



Dale R. Folwell, CPA

INVESTMENT MANAGEMENT

To: Supplemental Retirement Board of Trustees

From: Loren de Mey, Assistant Investment Director

Date: November 26, 2019

Subject: Discussion / Action: NC 401(k) and NC 457 Plans: Hotchkis and Wiley Mid Cap Value Termination Recommendation

Hotchkis Mid Cap Value Investment Strategy

Hotchkis and Wiley (“Hotchkis”) has been managing the Mid Cap Value strategy for the NC Small/Mid Cap Fund in the NC 401(k) and NC 457 Plans (“Plans”) since April 2009 and currently manages approximately \$140 million in the strategy for the Plans. The Hotchkis Mid Cap Value strategy employs an investment process that seeks to exploit attractively valued companies experiencing short-term mispricings but that have prospects for improving business fundamentals. The strategy invests in out of favor stocks that may require some time for intrinsic value to be recognized by the market. The strategy’s deeper value approach results in portfolio positioning that at times creates a headwind to performance, such as in periods when investors become risk averse or during a ‘risk-off’ environment. The portfolio may allocate away from certain sectors such as Utilities, REITs and Materials, particularly when Hotchkis perceives them as overvalued. There can be the potential for notable sector differences that may contribute to periods of short-term volatility and tracking error relative to the benchmark.

Performance

The Hotchkis Mid Cap Value strategy was initially placed on the watch list in the first quarter of 2017 due to underperformance. Hotchkis, like many value managers, struggled in 2016 when more defensive names were in favor. Hotchkis had avoided those companies with higher dividends than investors preferred throughout 2016 as the manager believed these companies had excessive valuations due to the low interest rate environment. Throughout 2017, Hotchkis’ deep value investment style continued to be out of favor.

The portfolio underperformed in 2018 mainly due to the portfolio’s overweight to the energy sector. At the end of 2018, the portfolio’s allocation to the Energy sector was 23 percent compared to 7 percent for their benchmark. The portfolio underperformed by 8.2 percent in the fourth quarter of 2018 as the price of oil fell by more than 40 percent.

Although Hotchkis outperformed the benchmark in the first quarter of 2019, Hotchkis has continued to underperform in both the second and third quarters by 522 basis points and 756 basis points, respectively. On a one-year basis, the Hotchkis portfolio is trailing its benchmark by 18 percentage points. Additionally, the strategy is in the bottom quartile relative to peers for the trailing one, three and five-year time periods. Their underperformance continues to be driven by not only their overweight to the energy sector but also poor stock selection within the energy sector. The portfolio’s current allocation (as of 10/31/19) to the energy sector is 15 percent compared to 4 percent for the benchmark.



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INVESTMENT MANAGEMENT

Staff conducted an onsite meeting in Hotchkis' offices in Los Angeles in October and met with the two co-portfolio managers of the Mid Cap Value strategy, Stan Majcher and Hunter Doble. Hunter Doble was recently added as a co-portfolio manager to the Mid Cap Value strategy although he has worked for Hotchkis for fourteen years and covers the energy, financials and healthcare sectors. Staff also met with additional analysts on the portfolio as well as the firm's CEO and Large Cap Value portfolio manager, George Davis. This provided an opportunity to further discuss the portfolio holdings, investment process and investment team dynamics.

While certain stocks within the energy sector may exhibit value, some of these holdings may require a higher oil price before they see a significant recovery in their stock price. Although the overall NC Small/Mid Cap Fund is well diversified, the underperformance of the Hotchkis portfolio has continued to weigh on the overall performance of the fund.

Staff recognizes that many value managers, particularly deep value managers, may require time for intrinsic value to be recognized by the market. In many cases, it may make sense to be patient. However, given the amount of time the Hotchkis strategy has been on the watch list coupled with the magnitude of the underperformance, staff recommends terminating the Hotchkis Mid Cap Value portfolio at this time. Callan supports the recommendation.

This recommendation does not impact the Hotchkis Large Cap Value strategy, which is not on the watch list and has been outperforming its benchmark year to date, as well as for the three-year and five-year trailing time periods.

