



# Mid Cap Value Equity

## Market Commentary

After a relatively quiet summer, the fourth quarter was anything but. Stocks in the Russell Midcap<sup>®</sup> Value Index (RMV) 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 RMV returned 5.5%, and for the year, the Index rose by 20.0%.

## Portfolio Performance & Developments

Against this backdrop, the Cooke & Bieler Mid Cap Value portfolio outperformed the Russell Midcap<sup>®</sup> Value Index. Gains were widespread across sectors and stocks, with the portfolio outperforming in seven of nine sectors in which it had weight. The primary driver of relative performance – accounting for around half the portfolio's excess return – was its underweighting in Real Estate and Utilities. We have frequently marked our concern with the overvaluation of these sectors, which comprised 27% of the Index heading into the quarter. Early steps toward interest rate normalization called investors' attention to this exposure.

Wrapped up in this important reversal, the highest dividend-yielding quintile of RMV companies, which had outperformed the lowest quintile through the first nine months, lagged low- and non-payers in the fourth quarter. And the interest-rate sentiment shift could augur more damage: valuations still largely ignore the potential fundamental risks of a higher interest rate regime for highly-levered Real Estate companies.

For the full year, the portfolio's return exceeded that of the benchmark. Strong outperformance during the early-year correction and a solid mid-year showing kept the portfolio slightly ahead of the surging RMV heading into the fourth quarter, when investors pushed the 10-year Treasury yield up by 85 basis points, and bond-proxy equities such as Utilities and Real Estate faltered. Broadly speaking, sector allocation decisions were additive, but stock selection accounted for about two-thirds of the portfolio's 2016 outperformance. Particularly strong stock selection in the Financials and Consumer Discretionary sectors stood out.

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 RMV has posted double digit returns in six of eight years. We have been pleased that the portfolio has managed to keep up with 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 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.

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