



*Dale R. Folwell, CPA*

## INVESTMENT MANAGEMENT

To: North Carolina Supplemental Retirement Board of Trustees

From: Loren de Mey, Assistant Investment Director

Date: March 6, 2019

Subject: Discussion / Action: NC 401(k) and NC 457 Plans - Watch List Recommendation

### **Background**

Hotchkis and Wiley's Small/Mid Cap Value strategy was placed on the watch list in the first quarter of 2017 due to underperformance. Hotchkis, like many other value managers, struggled in 2016 when more defensive companies were in favor. Hotchkis had avoided those companies with higher dividends that investors preferred through out 2016 as the manager believed these companies had excessive valuations due to the low interest rate environment. During 2017, Hotchkis' deep value investment style continued to be out of favor. At the time Hotchkis was initially placed on the watch list, the strategy was rated a B+ by Mercer. The strategy remains a B+ and has not been downgraded.

### **Investment Style**

Hotchkis employs a disciplined investment process that seeks to exploit attractively valued companies experiencing short-term mispricings, but have prospects for improving business fundamentals and strong economic returns. Hotchkis focuses on companies where their estimates of the intrinsic value of future cash flows exceeds the market price. The investment team is willing to invest in out-of-favor stocks that may require some time for intrinsic value to be recognized by the market. The team's deeper value approach may result in portfolio positioning that, at times, may create a headwind to performance, such as in periods when investors become risk averse or during a 'risk-off' environment.

Although the strategy tends to be diversified at the stock level, the portfolio may, at times, have a tendency to allocate away from certain sectors such as utilities, REITs and materials, particularly when Hotchkis perceives them as overvalued. Therefore, there is the potential for notable sector differences that may contribute to periods of short-term volatility and tracking error relative to the benchmark. While Hotchkis may have higher volatility and tracking error, this is not a concern at the white label fund level, given the level of diversification within the overall NC Small/Mid Cap Fund. The Hotchkis portfolio is meant to play the role of a deep value manager within the NC Small/Mid Cap Fund. The target weight to Hotchkis in the NC Small/Mid Cap Fund is 15.83 percent.

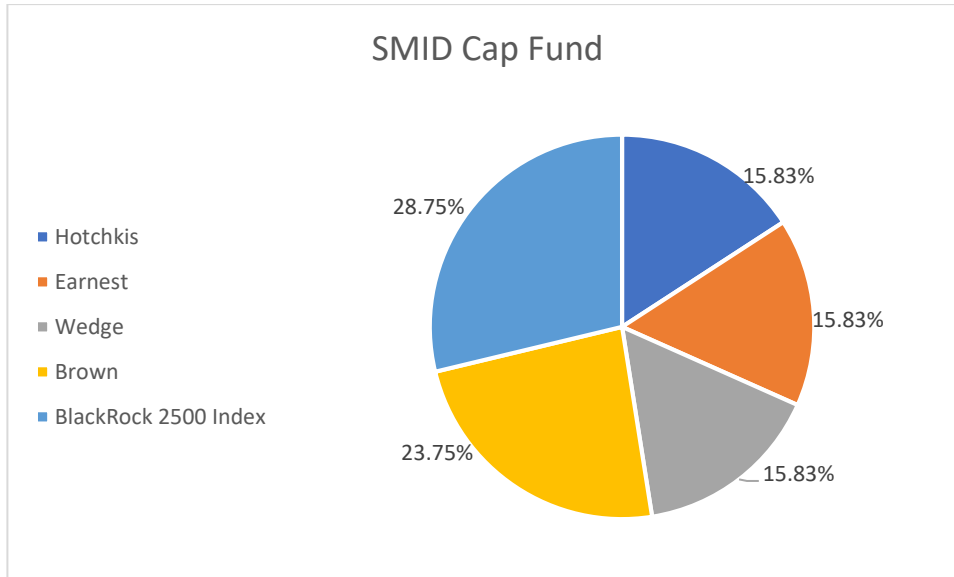


*Dale R. Folwell, CPA*

## INVESTMENT MANAGEMENT

### NC Small/Mid Cap Fund: Total AUM- \$802.7 million (as of 1/31/19)

Below are the target weights to the investment managers within the NC Small/Mid Cap Fund



### Recent Performance

#### 2018

The Hotchkis portfolio underperformed the benchmark in 2018 mainly due to the portfolio's overweight to the energy sector. At the end of December, the portfolio's weighting to the energy sector was 23 percent compared to 7 percent for the Russell 2500 Value. The portfolio underperformed the benchmark by 8.2 percent in the fourth quarter as the price of oil fell by more than 40 percent. Prior to underperforming in the fourth quarter, the portfolio had outperformed the benchmark in the first, second and third quarters of 2018.