Recommendation

1. Terminate the Hotchkis Mid Cap Value strategy.
2. Allocate the funds equally to the remaining Small/Mid Cap Value managers within the NC Small/Mid Cap Fund: 50 percent to Wedge Small/Mid Cap Value (approximately \$70 million) and 50 percent to Earnest Small Cap Value (approximately \$70 million).

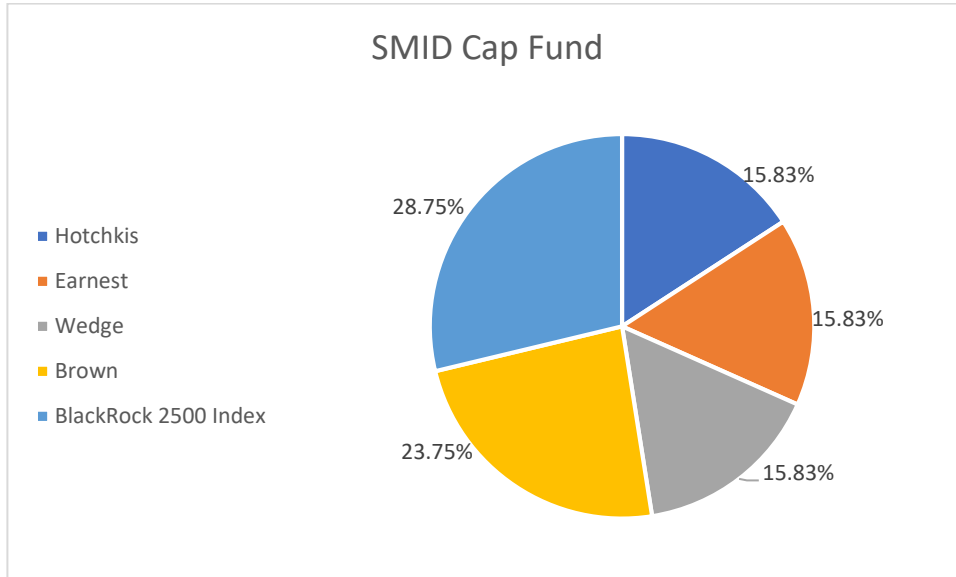


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INVESTMENT MANAGEMENT

NC Small/Mid Cap Fund total assets: \$851.8 million (as of 10/30/19)

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



Timing and Transition

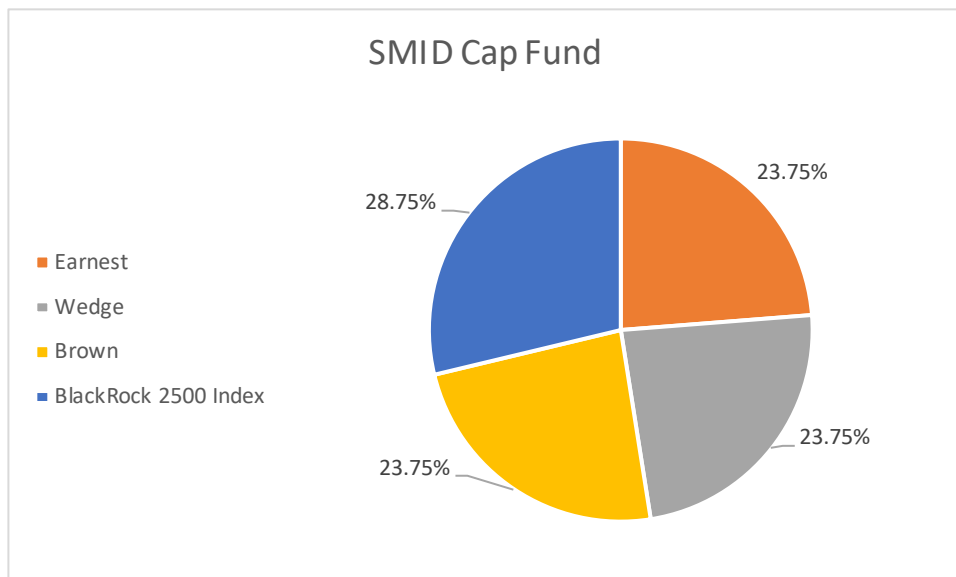
Staff recommends moving the funds from the Hotchkis Mid Cap Value strategy into the other existing Small/Mid Cap Value managers within the NC Small/Mid Cap Fund as follows: 50 percent to Earnest Partners and 50 percent to Wedge Capital. Earnest and Wedge each currently manage approximately \$135 million. Allocating 50 percent to each would increase the amount they manage by approximately \$70 million, to \$205 million. If approved, it is anticipated that the transition would occur by the end of December 2019. Note: Wedge Capital is currently on the watch list; however, they are outperforming their benchmark in the third quarter, year-to-date and for the one-year time periods. Staff and Callan do not have concerns with recommending additional funds to Wedge.



