COOKE & BIELER

Q3 2016

Mid Cap Value Equity

Market Commentary

Mid cap stocks generated strong returns in the third quarter. Many alternatives to stocks remain unappealing, and the continuing combination of moderate economic growth, low inflation, and accommodative monetary policy is supporting robust valuations and driving the bull market, now the second-longest on record. Volatility was also low, with the Standard & Poor's 500® Index changing by less than 1% daily for almost two months, the longest such period in two years.

With volatility low, the "risk-on" trade remained in full force. Small cap companies outperformed mid cap. Mid cap outperformed large cap. And smaller companies within each group tended to outperform their larger peers. High beta stocks dominated as well. The highest beta quintile within the Russell Midcap® Value Index (RMV) outperformed the lowest quintile by more than 1500 basis points. Similarly, stocks of companies generating no earnings advanced sharply, while cyclical industries such as Technology and Industrials outperformed the broader Index.

Portfolio Performance & Developments

Reflecting the favorable equity investing environment, the Cooke & Bieler Mid Cap Value portfolio generated strong returns during the quarter. And though a risk-on backdrop generally presents relative performance headwinds for our style, the portfolio outperformed considerably, clawing back a Q2 shortfall to finish the year-to-date period modestly ahead of the RMV – a result we are generally pleased with considering the extent to which most active managers have struggled against the Index this year.

Sector allocation decisions, always the result of our bottom-up fundamental research as opposed to macro predictions, were a major contributor to the strategy's success this quarter. The portfolio's significant underweight in Utilities and Real Estate/REITs was especially helpful as those sectors, together totaling a remarkable 28% of the Index, lagged meaningfully. For both sectors, this effect was a reversal from that witnessed during the first half of the year, when declining interest rates pushed many investors toward high-yielding stocks.

The impact of stock selection decisions was modestly negative for the quarter primarily due to weakness in two Consumer Discretionary holdings. Both companies have recently made significant commitments to their retail businesses following years of underinvestment under previous management teams. Though these investments have yet to generate accelerated revenue growth and positive margin leverage, we continue to believe they will do so over the long run.

The only full elimination was of a long-term Energy holding where divestitures had helped it rebound from an early-year oil-price-driven nadir. With its sale, the portfolio's Energy position now stands at roughly 20% of the benchmark's weight. This positioning reflects our belief that many of the smaller exploration and production, oil services, and drilling companies in the Index rely on increasingly fickle capital markets for support. While some of these firms will make it through an extended period of very low oil prices, many will not.

Market Outlook

Perhaps more than any other major stock index, the RMV has challenged active managers for a number of years. It has a heavy allocation to bond-proxy sectors, and as interest rates have fallen, those have done well. Some active managers have thrown in the towel in the face of this grind, but we have stayed true to our belief that long-term success is built by owning businesses with attractive fundamentals and not just attractive current yields.

Sources: Bank of America Merrill Lynch; Bloomberg; FactSet; Russell Investments; S&P Dow Jones Indices LLC
The material presented represents the manager's assessment of the Mid 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.

Additional Cooke & Bieler Mid Cap Value Performance Disclosures