COOKE & BIELER

Q4 2016

Large Cap Value Equity

Market Commentary

After a relatively quiet summer, the fourth quarter was anything but. Stocks in the Russell 1000® Value Index (RLV) trended down slightly until the election, and then jumped approximately 8% 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 RLV rose by 6.7%, its best quarterly performance in three years. And for the full year, the RLV returned a strong 17.3%.

Investors' appetite for risk increased this quarter. Commodities and the beaten-down stocks of Materials, Energy, and Industrials companies that have exposure to them rose strongly, while yield-oriented stocks fell in the face of sharply rising interest rates. The Financials sector alone was responsible for nearly 80% of the Index's total return for the quarter: stocks of banks surged as higher interest rates and a steepening yield curve are expected to enhance their profitability.

Portfolio Performance & Developments

Against this backdrop, the Cooke & Bieler Large Cap Value portfolio performed well, though it modestly lagged the Russell 1000® Value Index. As always, there were several puts and takes. Cooke & Bieler's investment style does not typically shine in "risk-on" markets, and our high quality, low risk bias was a headwind, particularly in the Financials and Materials sectors, where the highest beta quintiles outperformed the lowest.

In Financials, the smaller and more asset-sensitive (and generally lower quality) banks in the Index performed best, boosted by the prospect of higher interest rates. The portfolio's Financials holdings are more heavily weighted toward insurance companies, processors, and money-center banks whose multiple income streams are less dependent on higher rates. In the Materials sector, the portfolio's holdings sell largely to food and beverage producers and have little linkage to mining and commodities, and it was these sub-sectors that surged in this risk-on quarter. The style-related challenges we experienced in these sectors were offset by very good stock selection results in the Information Technology and Health Care sectors as well as the favorable impact of the portfolio's meaningful underweight in bond-like equities, including many in the Consumer Staples, Utilities, and Real Estate sectors, which substantially underperformed during the quarter.

The portfolio had a good full year but modestly lagged the Index. Outperformance in the first and third quarters and flat relative performance in the fourth quarter did not quite offset a shortfall during the low-quality, risk-on, yield-focused rally that started in mid-February and peaked in September. The companies that did best during the first three quarters of 2016 were of relatively low quality and/or featured high dividend yields; both themes presented significant headwinds for us. While these forces softened in the fourth quarter, investors' preference for risk persisted. Overall, high quality was less rewarded in 2016: the two highest ROE quintiles underperformed the two lowest quintiles.

Market Outlook

Mid-teens percentage equity returns, which the RLV has recorded since the end of 2008, are not sustainable over the long run for the broad market. 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

Additional Cooke & Bieler Large Cap Value Performance Disclosures