#### 2019 Year to Date

In January, Hotchkis outperformed the benchmark by 5.6 percent as the price of oil recovered to the mid-50's and the portfolio's energy holdings recovered as well. Looking at preliminary performance year to date through February, the portfolio is up 21.96 percent compared to the benchmark, which is up 14.65 percent, outperforming the benchmark by 7.3 percent (gross of fees).



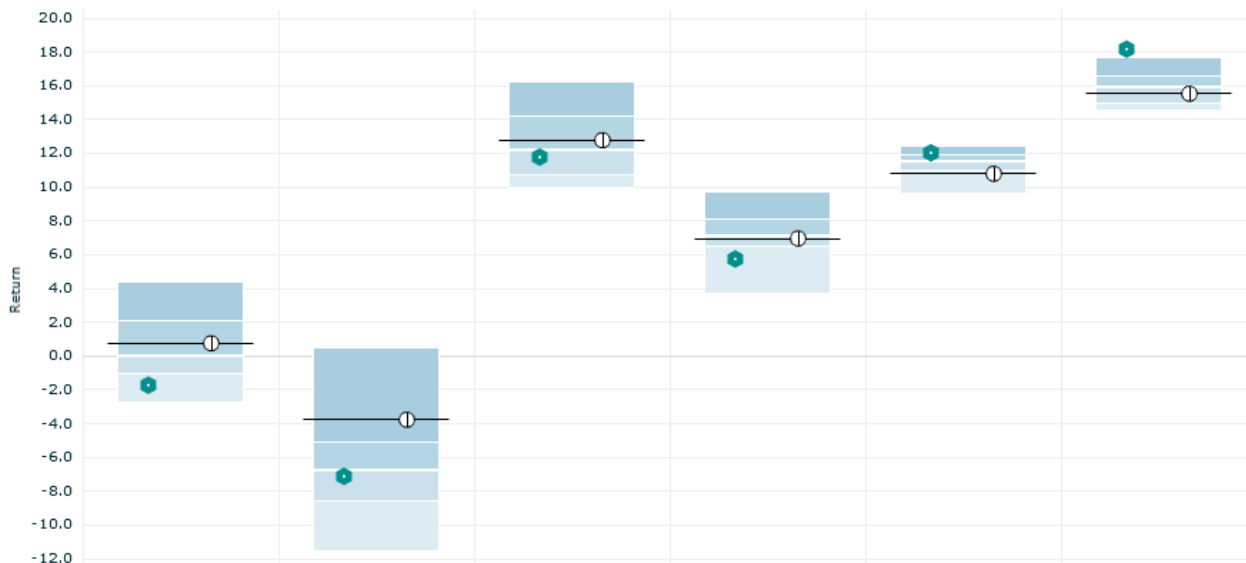
*Dale R. Folwell, CPA*

## INVESTMENT MANAGEMENT

Below is the historical performance for the portfolio. Calendar year performance and additional risk statistics can be seen in Appendix A.

Return in \$US (before fees) over 3 mths, 1 yr, 3 yrs, 5 yrs, 7 yrs, 9 yrs 10 mths ending January-19

Comparison with the US Equity SMID Value universe (Percentile Ranking)



	3 mths (%)	1 yr (%)	3 yrs (%pa)	5 yrs (%pa)	7 yrs (%pa)	9 yrs 10 mths (%pa)
● NC Hotchkis	-1.7 (87)	-7.1 (52)	11.8 (57)	5.8 (85)	12.0 (23)	18.2 (1)
○ Custom BM	0.8 (43)	-3.8 (17)	12.8 (39)	7.0 (55)	10.8 (79)	15.5 (61)
5th Percentile	4.4	0.5	16.3	9.7	12.4	17.7
Upper Quartile	2.1	-5.1	14.2	8.1	11.9	16.5
Median	0.0	-6.7	12.2	7.2	11.5	15.9
Lower Quartile	-1.1	-8.6	10.8	6.5	11.0	15.0
95th Percentile	-2.7	-11.5	10.0	3.7	9.6	14.5
Number	46	44	41	35	29	22

Created on 6 Mar 2019 at 11:15 AM



*Note: the benchmark is a blended benchmark comprised of the Russell Mid Cap Index from inception (4/1/09) through 6/30/11 and the Russell 2500 Value from 7/1/11 through 1/31/19.*

Although the manager underperformed significantly in the fourth quarter of 2018, the portfolio is outperforming its benchmark year to date. Additionally, the portfolio today is trading at a discount compared to the benchmark and is well positioned for potential future upside. As of the end of December, the portfolio was trading at 5.1 times normal earnings compared to 12.1 times normal earnings for the Russell 2500 Value Index.

