COOKE & BIELER

Q2 2016

Mid Cap Value Equity

Market Commentary

The Cooke & Bieler Mid Cap Value portfolio significantly underperformed the Russell Midcap® Value Index (RMV) in the quarter. The generally strong fundamental performance of the portfolio's holdings was not enough to offset macroeconomic headwinds, particularly falling interest rates. While this effect was felt across the market capitalization spectrum, it was most pronounced in the mid cap universe where the high-yielding REIT and Utilities sectors now comprise 28% of the Index. We believe this outsized influence is not reflective of the relative economic importance of these sectors.

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 RMV outperformed the lowest quintile by a remarkable 17%. 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 8.5% versus a median of 5.4% for all RMV companies. In the second quarter, when grouped by quintile, Index constituents with the *lowest* ROIC generated a 9.9% return, compared to 1.2% 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 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 stock selection and allocation effects to be negative. Its underexposure to Utilities and REITs hurt, as did its overweight in Consumer Discretionary, where stock selection was strong, but insufficient to offset the overweight allocation. Stock selection was also positive in Health Care and Technology, but strongly negative in Industrials, hurt by our exposure to aerospace.

The market's weakness and volatility during the quarter gave us opportunities to add three new companies: a provider of private label credit cards and marketing services, a specialist lender with a currently underappreciated deposit franchise, and an iconic jewelry brand that we have previously owned. In addition, we exited two holdings during the quarter that had reached fair value. The portfolio continues to be overweight attractively valued stocks of high-quality Consumer Discretionary and Industrials companies.

Market Outlook

While underperformance is frustrating, it is important to distinguish between fundamental problems that can impair the long-term value of a business and sentiment-driven changes in stock prices. 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 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. Their value compounding ability uniquely positions the portfolio to both capture upside in a favorable market environment and protect in an extended downturn.

Sources: FactSet; Bloomberg; Russell Investments

Additional Cooke & Bieler Mid Cap Value Performance Disclosures