Large Cap Value Equity

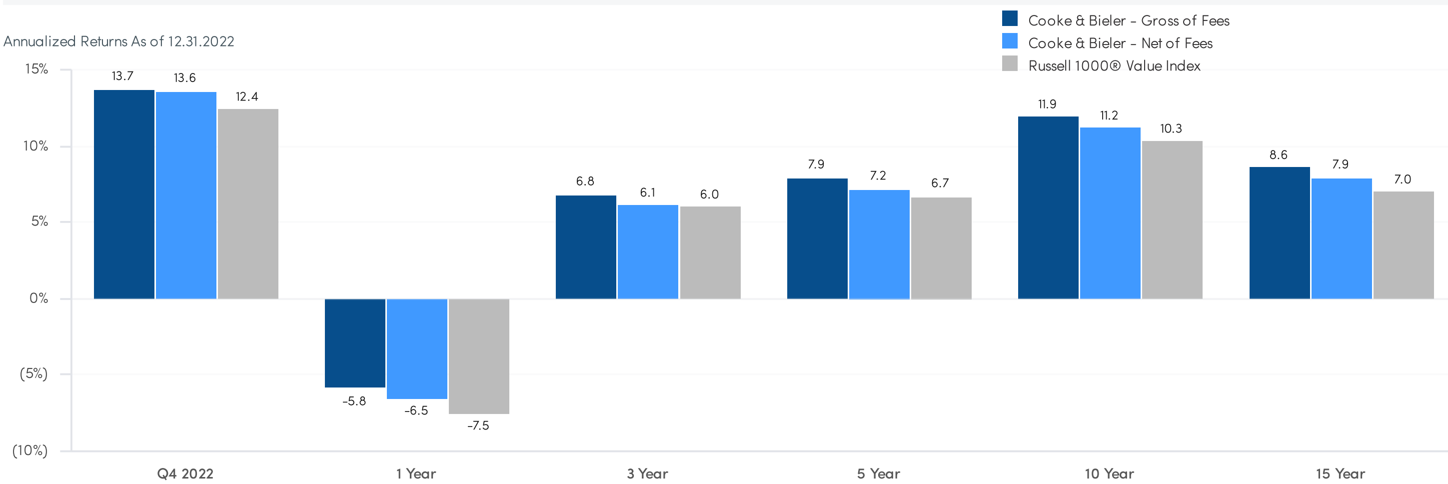
Overview

Stocks recovered strongly in the fourth quarter, but the rally was not strong enough for major indices to avoid their worst calendar year returns since 2008. Improved sentiment was driven by the slower pace of Fed tightening and signs inflation pressures had peaked, with markets also skirting any significant macroeconomic shocks. Oil prices and long-term interest rates ended the quarter broadly flat and the main geopolitical development – China's decision to relax its Covid Zero policy – bodes well for global growth. Domestically, both employment data and consumer spending appeared healthy despite the sharp tightening of monetary conditions since the start of the year, bolstering hopes for a soft landing. Against that backdrop, Energy continued its reign as the best performing sector, while value outperformed growth across the capitalization spectrum for the quarter and the year. Conversely, the most speculative areas of the market, including unprofitable technology companies, cryptocurrency related businesses, and small biotech, posted weak and at times catastrophic returns.

Portfolio Performance & Developments

Cooke & Bieler's Large Cap Value Strategy generated strong absolute and relative results to end the year, posting a 13.72% return gross of fees (13.56% net of fees) versus a 12.42% return for the Russell 1000® Value Index. This outperformance was due entirely to positive stock selection effect, somewhat offset by negative sector allocation effect. Stock selection was additive in eight out of 10 sectors where the portfolio had weight, with particularly strong performance from Communication Services companies. Industrials holdings also fared well, partially reversing the sector's negative selection effect from earlier in the year. Conversely, the strategy's Consumer Discretionary holdings continued to struggle as investors weighed potential recession scenarios. The portfolio's Energy stocks also underperformed the benchmark's sector constituents.

Large Cap Value Equity Composite Performance



Source: Factset and Russell®
Past performance is not indicative of future results. All investing involves risk, including loss of principal.
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Contributors & Detractors

Largest Contributors

AerCap (AER), the largest independent aircraft lessor, was the largest contributor. AER continued to benefit from the recovery in air travel. In addition, its acquisition of GE's aircraft leasing business has proved accretive to the company's cash flows.

