



# All Cap Value Equity

## Market Commentary

After a relatively quiet summer, the fourth quarter was anything but. Stocks in the Russell 3000<sup>®</sup> Value Index (RAV) trended down slightly until the election, and then jumped about 9% in the final seven weeks, putting an exclamation point on a very good year for the U.S. market. Donald Trump's surprising win sent shockwaves through the market as investors rushed to position their portfolios for the new political order. For the quarter, the RAV rose by 7.2%, its best quarterly performance in three years. And for the full year, the RAV returned a strong 18.4%.

## Portfolio Performance & Developments

Against this backdrop, the Cooke & Bieler All Cap Value portfolio outperformed the Russell 3000<sup>®</sup> Value Index. Gains were widespread across sectors and stocks, but being overweight the surging Financials sector and having no weight in Real Estate and Utilities were particularly additive. We have frequently marked our concern with the overvaluation of the latter two sectors, and early steps toward interest rate normalization called investors' attention to this exposure.

Wrapped up in this important reversal, the two highest yielding quintiles within the RAV, which had outperformed the two lowest quintiles through the first nine months, lagged the lowest in the fourth quarter. And valuations still largely ignore the potential fundamental risks of a higher interest rate regime for highly-levered Real Estate companies. Low quality continued to prevail in the fourth quarter, and that was a headwind for us. Companies with high returns on invested capital, one of the best proxies for business quality, underperformed their low-ROIC counterparts.

For the full year, the portfolio's return exceeded that of the benchmark. Strong outperformance during the early-year correction and the strong fourth quarter offset a lag during a long mid-year, low-quality rally. After several puts and takes among the sectors, stock selection accounted for the bulk of the portfolio's 2016 outperformance. Particularly strong stock selection in the Financials and Industrials sectors stood out. The Materials sector was a modest negative, where lower-quality, commodities-driven firms outperformed the more stable, consumer-driven Materials companies we own.

It is worth pausing here and noting that U.S. equities have outperformed virtually every other asset class in the past decade. Since the end of 2008, the RAV has posted double-digit returns in six of eight years. We have been very pleased that the portfolio has substantially outrun the Index over this span, as these sorts of extended bull markets, frequently driven by macro themes (Quantitative Easing in this case) and unbridled optimism, can outshine our more fundamental, data-driven approach to investing.

## Market Outlook

Mid-teens percentage equity returns are not sustainable over the long run. Historically, equities have offered high single-digit returns and the inexorable math of reinvestment rates and returns on equity suggests a similar level going forward. This is not to say the market is due for a significant correction – the last eight years included a recovery from a deep recession – but we are well past the point where investors can count on a tailwind from depressed operating conditions or conservative valuations. Taking the long view forward, we believe returns will be more modest and hope the market will even more fully reward a detailed understanding of fundamentals and a 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 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.

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