Classic Large Cap Value

Quarterly Commentary

Our results this quarter—and now for the last year and a half—are painful. We are now in 1997-99 territory, when looking for a comparison for a pure value style. We are frankly stunned at the magnitude of the performance gap; it's not that we haven't seen value out of favor before, although we've tried to forget the pain. To put it simply, we believe the current market environment is irrational and cannot be sustained.

Over the last year, every large-cap value manager in the bottom 10th percentile on price-to-earnings (P/E) is in the bottom 10th percentile on performance*. The cheaper the portfolio, the worse the performance is. Does cheapness work? We know that it has historically worked over the long-term. When we talk about behavioral finance, we talk about how value opportunities emerge because investors drive a particular company or theme far out of favor. Emotion is interjected into what should be objective financial decisions. That certainly is the case now for many companies and industries.

There is indisputable quantitative evidence that we are in an anomalous period, much like that late-1990s environment. There is a valuation bubble affecting our results, which we will present below. In the late 1990s' mega-cap and tech bubble, growth managers did not make the market top; it was made by value managers capitulating and buying the likes of AOL and Yahoo in an attempt to "participate" in the new paradigm. Brandywine Global equity strategies had clients that fired us in 1999 and 2000 and preferred to go with managers with better recent performance. Many of you may remember this era, where the allure of the "New Economy" theme prompted many value managers to drift away from their time-proven processes in an attempt to avoid the pain. Some clients even went to overweight growth managers because value had done so poorly for so long.

We presently find ourselves at a similar jumping-off point. Should we eschew our investment discipline and position the strategy in stocks that we believe are mispriced to the upside but have produced good performance recently? Should we assume that what has worked over the past 18 months is what will work in the future, in a new paradigm?

We will not give in to the temptation to chase overvalued themes that have become even more overvalued. We know who we are, and what our process is: we have a disciplined value process in a period where value has been abandoned by the marketplace.

We will first discuss the evidence, and then move on to what you would have to believe in order to justify the current situation. There is a scenario where the current market environment does make sense, and in which our strategy is not one you would want to own. We will present that scenario.

One interesting parallel to the late-1990s scenario is we find ourselves again obliged to talk a lot about what we don't own. We essentially don't own utilities, staples, and telecommunications (telecomm). These groups are highly valued, and represent one side of the bubble. We point to three pieces of current research to explain the current, anomalous market conditions:

1. Michael Goldstein at Empirical Research Partners observed on June 30, "The 10% of stocks most correlated with Treasury yields trade at a 11% premium to the market, the 10% of stocks least correlated trade at a 27% P/E discount…that 38 percentage point differential is hard to justify based on fundamentals as both groups grow at the same rate and have similar dividend yields." Stocks in that lowest decile are at the 98th percentile in terms of valuations since 1952. Empirical Research Partners further observed that the largest increase in correlation among stocks has been seen in the lowest quintile of valuation. We have certainly suffered as a diversified strategy of cheap stocks hasn't produced the benefits sought from diversification, with an absence of winners as seemingly unrelated companies traded in tandem.
2. Vadim Zlotnikov, the respected Bernstein strategist, recently gave a talk where he presented evidence that the "most crowded" trades are consumer staples, healthcare, low beta and high dividend yield, while the "least crowded" are energy, financials, high beta, and low price-to-book (P/B). The least-owned stocks historically deliver the best return going forward, and valuation spreads are as high as during prior crises.

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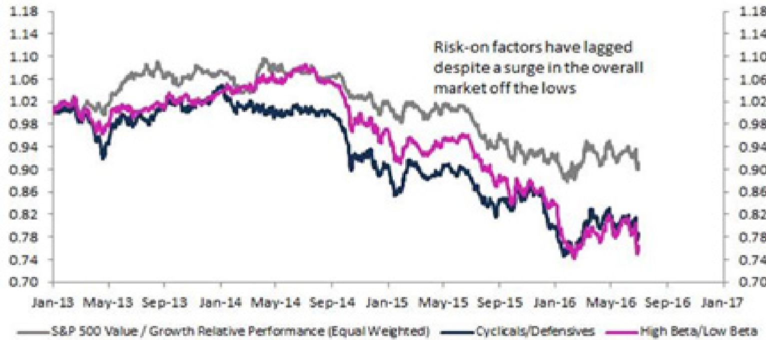
He went on to say that a bet on reflation is the "single most contrarian trade in the world." In essence, the market is uniformly and richly pricing in a recession with little-to-no probability of a different outcome.

