



COOKE  
& BIELER

Q2  
2016

# All Cap Value Equity

## Market Commentary

The Cooke & Bieler All Cap Value portfolio underperformed the Russell 3000® Value Index (RAV) significantly in the quarter. Relative weakness was broadly dispersed, yet the portfolio's holdings virtually all performed well on a fundamental basis. However, the generally strong fundamental performance of the portfolio's holdings was not enough to offset macroeconomic headwinds, particularly falling interest rates.

The extent to which continuing downward pressure on interest rates – which now sit at unprecedented levels – has profoundly impacted the stock market cannot be overstated. Year to date, the highest dividend paying quintile within the RAV has outperformed the lowest quintile by over 14%, resulting in a more than 250 basis point relative headwind for the portfolio. While dividends are an important component of an investor's total return, for the most part today the companies with the highest current yields will struggle to grow earnings and cash flow over time, leaving dividend yield as the dominant source of return. Absent further declines in interest rates, the returns on these stocks will prove disappointing to investors.

Beyond pushing investors toward yield, the world's central bankers are also encouraging investors to take on more risk and providing an incentive to buy lower quality, more levered businesses. "High quality" has many dimensions, but one marker is Return on Invested Capital (ROIC). Over the last five years, the median ROIC of portfolio companies was 9.6% versus a median of 4.0% for the companies in the RAV. In the second quarter, when grouped by quintile, Index constituents with the *lowest* ROIC generated a 6.1% return, compared to 2.5% for those with the *highest* ROIC. It is axiomatic that high ROIC companies with the ability to expand their invested capital will grow faster and generate better fundamental returns than their low ROIC counterparts. So holding valuations constant, we believe strongly that the portfolio's higher ROIC companies should outperform over time.

## Portfolio Performance & Developments

For the quarter, the portfolio's high-quality bias as well as its lack of exposure to companies that would benefit from a continued decline in interest rates caused both allocation and stock selection effects to be negative. Its underexposure to Utilities and REITs, where yield-seeking investors have pushed valuations to elevated levels despite generally mediocre prospects, and to Energy, where our stock selection was strong, were both negatives. The portfolio's overweight position in the poorly-performing Consumer Discretionary sector – even though its holdings there did quite well – was a detractor. The impact of stock selection was also positive in Information Technology, but strongly negative in Industrials.

During the quarter, we initiated one position: a consumer finance company with a long track record of growing earnings and book value led by a skilled and experienced management team. We also exited one holding, as we felt investors had become overly enthusiastic about its prospects. The portfolio continues to be overweight attractively valued stocks of high-quality Consumer Discretionary and Industrials companies.

## Market Outlook

Over time, return on capital and management's stewardship of it are the determinants of stock returns. In this regard, we are very optimistic about the portfolio's relative performance prospects. We have invested in a collection of financially strong companies with favorable underlying economics that are reflected in attractive returns on invested capital. The value compounding ability of the portfolio's holdings uniquely position it to both capture upside in a favorable market environment and protect during an extended downturn.

Sources: FactSet; Bloomberg; Russell Investments

The material presented represents the manager's assessment of the All 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 All Cap Value Performance Disclosures](#)

