, but even at a perfectly reasonable 11-12x our estimate of normal earnings the stock would trade at $80 to $90 per share.

To get a sense of your selling discipline, describe a position you've sold out of recently and why.

HD: One example would be Evercore [EVR], the boutique investment bank. The stock sold off meaningfully at the outset of Covid and the price in the $40s seemed far too inexpensive for a company with strong growth over time, good profitability, a net cash balance sheet, and what we thought was normal earnings power of around $8 per share.

By mid-2021 the business had improved, the market's perception of it had improved, and the stock was at around $140. At that point we didn't consider it overvalued at a mid- to high-teens multiple of normal earnings, but given the unusually attractive opportunities elsewhere in financials we felt we could put the capital to better use in names that offered more upside to our estimates of fair value.

You mentioned earlier having insurance against higher inflation and higher interest rates. Are those the biggest macro worries you see today for investors?

SM: There's always a lot to worry about, and most of the risks we handicap are at a bottoms-up, company-specific level. But we think it's important for portfolio managers to understand the macro risks

INVESTMENT SNAPSHOT

American International Group
(NYSE: AIG)

Business: Provider of a range of property/casualty insurance, life insurance, retirement solutions and other financial services to customers in some 80 countries and jurisdictions.

Share Information (@12/30/21):

Price	**56.74**
52-Week Range	36.80 – 62.54
Dividend Yield	2.3%
Market Cap	$47.14 billion

Financials (TTM):

Revenue	$47.35 billion
Operating Profit Margin	16.7%
Net Profit Margin	11.8%

Valuation Metrics
(@12/30/21):

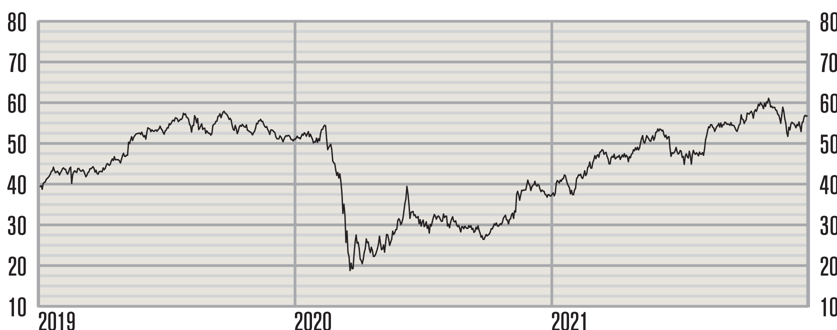
	AIG	S&P 500
P/E (TTM)	8.9	28.8
Forward P/E (Est.)	10.6	22.7

Largest Institutional Owners
(@9/30/21 or latest filing):

Company	% Owned
Vanguard Group	9.4%
T. Rowe Price	9.1%
Capital Research & Mgmt	6.6%
State Street	4.6%
BlackRock	4.6%

Short Interest (as of 12/15/21):

Shares Short/Float	1.0%



THE BOTTOM LINE

As the company improves underwriting quality and continues to shift focus to more profitable and capital-efficient business lines, Hunter Doble expects its normal earnings power to improve to around $7.50 per share. At what he would consider a reasonable 11-12x multiple on that estimate, the shares would trade at 50-60% above today's price.

Sources: Company reports, other publicly available information

they're exposed to, and that the biggest risks today are around interest rates and inflation. Given our portfolio's discounted valuation and the free cash flow being generated by our companies, I feel good about our overall risk/reward profile even if nothing changes with interest rates or inflation. But if there are material changes, there's a lot of upside to our portfolio and a lot of downside to the rest of the market. Sometimes having that kind of insurance is expensive – that's not the case today. VII

Important Disclosure

All investments involve risk and may lose value. This article is for general information purposes only and is not intended to be and should not be relied on for investment advice. The portfolio manager's views and opinions are as the publication date. Such views are subject to change without notice and may differ from others in the firm, or the firm as a whole. The portfolio manager's comments may include estimated and/or forecasted views, which are believed to be based on reasonable assumptions within the bounds of current and historical information. However, there is no guarantee that any estimates, forecasts or views will be realized. In the event of new information or changed circumstances, Hotchkis & Wiley reserves the right to change its investment perspective and outlook and has no obligation to provide revised assessments and/or opinions.

COMPOSITE PERFORMANCE (%) as of December 31, 2022

	QTR	YTD	1 Yr	3 Yr	5 Yr	10 Yr	Inception
H&W Mid-Cap Value Composite (gross)	17.57	2.56	2.56	13.22	6.20	10.02	12.08
H&W Mid-Cap Value Composite (net)	17.36	1.89	1.89	12.61	5.58	9.32	11.27
Russell Mid-Cap Value Index	10.45	-12.03	-12.03	5.82	5.72	10.11	9.73

Commencement of the Mid-Cap Value Composite: 1/1/97. Average annual total returns for periods greater than one year.

Investment returns include reinvestment of dividends, interest and capital gains. Valuation is based on trade-date information. Gross performance results are presented before management and custodial fees but after all trading expenses. Net performance results are presented after actual management fees and all trading expenses but before custodial fees. The Composite includes all Mid-Cap Value discretionary accounts. The Mid-Cap Value strategy seeks capital appreciation primarily through investments in equity securities of mid-cap companies and may invest in the securities of small capitalization companies and in foreign (non-U.S.) securities. Other performance disclosures are included in the strategy's GIPS Report. The Mid-Cap Value strategy's returns for different time periods and market cycles can result in significantly different performance results. A portfolio's investment guidelines, timing of transactions, market conditions at the time of investment and other factors may lead to different performance results.

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. Investing in value stocks presents the risk that value stocks may fall out of favor with investors and underperform growth stocks during given periods.

Characteristics and holdings are based on a representative portfolio of the Mid-Cap Value Strategy. This information may vary by portfolio due to different restrictions, cash flows, and other relevant considerations. As of 12/31/22, the securities identified comprise the following percentages of a representative portfolio within the Mid-Cap Value strategy: Kosmos Energy Ltd. 5.2%, Fluor Corp. 4.5%, Popular Inc. 4.3%, APA Corp. 4.2%, Citizens Fin'l Group Inc. 4.0%, First Citizens Bancshares 3.5%, American Int'l Group Inc. 3.1%, Adient PLC 3.1%, State Street Corp. 2.7%, and F5 Inc. 2.7%. Any security mentioned but not listed here was not held in the representative portfolio as of 12/31/21. The Russell Midcap® Value Index measures the performance of those Russell Midcap® companies with lower price-to-book value ratios and lower forecasted growth values.

Securities identified do not represent all of the securities purchased, sold, or recommended for advisory clients, and may not be indicative of current or future holdings or trading activity. Any discussion or view of a particular company is as of the publication date but may be sold and no longer held in the Mid-Cap Value strategy at any time, for any reason, without notice, subsequent to the publication date. The securities reflected herein are intended to be for illustrative purposes only and are not intended to be, and should not be construed as, investment recommendations or investment advice. Past performance of these securities, or any other investments, is not an indicator of future results. Hotchkis & Wiley's opinions regarding these securities are subject to change at any time, for any reason, without notice. No assurance is made that any securities identified, or all investment decisions by H&W were or will be profitable. Portfolio holdings are subject to change without notice; a complete list of holdings is available upon request at hotchkisandwiley@hwcm.com, subject to the firm's portfolio holdings disclosure policy.

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.

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