Q4 2022

Mid Cap Value Equity

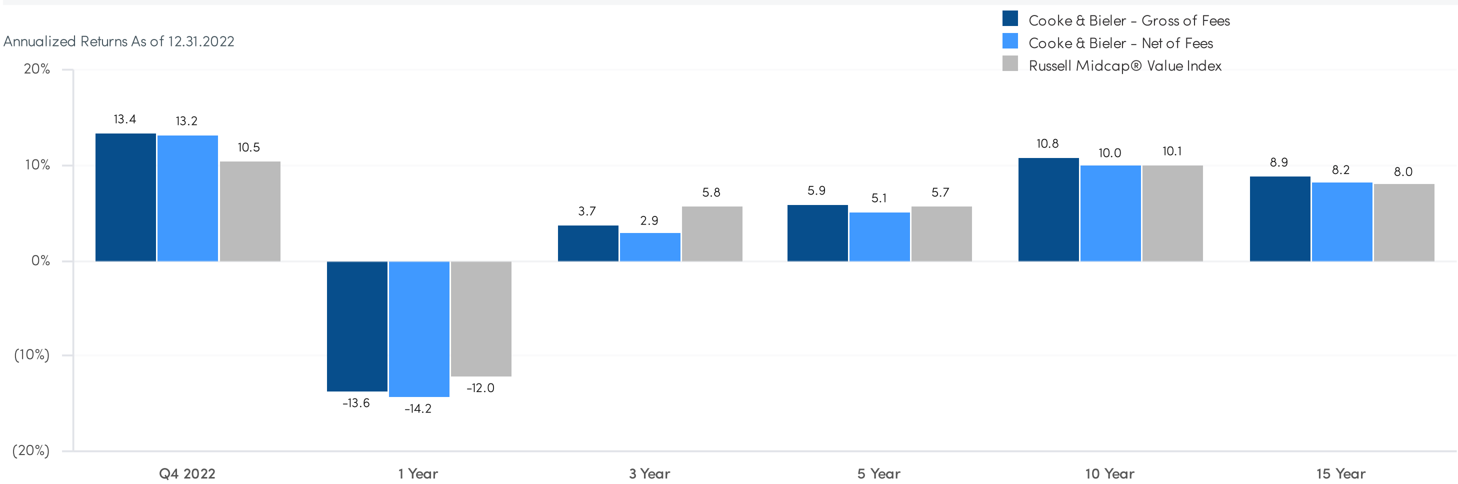
Overview

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 Mid Cap Value Strategy generated strong relative and absolute results for the quarter, though still lagged for the full year. During the quarter, the strategy posted a 13.42% return gross of fees (13.22% net of fees) versus a 10.45% return for the Russell Midcap® Value Index. Stock selection effect drove most of the outperformance, though sector allocation effect also added to results. As has been true throughout the year, selection effect was particularly strong among Financials holdings. The portfolio's Industrials holdings also performed well, as did Communication Services holdings. Conversely, the strategy's Consumer Discretionary stocks continued to struggle as investors weighed potential recession scenarios. The portfolio's Health Care holdings also underperformed the benchmark's sector constituents.

Mid 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

Syneos Health (SYNH), a leading provider of outsourced pharmaceutical clinical trial and commercialization services, was the largest detractor. The stock's valuation contracted sharply in response to very disappointing new business awards during the quarter and management's cautious outlook for improvement.

Armstrong World Industries (AWI), the leading North American manufacturer of non-residential ceiling systems, was the second-largest detractor. AWI posted solid revenue growth, but volume performance in its Mineral Fiber segment was disappointing due to project delays. In addition, margins were weaker than anticipated owing to an unexpected spike in natural gas prices. Backlogs remain strong for non-residential construction. We believe that any pullback in activity is unlikely to be severe given the already dramatic industry correction that occurred during COVID and that earnings should prove resilient in a recession thanks to the company's significant pricing power.

CarMax (KMX), an independent used car retailer operating through both brick & mortar and online channels, was the third-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.

Sector Positioning

Sector allocation effect was positive for the quarter. The strategy's underweight to Real Estate, one of the benchmark's worst performing sectors, was the largest performance tailwind. An overweight to Industrials and Consumer Discretionary also added to results. An underweight to Materials posed the largest headwind in the quarter, closely followed by the portfolio's underweight to Energy, which was also the largest detractor for the year.

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Initiations & Eliminations

Initiations

Brookfield Asset Management (BAM) was spun out of Brookfield Corporation, a current Large Cap Value holding. BAM is an asset-light manager of alternative assets, predominantly real assets such as infrastructure, renewable energy, and real estate. A company with strong operational expertise, BAM trades at an attractive valuation and is a beneficiary of scale and secular tailwinds. We were able to initiate BAM in Mid Cap Value portfolios shortly after the spin-off when the market cap fell within the strategy's range.

M&T Bank (MTB) is a large regional bank with robust cost discipline and conservative underwriting standards. In addition to these core capabilities, MTB also has a long record of capital efficiency, a relatively low-cost deposit base, and high levels of liquidity and capital, which we believe make it an attractive holding.

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

Commerce Bancshares (CBSH) and **Huntington Ingalls Industries (HII)** were eliminated to make room for better opportunities.

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

Notable Stock Updates

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

Past performance is not indicative of future results. All investing involves risk, including loss of principal. 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 security or sector. The above commentary and portfolio attribution are based on a representative Mid Cap Value institutional portfolio for the quarter ending 12/31/22. Certain client portfolios may or may not hold the securities identified above due to the respective account's guidelines, restrictions, required cash flows, or other relevant considerations. The performance attribution is an analysis of the portfolio's return relative to the Russell Midcap® Value Index. The holdings identified do not represent all of the securities purchased, sold, or recommended for Cooke & Bieler's Mid Cap Value clients. To obtain the calculation's methodology and a list showing every holding's contribution to the overall account's performance during the quarter, contact your client service representative or email your request to contact@cooke-bieler.com.

Additional Cooke & Bieler Mid Cap Value Performance Disclosures