



# Small Cap Value Equity

## Market Commentary

U.S. equity indices posted positive returns in the second quarter, with small capitalization stocks outperforming larger ones by a meaningful margin and – at least within the small cap universe – value outperforming growth. The Russell 2000® Value Index (RUJ) returned 8.30% for the quarter, with the late-quarter rise in oil prices – up 14% in the quarter – driving outsized returns among the benchmark’s Energy constituents and a flattening yield curve propelling REITs. That said, market strength was broad within the small cap value universe, with every economic sector generating positive returns for the benchmark.

## Portfolio Performance & Developments

For the second quarter of 2018, Cooke & Bieler’s Small Cap Value Strategy posted positive absolute returns, but underperformed the RUJ on a relative basis. While disappointing, this quarter’s performance is not unusual given the portfolio’s high active share and our focus on long-term results – which remain favorable on a three- and five-year basis as well as since the strategy’s inception. Cooke & Bieler’s underperformance in a very strong up market – not typically our strong suit – is not surprising either. However, the composition of the market’s performance drivers within small cap equities this quarter does surprise us a bit. Such broad-based strength in small cap stocks seems on one hand to indicate a generally optimistic economic outlook, while on the other hand seems incongruent with rising energy prices and expectations for a sustained period of low interest rates. So similar to our conclusion last quarter, we think sentiment played a key role in the second quarter’s market outcome, further widening the gap between fundamental progress and stock price performance.

Portfolio positioning was a headwind primarily due to the strategy’s significant underweight in Energy and Real Estate – among the quarter’s best performing sectors. The drag from this underallocation accounted for the entirety of the portfolio’s relative shortfall in the second quarter. More generally, companies with the lowest returns on capital and highest levels of debt performed best, seemingly related to the flattening yield curve, which provided support for companies of lower quality and greater financial leverage. Such conditions are typically adverse to Cooke & Bieler’s investment style.

Stock selection was positive for the quarter with strong returns in Industrials and Consumer Discretionary. In Industrials, companies with greater exposure to the Energy-related industries benefitted as energy markets stabilized and gradually recovered. Recently, we have gained exposure to energy markets through companies that, in our opinion, are better able to compound value over a full cycle while having the balance sheet flexibility necessary to weather an extended downturn. In Consumer Discretionary, several of the portfolio’s holdings contributed meaningfully to the portfolio’s return. Poor stock results in Energy and Real Estate partially offset the positive selection results for the quarter.

## Market Outlook

As we enter the second half of the year, the portfolio is now more attractive on a forward P/E basis than it was at the start of the year. More importantly, though, the market has continued to move toward a place more conducive to active management. For instance, the positive point-to-point total return posted by market indices during the second quarter disguised considerable underlying intra-quarter volatility. We welcome such volatility as related potential mispricings provide opportunities for skilled stock pickers. As always, we at Cooke & Bieler believe that returns ultimately track fundamentals. We remain confident in our investment team’s proven and experienced stock-picking ability underpinned by a disciplined process, rigorous research effort, and unique culture.

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

The material presented represents the manager’s assessment of the Small Cap 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. Past performance is no guarantee of future results.

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