COOKE & BIELER

Q3 2017

All Cap Value Equity

Market Commentary

After retreating slightly and struggling to gain traction most of the summer, the U.S. stock market rallied strongly in September with smaller cap and Energy stocks leading the charge. In the end, Q3 was another positive quarter for stocks – the eighth consecutive one for the market as measured by the S&P 500 Index. The Russell 3000® Value Index (RAV) returned just over 3% in the quarter, bringing its year-to-date performance to nearly 8%.

Portfolio Performance & Developments

Against this backdrop and after a year of very meaningful outperformance, the Cooke & Bieler All Cap Value strategy posted solid absolute results, but lagged its benchmark, the RAV. Unlike the trend witnessed in the first half of the year, stocks of higher quality companies did not noticeably outperform others in the third quarter. In fact, stocks of lower quality businesses dominated in some sectors.

Though there were puts and takes, our bottom-up-driven sector allocations did not meaningfully impact relative results. Most of the C&B All Cap Value strategy's underperformance was attributable to mixed but overall negative stock selection. Here, several things stood out. First, in the Materials sector, the strategy's holdings underperformed their Index peers, many of which are highly levered to commodity prices, some of which surged off low levels in the quarter. We have generally avoided these typically lower-quality businesses, where durable competitive advantages are scarce and underlying economics are largely a function of inherently volatile and unpredictable commodities prices. While this may have been a sin of omission, the positioning was intentional. We prefer to invest in Materials companies that have structural competitive advantages, and generate high returns on invested capital not reliant on rising commodity prices. Though this quarter's showing illustrates that no approach works all the time, underlying economics dictate that ours should add value over the long-run. The other negative driver was a small number of company-specific issues, none of which we believe are permanent or reflective of broken investment theses.

These negative drivers were nearly offset by very strong stock selection in Industrials and Consumer Staples. Overall, the strategy's holdings appear to be performing well fundamentally and we view this quarter's modest performance shortfall not with concern, but as more of a pause after a strong run of outsized relative returns. Year-to-date and longer-term results remain strong.

Market Outlook

During the quarter, the Fed announced it would begin shrinking its balance sheet, marking the latest installment in this slowly ebbing period of extraordinary monetary stimulus. This transition away from stimulus brings with it a set of concerns, but also of opportunities. As we have written before, the various forms of quantitative easing have supported many companies of questionable quality. As monetary policy becomes more restrictive and rates potentially rise, weaker companies will find it increasingly hard to compete with their higher-quality peers. As a result, returns should be increasingly based on more divergent company specific fundamentals rather than on macro factors.

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

Additional Cooke & Bieler All Cap Value Performance Disclosures