COOKE & BIELER

Q3 2018

SMID Cap Value Equity

Overview

U.S. markets performed well in the third quarter, propelled by strong corporate profits and economic growth. The Russell 2500™ Value Index (R25IV) saw the most significant gains in the Telecommunications Services, Health Care and Industrials sectors. In a reversal from the year's first half, large company stocks outpaced smaller ones and low volatility returned. Beneath the surface, though, the Energy sector saw relative weakness following pronounced strength in Q2, while Real Estate holdings also surrendered a portion of last quarter's gains in response to rising interest rates.

Portfolio Performance & Developments

After a difficult second quarter, Cooke & Bieler's SMID Cap Value portfolio generated a total return of 4.41% gross of fees (4.18% net of fees), outperforming the R25IV's 2.67% return for the third quarter, with contributions from both stock selection and portfolio positioning.

Five Largest Contributors/Detractors

	Avg Weight (%)	Total Return (%)	Contrib. to Return (bps)
Helen of Troy	4.6	33.0	132
Steelcase Inc.	2.9	38.0	101
Fox Factory	1.5	50.5	69
Ball Corp.	2.5	24.0	56
Donaldson Co.	1.9	29.6	55

	Avg Weight (%)	Total Return (%)	Contrib. to Return (bps)
Winnebago Industries	2.6	-18.1	-50
Schweitzer-Mauduit Int'l	3.4	-11.4	-40
United Natural Foods	1.0	-29.8	-34
Varex Imaging	1.8	-22.7	-34
Whirlpool Corp.	1.6	-18.1	-32

Source: FactSet
Past performance is not indicative of future results. The performance attribution is an analysis of a representative SMID Cap Value institutional portfolio's gross of fees return relative to the Russell 2500™ Value Index. The holdings identified do not represent all of the securities purchased, sold, or recommended for Cooke & Bieler's SMID Cap Value clients. To obtain the calculation's methodology and a list showing every holding's contribution to the overall account's performance during the quarter, contact your client service representative or email your request to contact@cooke-bieler.com.

Largest Contributors

Helen of Troy (HELE), a diversified consumer goods company with leading positions in various niche categories, was the largest contributor for the quarter. HELE had been unfairly penalized in the first half of the year following the publication of a poorly-researched short thesis that misunderstood the company's distribution channels, ignored its very attractive valuation, and discounted its significant balance sheet flexibility. The stock price has been steadily recovering since.

Steelcase Inc. (SCS), a leading manufacturer of office furniture and systems, was the second largest contributor. SCS delivered earnings results that were considerably above expectations, driven by an improving environment, better traction for the company's new offerings, and good expense leverage.

Fox Factory (FOXF), a designer and manufacturer of high-performance, premium suspension systems for high-end mountain bikes and powersport vehicles, was the third largest contributor. FOXF posted a good quarter as growth in their bike and powered segments exceeded management's long-term growth targets. The company continues to penetrate the lower price points in the premium mountain bike category and win new programs and content for powersport vehicles.

Largest Detractors

Winnebago Industries (WGO), a leading manufacturer of motorhomes and towable units in the U.S., was the largest detractor for the quarter. Investors have all but abandoned the stock as the recreational vehicle industry sees a deceleration from double digit retail volume growth to mid-single digit growth. We still believe WGO is a share-gaining franchise with a sizeable margin improvement opportunity as well.

Schweitzer-Mauduit (SWM), a leading supplier to the tobacco products industry, was the second largest detractor. SWM reported encouraging fundamental earnings results but will incur higher interest expense as it refinanced some acquisition-related debt.

United Natural Foods (UNFI), the leading domestic distributor of natural, organic and specialty foods, and related products, was the third largest detractor. UNFI declined in response to disappointing earnings results and the poorly-received acquisition of SuperValu. We are evaluating the position in the context of the proposed transformational merger that creates a company with much greater scale and much less dependence on its largest customer, Whole Foods, but requires significant financial leverage.