3. Dennis DeBusschere of EvercoreISI provided the next two charts, which look at the magnitude of the underperformance of some of these disparities:



As for the sectors:

When looking at the chart above, keep in mind that according to Baseline, these sectors within the Russell 1000 Value index trade at the following trailing-earnings multiples:

- Consumer staples: 21.6x
- Utilities: 20.3x
- Telecomm: 15.8x
- Financials: 13.5x
- Consumer discretionary: 11.3x

Drilling down into a specific sector, let's present additional evidence: We have been showing a chart for a number of quarters that utilities are overvalued relative to history. Utilities have become even more overvalued, with many up 20% this year and the group now trading at a 30% premium to historical levels (a higher premium than during the 2008 global financial crisis). What are the underlying beliefs that would justify this premium? You have to believe interest rates remain low, that regulators do not lower allowed returns on equity (ROEs) in response, that a lower discount rate justifies a higher multiple for utilities but not for other groups, and that alternative energy technologies—especially a new battery storage technology—does not come along to disrupt their business model. Believing these assumptions, in order to continue to outperform from here, one has to believe that multiples will continue to expand from the valuation at which investors currently own these—or that the economy is going to collapse. Since these companies trade above a market multiple, they cannot be considered traditional value stocks; an investor must believe in the forecast and the story behind it.

Right now the strategy holds companies generating a lot of earnings. The impact of the above is that we own $1 of earnings for less than half of what other investors are paying for $1 of earnings. Is there a reason to think that $1 of earnings at a financial services company, for example, might be worth more than 40% of $1 of earnings at a tobacco company?

What could justify overpaying for earnings?

Let's start by assuming that domestic tobacco earnings will be flat. We think that might be a leap, but it allows us to lock in that premium for stability. The tobacco company trades at over 20x trailing earnings. Let's next look at the financial services company's valuation: less than 8x trailing earnings, and less than 65% of tangible book value.

What would one have to believe to think the tobacco stock will continue to outperform from this point? The tobacco company could grow earnings, either from price increases, increased tobacco usage, or an acquisition using its highly valued stock. Good results are one way the stock could do well.

Alternatively, the bank could have an earnings decline; however a major event would need to occur that would cause this particular bank to stop earning over $20 billion and lose more than $50 billion. Low 10-year Treasury yields typically impact earnings by only 2-3%, so that won't do it. Defaults on energy loans may appear to be less of a concern, but aren't a big enough portion of the bank's loan book to matter much. This financial services company no longer offers subprime loans—mortgages, credit cards, home equity loans, or car loans—so the categories that hurt banks in 2008 are no longer represented. The bank is actually under-earning pretty meaningfully relative to history on metrics like return on assets (ROA) and ROE. No, what one would have to believe is that the Federal Reserve (Fed) would lower rates from here—reversing the December hike—and the global economy has a financial crisis as bad as or worse than the last one. Such a crisis could be prompted by an uncontrolled collapse of Deutsche Bank, for instance, or maybe it's just sentiment that somehow collapses further. We believe the reason the bank's stock is trading at $42 with tangible book value well above $60 is really predicated on the belief that bank stocks won't appreciate; not because of their fundamentals. We believe fundamental analysis of companies tends to be most important when everyone else believes it no longer matters.

What does the consensus believe? The conversations we have include the following presumptions: interest rates will not rise for several years, the economy is more likely to go into a recession than grow 2% or faster, the auto manufacturing cycle has peaked, the subprime auto loan bubble will burst, and central banks have inflated asset prices, which could also burst.