Staff does not have concerns with the overweight to the energy sector within the Hotchkis portfolio, given the overall diversification at the white label fund level. The average energy weighting within the NC Small/Mid Cap Fund is 3.4 percent. Although disappointed with the recent performance of Hotchkis, this type of performance and volatility is not unexpected given the manager's deep value and high tracking error investment style.

### **Recommendation**

Although there have been signs of a turn-around more recently in relative performance, staff and Mercer recommend keeping Hotchkis and Wiley on the watch list until we see a longer period of

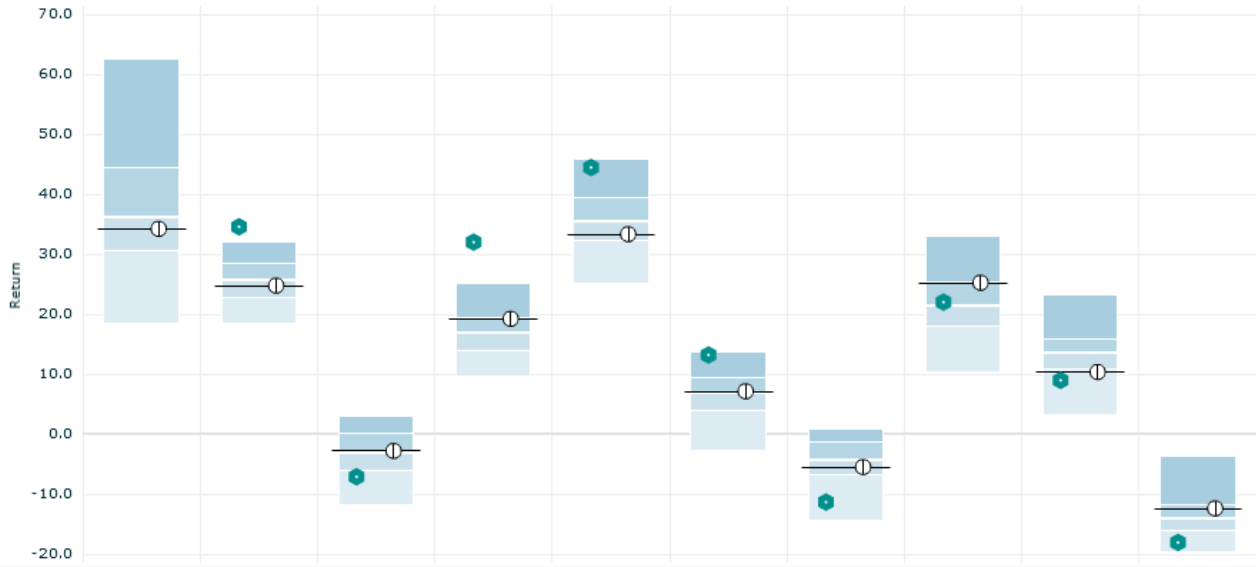


## INVESTMENT MANAGEMENT

relative outperformance, both against the index and peers. Staff will continue to monitor the portfolio and performance of Hotchkis.

### Appendix A: Calendar Year Performance

Return in \$US (before fees) over last 10 calendar years ending December-18  
Comparison with the US Equity SMID Value universe (Percentile Ranking)



