



Small Cap Value Equity

Market Commentary

Small cap value stocks paused in the first quarter following a very strong 2016. Markets struggled to process and predict the impact of legislative outcomes across a variety of industries. As a result, sectors that did well in the post-election surge took a step back, and others, particularly Health Care and Information Technology, advanced. Slightly lower interest rates (despite the Fed's December tightening) supported the stock prices of more highly levered companies and Utilities. Non-earners also did well, an environment well-suited neither for Cooke & Bieler's investment style nor the portfolio's current positioning. Growth also outperformed value, standing in clear contrast to the trends observed in Q4 2016.

As economic cycles mature, divergence in operating results and stock price performance increases, providing opportunities for active managers. Such opportunities can be harder to find in early portions of market cycles, when stock prices tend to be driven by a single factor, such as Quantitative Easing in the most recent case. In our view, great businesses with strong balance sheets, the ability to reinvest for growth, and that are not reliant on policy decisions are the best starting point for a successful investment strategy. These types of companies go in and out of market favor, but they also tend to quietly and steadily compound value.

Portfolio Performance & Developments

At the end of 2016, many observers, ourselves included, worried that equity valuations embedded expectations that shaded toward optimistic. But during the first three months of 2017, the portfolio's holdings disproportionately delivered on or exceeded these hopeful expectations, with most of our companies performing well fundamentally. As a result, the Cooke & Bieler Small Cap Value portfolio's return exceeded that of the Russell 2000[®] Value Index (RUJ).

The portfolio benefitted from both favorable sector positioning and effective stock selection. Among sectors, the strategy's Energy underweight and Health Care overweight were additive, as were decisions to trim the portfolio's Financials holdings as they approached fair value. As for major contributors in the quarter, all of the portfolio's Information Technology holdings appreciated by more than 20%; by comparison, the IT constituents within the RUJ were up only 6.1% as a group. Here, the portfolio benefitted from its relative concentration in the semiconductor equipment manufacturing industry, which performed well in the quarter.

In addition to several adds and trims of existing positions, we initiated two holdings and eliminated six others, two of which were the subjects of takeout offers that closed in the quarter, one whose market cap now exceeds the upper limit of the strategy, and three of which had reached our estimates of fair value.

Market Outlook

Over the last 12 months the RUJ's 29% return, which the portfolio has successfully matched, has been driven by the expectation of a positive inflection in corporate profit growth, but also by hopes for deregulation and tax reform. Gains from here, and indeed support for current valuations, will depend on that optimism being borne out. However, after years of sub-par growth and with a generally favorable macro-economic outlook, there is room for positive surprises as well. Regardless, our investment decisions are based on a detailed understanding of fundamentals and our disciplined approach to quality and valuation.

Sources: Bank of America Merrill Lynch; FactSet; Bloomberg; Russell Investments

The material presented represents the manager's assessment of the Small Cap Value institutional portfolio and market environment at a specific point in time and should not be relied upon by the reader as research or investment advice regarding any particular sector.

[Additional Cooke & Bieler Small Cap Value Performance Disclosures](#)