We believe investors are generally now conditioned to believe that anything other than a continuation of all current trends is wrong. Everyone seems to "know" that conditions are going to get worse. This is the new normal, things are different this time, and valuations no longer matter. In essence we believe the prevailing sentiment is currently, "Stocks have gotten cheaper, therefore the companies are bad." Maybe that will prove to be true, but in our opinion, the reason value investing persists as a winning discipline over time is that the market is more often overly emotional in its judgments and penalizes good businesses far too much.

A good case in point: Unilever plc sold 4-year bonds this quarter yielding 0%. Actually, let's rephrase that for clarity: investors provided capital to a private enterprise with no expectation of a return on that capital if plans go perfectly.

That. Doesn't. Make. Sense. There are a bunch of irrational deals like the Unilever plc bond issue in the market right now, and they don't seem to make sense.

MOVING ON TO ATTRIBUTION

The Classic Large Cap Value strategy returned -1.43% gross of fees (-1.60% net) during the second quarter versus the Russell 1000 Value index, which returned 4.58% for the same period. The industrials, consumer discretionary, and financials sectors combined detracted more than 700 basis points (bps) of relative performance. Basically, any economically sensitive industry was the wrong place to be, and low valuations offered no protection. Owning large index holdings at high valuations would have delivered much better performance, but that is not our process—at least the high valuations part. It is essential to note that operating results at the companies driving this underperformance were fine, and certainly not materially different from most stocks that outperformed. The market continued to discount the earnings of the companies we owned and mark up the earnings of companies already trading at a premium.

Within industrials, airlines accounted for more than 180bps of underperformance. The two largest detracting airlines had midrange single-digit P/E ratios. Brexit concerns also added to the rout late in the quarter. Our biggest detractor for consumer discretionary was a retailer, which surpassed earnings expectations but continues to hold an approximately 11 P/E ratio. Other retailers had declines of more than 20% as well. As for financials, two private equity firms had double-digit percentage declines, taking off more than 90bps of relative performance. While low rates should help them, economic concerns hurt these stocks. These two private equity firms both trade at less than 10x forward earnings estimate. The few bright spots of the quarter included our large exploration and production (E&P) weighting, which drove energy to a 19.8% gain for the strategy, adding 141bps.

As Warren Buffet once famously said, investors are habitually guided by the rearview mirror and the vistas reflected in them. Oil appears to be a prime example of the notion if something is unsustainable it won't continue. With many investors and companies losing money at $30/barrel, $30 oil had to give. One notable Wall Street firm had predicted when oil hit $150/barrel, prices would go to $200. When oil hit $30, this same firm predicted oil would go to $20 and not higher than $40. That same firm is now predicting $50 oil.

From a factor standpoint, the cheapest stocks crushed us. More than 50% of the strategy screens as being in the lowest 20% of the Russell 1000 Value Index; we are dramatically overweight low P/E even within value. We lost more than 400bps of relative performance from these extremely cheap stocks.

Brandywine Global's factor work shows that within the value index, low price-to-book (P/B), low P/E, and higher beta have all hurt returns. Higher earnings growth and higher ROE haven't helped either. What has worked? High dividend yields, low debt-to-equity, and low volatility.

RUSSELL 1000 VALUE INDEX

Factor:	Second Quarter	Year-to-Date
Low Price-to-Book	-1.4%	-7.8%
Low Price/Earnings	-5.7%	-11.4%
High Dividend Yield	4.2%	18.4%
High ROE	-4.0%	-2.4%
Low-Debt-to-Equity	2.9%	9.4%
Low Price Volatility	1.3%	3.8%
High Earnings Growth	-6.5%	-11.9%
Higher Beta	-2.3%	-6.7%

Return Spread - Quartile 1 minus Quartile 4

As of June 30, 2016

From a transaction standpoint, turnover was slightly less than 10%. We sold and added six names. Within energy, we sold two positions entirely, and added another. The former two look fully valued to us, while the new position still appears to be pricing in skepticism regarding its management and its deepwater drilling exposure. Within financials, we sold two positions, one since it is being taken over and the other because our thesis was compromised. Within healthcare, we sold two broken theses and added another.