	2009 (%)	2010 (%)	2011 (%)	2012 (%)	2013 (%)	2014 (%)	2015 (%)	2016 (%)	2017 (%)	2018 (%)
★ NC Hotchkis	-	34.5 (3)	-7.1 (79)	32.0 (0)	44.5 (7)	13.2 (6)	-11.3 (89)	22.0 (42)	9.0 (83)	-18.0 (88)
○ Custom BM	34.2 (59)	24.8 (60)	-2.8 (46)	19.2 (29)	33.3 (71)	7.1 (48)	-5.5 (60)	25.2 (28)	10.4 (78)	-12.4 (33)
5th Percentile	62.4	32.1	3.1	25.2	45.8	13.8	0.9	32.9	23.3	-3.7
Upper Quartile	44.4	28.6	0.1	19.4	39.3	9.4	-1.3	25.4	15.9	-11.8
Median	36.3	25.7	-3.0	17.0	35.5	6.9	-4.2	21.5	13.5	-14.0
Lower Quartile	30.5	22.9	-6.0	14.0	32.2	4.0	-6.7	17.9	10.9	-16.2
95th Percentile	18.5	18.6	-11.7	9.8	25.1	-2.9	-14.4	10.4	3.3	-19.6
Number	66	62	62	70	64	67	70	69	70	71

Created on 6 Mar 2019 at 11:15 AM





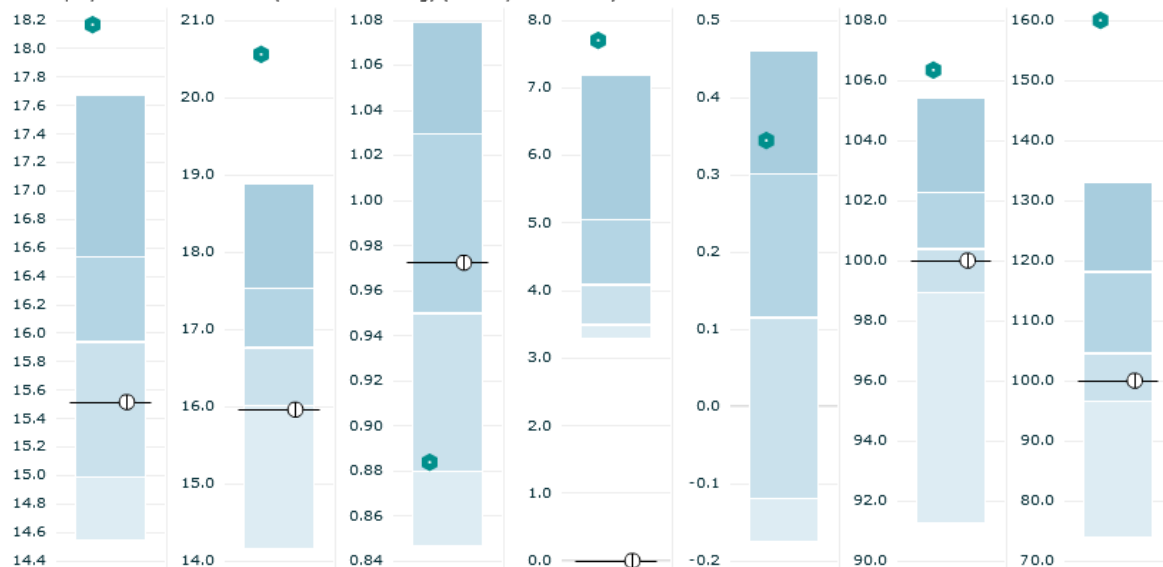
*Dale R. Folwell, CPA*

## INVESTMENT MANAGEMENT

### Risk and Return Characteristics

Performance characteristics vs. Hotchkis Custom in \$US (before fees) over 9 yrs and 10 mths ending January-19

Comparison with the US Equity SMID Value universe (Percentile Ranking) (monthly calculations)



	Ret (%pa)	Std Dev (%pa)	Ret/SD	TE (%pa)	IR	Down Cap (%)	Up Cap (%)
● NC Hotchkis	18.2 (1)	20.6 (0)	0.9 (74)	7.7 (3)	0.3 (18)	106.3 (3)	160.0 (0)
○ Custom BM	15.5 (61)	16.0 (76)	1.0 (45)	0.0 (100)	-	100.0 (59)	100.0 (67)
5th Percentile	17.7	18.9	1.1	7.2	0.5	105.4	133.1
Upper Quartile	16.5	17.5	1.0	5.0	0.3	102.3	118.1
Median	15.9	16.8	1.0	4.1	0.1	100.4	104.6
Lower Quartile	15.0	16.0	0.9	3.5	-0.1	98.9	96.6
95th Percentile	14.5	14.2	0.8	3.3	-0.2	91.3	74.0
Number	22	22	22	22	22	22	22

Created on 6 Mar 2019 at 11:15 AM