INVESTMENT MANAGEMENT

Recommendation Target Weights

Following are the new target weights after reallocating the capital from Hotchkis to the other existing value investment managers within the NC Small/Mid Cap Fund.



Below is the historical performance for the Hotchkis Mid Cap Value portfolio. Calendar year performance and additional risk statistics are in Appendix A.

	October	3 rd Qtr	YTD	1 Year	3 Year	5 Year	ITD*
Hotchkis	0.94	-4.57	4.72	-12.18	3.02	0.64	15.75
Benchmark**	1.44	0.92	17.07	6.10	8.47	6.36	15.68
Excess	-0.5	-5.49	-12.35	-18.28	-5.45	-5.72	0.07

*Inception date: April 1, 2009

**Note: the benchmark is a blended benchmark comprised of the Russell Mid Cap Index from inception through 6/30/11 and the Russell 2500 Value from 7/01/11 through October 31, 2019.



INVESTMENT MANAGEMENT

Appendix A

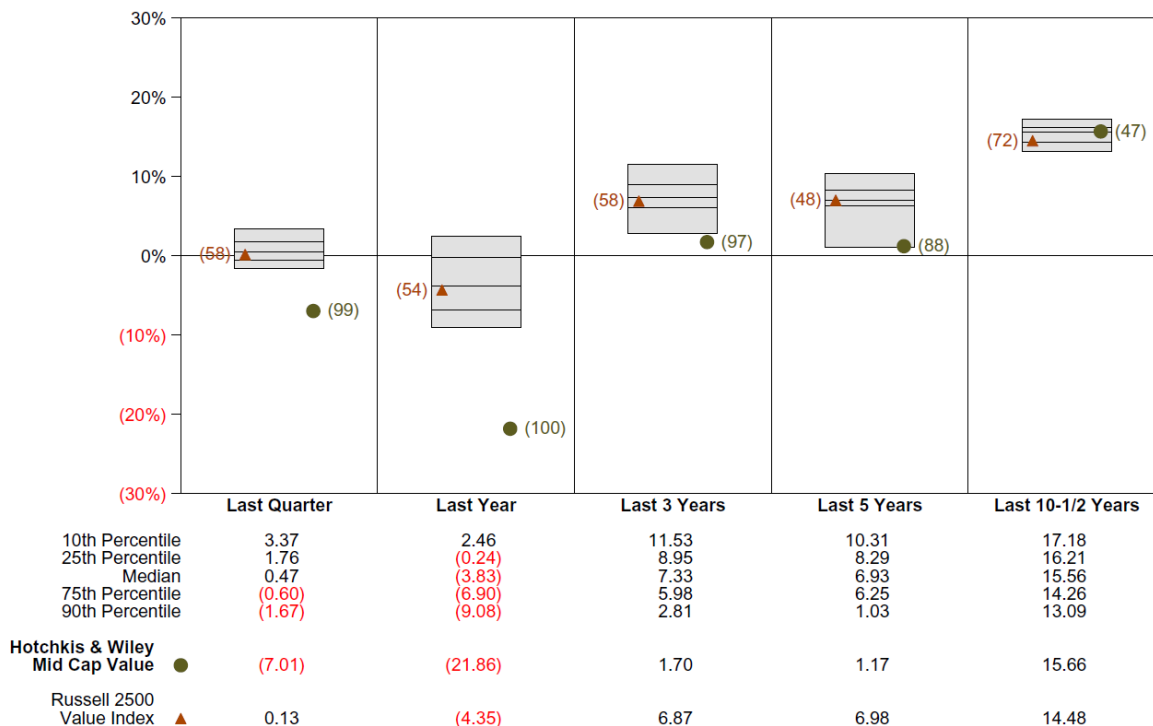
Calendar Year Performance

	2019 YTD*	2018	2017	2016	2015	2014	2013	2012	2011	2010
Hotchkis Mid Cap Value	4.72	-18.45	8.37	21.40	-11.81	12.49	43.56	31.19	-7.65	33.84