ECONOMIC VIEW

Here is a brief list courtesy of EvercoreISI of what investors are worried about:

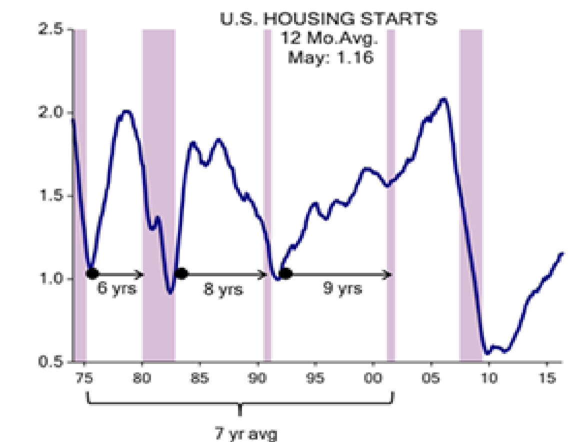
Brexit	Middle East instability
Negative rates	Central banks out of ammunition
Trump uncertainties	Income disparities
Productivity	Greece
Participation rate	High frequency trading
Protectionism	Student debt
Global warming	Exchange traded funds
Orlando	China risk
Immigration	Program trading
U.K. recession risk	S&P earnings
ISIS	Japan risk

It's a pretty long list. Also, very few things on that list are new this year, with the exception of "Brexit," the U.S. election, and Orlando Of course, some events that investors worried about in prior years—remember the Fiscal Cliff—are no longer on the list.

The U.K. decision to Brexit caught most investors off guard, and the outcome was largely unexpected within Brandywine Global. The impact is uncertain, because Brexit itself is uncertain. We do know that any exit is at least two years away—if it even happens. Still, the strategy underperformed by a soul-crushing 400bps in the two market days following the referendum results, driven by a flight to perceived "safe havens" elsewhere.

Despite all the fear and skepticism, did you know the U.S. Manufacturing Purchasing Managers Index (PMI) for June rose at its fastest rate in more than a year, with new orders hitting their highest level in 19 months and employment hitting expansionary levels for the first time this year? We assume everyone knows that U.S. jobs data looks fine—or even good—and that wages are rising. The "profit recession" may have ended this quarter, driven by a decline in oil prices; the partial recovery may mean corporate profits rose in the second quarter. Oil rig activity is picking up which might spur capital expenditures; the economy could add more than 200 rigs and still not be back to the levels of December 31, 2015!

Housing is finally just getting back to a level of 1 million starts that historically is reached 7 years before the next recession:



Source: Ed Hyman at EvercoreISI, 7/5/16

Most of the actual data supports moderate U.S. economic growth. Although this data point has issues, the Atlanta Fed's GDPNow index is one widely quoted real-time indicator that ended the quarter showing 2.6% growth. Predictions of doom are just that: predictions. The market swings between fear and greed; right now, we believe the market is being driven by fear.

We understand that we are underperforming both our benchmark and other value managers. While underperformance is very unpleasant, we are sticking to our process. We are not capitulating and we are not "swinging for the fences" to make up ground. Instead, we are relying on what has always happened before to happen again, which is that a disciplined value approach will work.

RUSSELL 1000 VALUE RELATIVE TO 1000 GROWTH

Commence	End	Duration	Cumulative Relative	Subsequent Cumulative	Duration
9/30/93	2/29/00	77	-43.1%	119.6%	28
7/31/06	5/31/16	119	-27.5%		
11/30/88	12/31/91	37	-26.3%	29.3%	21
5/31/80	11/30/80	6	-14.7%	23.2%	16
9/30/86	8/31/87	11	-8.8%	16.3%	15
6/30/02	3/31/03	9	-6.3%	30.5%	40
3/31/82	11/30/82	8	-6.1%	29.0%	46
Average		38	-19.0%	41.3%	28

The growth cycle itself is very extended; the cycle is the longest in duration and the second largest underperformance according to our calculations.