Arch Capital (ACGL), a Bermuda-based specialty property & casualty and mortgage insurer, was the second-largest contributor. ACGL continued to achieve strong operating results, growing its insurance premiums into a hard market environment and compounding book value significantly versus the prior year. Expectations that property catastrophe reinsurance conditions would harden significantly in 2023 also helped the stock's performance. Additionally, investor sentiment on ACGL strengthened due to the stock's inclusion in the S&P 500®.

State Street (STT), a leading custodian and recordkeeper for financial assets, was the third-largest contributor. In addition to showing improved profitability during the quarter, STT demonstrated disciplined use of cash flow as it continued to reduce its share base. Investors also reacted positively to the cancelation of its acquisition of Brown Brothers Harriman's Investor Services business.

Largest Detractors

CarMax (KMX), an independent used car retailer operating through both brick & mortar and online channels, was the largest detractor. In the third quarter of the year, KMX reported a worse-than-expected decline in used vehicle unit sales while SG&A spending remained elevated. These trends persisted into the fourth quarter as increasing consumer auto loan rates continued to put pressure on used car prices and volumes.

Hasbro (HAS), a leading global play and entertainment company with a broad and deep portfolio of brands and entertainment properties, was the second-largest detractor. HAS shares were pressured by modestly disappointing top line performance during the third quarter and concerns about further weakness during the important holiday season.

Alphabet (GOOGL), a technology company that generates over 90% of its revenues from advertising, primarily on its Google Search and YouTube offerings, was the third-largest detractor. Although GOOGL reported good results relative to its peers, the stock price still suffered from fears that global advertising spending was decreasing and that competitors, particularly TikTok, were becoming increasingly aggressive.

Sector Positioning

Sector allocation effect was slightly negative during the quarter. The portfolio's underweight to Energy, once again the benchmark's best performing sector, continued to weigh on performance and was the largest detractor for the quarter and the year. An underweight to Materials and overweight to Communication Services also hindered results. Partially offsetting these headwinds were underweight positions in Real Estate and Utilities, two of the worst performing sectors within the Index. The strategy's significant overweight to Financials was also additive.

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Initiations & Eliminations

Initiations

Warner Music Group (WMG) is the world's third largest music label, providing recording, distribution, rights management, and other services to artists worldwide. The global shift to music streaming has greatly improved record labels' ability to monetize their intellectual property, making them one of the first media businesses to successfully complete the digital transition. Music labels benefit from high barriers to entry as their large existing catalogs make them essential partners for streaming services while their broad distribution reach makes them an attractive platform for new and emerging artists, further deepening their catalog. Newly public in 2020, Warner's stock languished earlier in the year as investors struggled to digest some poorly communicated one-off impacts to revenue and margins, creating an opportunity for more long-term oriented investors.

Eliminations

Brookfield Asset Management (BAM) was spun out of Brookfield Corporation during the quarter and subsequently eliminated, with the proceeds reinvested back into Brookfield Corporation.

General Mills (GIS) reached its price target and was eliminated.

Notable Stock Updates

Long-term holding **Brookfield Asset Management (BAM)** renamed itself **Brookfield Corporation (BN)** and spun off 25% of its asset management business as a new entity named **Brookfield Asset Management (BAM)**.

F&G Annuities & Life (FG) was partially spun out of its parent, Fidelity National Financial, and subsequently eliminated from the portfolio to make room for better opportunities. FG primarily offers indexed annuities.

Outlook

With an ostensibly better line of sight on the end of the Fed's tightening cycle, investors seemed to focus more on longer-term fundamentals as the year drew to a close. The related underperformance within more speculative areas of the market and greater strength among enterprises with proven business models were steps in the right direction for Cooke & Bieler's style of investing. Similarly, it seems many investors who were concerned about a recession are now anticipating a soft landing – a shift in sentiment that benefited many of the portfolio's more cyclical holdings. That said, prevailing macroeconomic forces are likely to keep inflation higher and financial conditions tighter in 2023 and 2024 than they were in the middle part of the last decade, in which case the investing environment will remain challenging, particularly for highly valued stocks. However, we believe the portfolio should be positioned well for either a soft or hard landing due to the strong profitability and healthy balance sheets of our holdings. In addition, many of the more economically sensitive holdings had discounted a long and severe recession going into the fourth quarter. Favorable absolute and relative returns in the fourth quarter represented only a partial reversion to normal valuations for many of the portfolio's egregiously undervalued holdings. Remaining latent value and solid long term fundamentals are reasons we remain optimistic about the portfolio's future prospects.

Sources: Bloomberg, CNBC, CNN, FactSet, NBC, Reuters, U.S. Department of the Treasury

Additional Cooke & Bieler Large Cap Value Performance Disclosures