R2500 Value	17.07	-12.36	10.36	25.20	-5.49	7.11	33.32	19.21	-2.82	24.75

*YTD through October 2019

Performance Versus Peers

Performance vs Callan Small/MidCap Value (Gross)



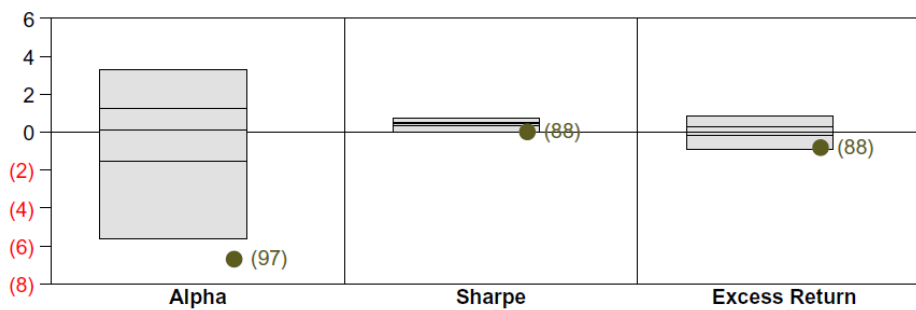


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Risk and Return Statistics

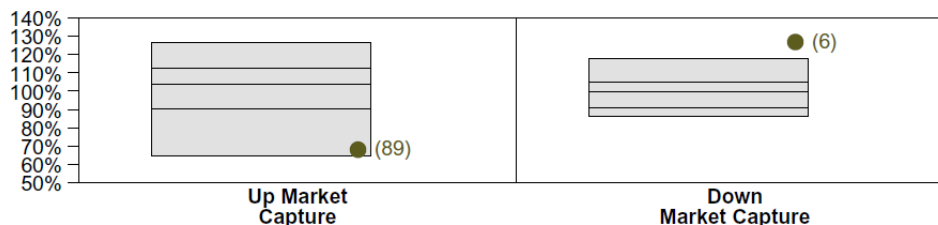
Risk Adjusted Return Measures vs Russell 2500 Value Index
Rankings Against Callan Small/MidCap Value (Gross)
Five Years Ended September 30, 2019



	Alpha	Sharpe Ratio	Excess Return Ratio
10th Percentile	3.31	0.71	0.87
25th Percentile	1.22	0.53	0.26
Median	0.10	0.45	(0.02)
75th Percentile	(1.52)	0.33	(0.17)
90th Percentile	(5.60)	0.00	(0.91)

Hotchkis & Wiley Mid Cap Value ● (6.70) 0.01 (0.82)

Market Capture vs Russell 2500 Value Index
Rankings Against Callan Small/MidCap Value (Gross)
Five Years Ended September 30, 2019



	Up Market Capture	Down Market Capture
10th Percentile	126.76	118.01
25th Percentile	112.48	104.86
Median	103.77	99.96
75th Percentile	90.11	91.05
90th Percentile	64.69	86.20

Hotchkis & Wiley Mid Cap Value ● 68.05 126.86