The spring-back for value is quite powerful when taking the "Subsequent Cumulative" column in the chart above into account; however, an investor obviously needs to own those stocks to benefit. Note that the end of the period—including the 1997-99—resulted in the best subsequent returns for value investors.

With a portfolio P/E of 11.2x compared to an index P/E of 17.0x, plus a substantial discount on P/B (1.3x versus 1.8x) and other metrics versus the index, we feel confident in the opportunity before us and believe we will be rewarded for our patience. The absence of that reward to date is frustrating and perplexing, but history shows us that time is on the side of those with patience.

Many investors are currently positioned for what they believe is "safety." Many investors believe they are accepting lower returns in return for lower risk, but if utilities for example, return to normal valuations, investors could be facing more than 30% losses in that "defensive" trade. If financials return to more normal valuations, that could result in more than 30% gains, for a total spread of greater than 60% between the two groups. Investors in the low-beta, defensive areas right now are likely taking more risk than they realize.

We will continue to do our job analyzing companies and implementing our disciplined value strategy. The deficit we have from a performance standpoint looks daunting, but is a result of abnormal movements, which one of our value peers described as a "four standard deviation event." These market conditions do not persist forever, and we believe we are well-positioned for a return to normalcy when it occurs.

Supplemental Information to the attached Classic Large Cap Value GIPS-compliance Composite.

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* Data is obtained through eVestment Alliance, LLC. Performance rankings presented are based on the U.S. Large Cap Value Equity Universe for the year through March 31, 2016. eVestment is a third-party, global provider of institutional investment data intelligence and analytics solutions. eVestment universes are based on a set of criteria which includes qualitative and quantitative factors to create and maintain a comparative peer group. eVestment collects information directly from investment management firms and other sources believed to be reliable and accurate.

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ANNUALIZED RETURNS (%) (Results shown in USD)

	Gross	Net	R1000V	SP500
QTD	- 1.54	- 1.71	4.58	2.46
YTD	- 4.86	- 5.20	6.30	3.84
1 Year	- 14.52	- 15.12	2.86	3.99
3 Year	4.13	3.41	9.86	11.64
5 Year	9.02	8.27	11.34	12.09
7 Year	12.20	11.43	14.49	14.91
10 Year	7.17	6.43	6.13	7.42
Since Inception	8.16	7.41	7.27	7.76

Inception Date: 10/1/2004

GIPS INFORMATION (%, Unless Otherwise Noted) (Results shown in USD)

	Gross	Net	R1000V	SP500	# of Accounts	Market Value (M)	Total Firm Assets (M)	Composite Dispersion	Composite Rolling 3Y SD	R1000V Rolling 3Y SD	SP500 Rolling 3Y SD
2016	- 4.86	- 5.20	6.30	3.84	19	3,529	69,828	0.23	13.64	11.18	11.10
2015	- 9.85	- 10.48	- 3.83	1.38	19	3,407	68,819	0.22	13.00	10.68	10.47
2014	11.35	10.58	13.45	13.69	17	983	63,375	0.27	10.85	9.20	8.97
2013	40.97	40.02	32.53	32.39	16	678	50,050	0.38	14.53	12.70	11.94
2012	22.39	21.56	17.51	16.00	19	386	42,894	0.39	16.60	15.51	15.09
2011	- 5.08	- 5.74	0.39	2.11	26	516	33,122	0.26	19.77	20.69	18.71
2010	13.99	13.21	15.51	15.06	21	463	31,996	-	20.47	23.18	21.85
2009	29.83	28.94	19.69	26.46	1	32	29,199	-	18.36	21.10	19.63
2008	- 30.33	- 30.83	- 36.85	- 37.00	1	13	32,755	-	12.91	15.36	15.08
2007	7.37	6.63	- 0.17	5.49	1	20	49,208	-	7.16	8.06	7.68
2006	22.63	21.79	22.24	15.79	1	20	39,241	-	-	-	-