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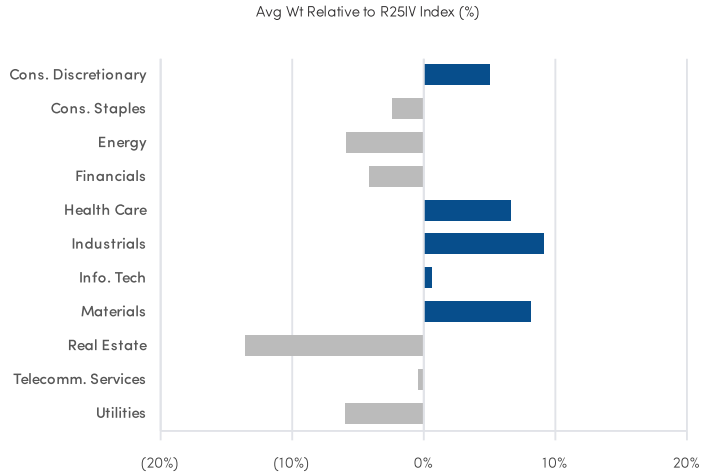
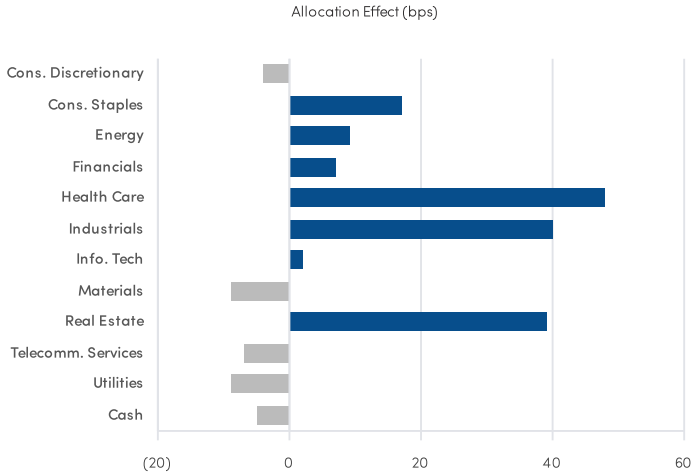
Sector Positioning





Source: FactSet
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In contrast to the second quarter, portfolio positioning was a tailwind as the strategy's significant overweights in the Industrials and Health Care sectors and its underweight in Real Estate were additive. Conversely, the overweight in the Materials and the underweights in Utilities and Telecommunication Services posed a relative performance drag.

Initiations

Arch Capital Group (ACGL) is a Bermuda-based specialty property & casualty (P&C) and mortgage insurer. Their niche approach to P&C underwriting and emphasis on risk management in mortgage insurance combined with their superior cycle management and appreciation for capital preservation – all engrained in their culture – have led to a long track record of above-average returns. Despite this track record, which we expect to continue, the stock trades at a discount to peers as investors seem to prefer insurers with less diverse business mixes.

Extended Stay America (STAY) is the largest owner and operator of extended stay hotels in the U.S. Their hotels provide an affordable alternative to traditional lodging – particularly for business travelers – featuring in-room kitchens and limited housekeeping services. The extended stay market is attractive on a long-term basis, and STAY has an opportunity to improve margins and returns by divesting less profitable properties and selectively building in markets with better economics. Valuation is compelling as some investors are disappointed management has not moved faster to formally separate its property ownership from is franchise functions. We think this is likely over time, and in the near-term believe STAY's portfolio transformation should create significant value for shareholders.

Eliminations

Penske Automotive Group (PAG) was eliminated as it reached fair value. We consider it to be a high-quality business with an extremely talented management team. The stock had been a solid performer over several years, but valuation is an important part of our discipline.

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Outlook

As we enter the final quarter of 2018, we continue to see pockets of value in a market that as a whole has grown more exuberant. Staples, Utilities, and Energy in particular seem more than fairly valued, and the strategy remains underweight these areas. We find more compelling value in the Industrials, Consumer Discretionary, and, increasingly, the Information Technology sectors. The economy appears to be growing robustly and corporate profits are benefiting from lower taxes, which should provide support for stock prices. However, after an extended period of extraordinary monetary stimulus, the Federal Reserve has been steadily moving toward a more neutral stance – raising rates seven times since December 2016. Rising interest rates will put pressure on companies and business models that have grown dependent on cheap financing and should slow the economy over time. The risks of a more significant crisis, while not high, are rising as well. Against this backdrop, the strategy continues to be positioned in conservatively financed, high-quality businesses.

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

Past performance is not indicative of future results. The material presented represents the manager's assessment of the SMID 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 security or sector. The above commentary and portfolio attribution are based on a representative SMID Cap Value institutional portfolio for the quarter ending 9/30/18. The portfolio attribution is gross of fees. Certain client portfolios may or may not hold the securities identified above due to the respective account's guidelines, restrictions, required cash flows, or other relevant considerations. The performance attribution is an analysis of the portfolio's return relative to the Russell 2500™ Value Index. The holdings identified do not represent all of the securities purchased, sold, or recommended for Cooke & Bieler's SMID Cap Value clients. To obtain the calculation's methodology and a list showing very holding's contribution to the overall account's performance during the quarter, contact your client service representative or email your request to contact@cooke-bieler.com.

Additional Cooke & Bieler SMID Cap Value Performance Disclosures