R1000V = Russell 1000® Value Index SP500 = S&P 500® Index

Organization: Brandywine Global Investment Management, LLC (the "Firm") is a wholly owned, independently operated, subsidiary of Legg Mason, Inc. The Firm has prepared and presented this report in compliance with the Global Investment Performance Standards (GIPS). For the periods July 1, 2000 through June 30, 2014, the Firm has been verified by Kreischer Miller. A verification includes assessing whether the Firm (1) complied with the composite construction requirements of the GIPS standards on a firm-wide basis, and (2) designed its processes and procedures to calculate and present performance results in compliance with the GIPS standards. A copy of the verification report is available upon request. Disclosed total firm assets represent the total market value of all discretionary and nondiscretionary, fee-paying and non-fee-paying assets under the Firm's management. Composite Description: Classic Large Cap Value Unrestricted Composite (the "Composite") Inception date: October 1, 2004. Creation date: January 1, 2014. The Composite includes all fully discretionary, fee-paying portfolios invested in the Classic Large Cap Value Unrestricted strategy (the "Strategy") with no client mandated restrictions. The strategy invests primarily in domestic equity securities with market capitalizations of greater than $1 billion, and have a lower price to book (P/B) and price to earnings (P/E) ratios, but may also invest in select preferred, convertible, and debt securities. This results in approximately 55 - 75 security positions in each portfolio. Benchmark: The Russell 1000 Value Index measures companies from the Russell 1000 Index that exhibit lower price to book and price to earnings ratios and lower forecasted growth values.The S&P 500 is a broad measure of U.S. domestic large cap stocks. The 500 stocks in this capitalization-weighted index are chosen based on industry representation, liquidity, and stability. Performance Calculation: Preliminary data, if so noted, reflects unreconciled data for the most recent reporting period. Portfolios are valued daily on a trade date basis and include dividends and interest as well as all realized and unrealized capital gains and losses. Return calculations at the portfolio level are time-weighted to account for periodic contributions and withdrawals. Performance results are calculated on a before tax, total return basis. Prior to July 1, 2007, portfolios were included in the Composite beginning with the first full quarter of performance through the last full quarter of performance. After July 1, 2007, portfolios are included in the Composite beginning with the first full month of performance through the last full month of performance. Composite returns are reported on quarterly basis. The Composite returns consist of size-weighted portfolio returns using beginning of period values to weight the portfolio returns. Monthly linking of interim performance results is used to calculate quarterly and annual returns. Composite's valuations and returns are computed in U.S. Dollars ("USD"). The results are presented in USD or in other currencies (to accommodate overseas investors), the latter by converting monthly USD returns into other currency returns using the appropriate currency exchange rate returns. Gross returns reflect the deduction of trading expenses. Net of fee returns reflect the deduction of trading expenses and the highest investment management fees charged within the composite membership as stated in the fee schedule below. Composite dispersion is calculated using the asset-weighted standard deviation method for all portfolios that were in the Composite for the entire year. Composite dispersion is not presented for periods with five or fewer portfolios. The number of accounts and market values are as of the end of the period. The three-year annualized standard deviation measures the variability of the composite and the benchmark returns over the preceding 36-month period. Past performance is no guarantee of future results. A complete list describing the Firm's composites as well as any additional information regarding the Firm's policies for calculating and reporting performance results is available upon request. Fee Schedule: The Institutional Client Separate Account Management Fee Schedule (minimum initial investment: $25 million): 0.700% on the first $10 million; 0.500% on the next $40 million; 0.450% on the next $50 million; and 0.350% on any portion of assets in excess of $100 million. Additional information on the Firm's fee schedule can be found in Form ADV Part 2A which is available upon request.

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