COOKE & BIELER

Q2 2016

Small Cap Value Equity

Market Commentary

The Cooke & Bieler Small Cap Value portfolio performed well, but its return fell short of that generated by the Russell 2000® Value Index (RUJ) in the quarter. By pushing real yields into negative territory, the world's central banks are all but forcing investors into assets that are increasingly risky on one hand and high-yielding on the other. This combination of distortions created challenges for the portfolio which was comprised of high-quality companies with favorable underlying economics – economics that justify considerable reinvestment rather than maximum dividend payout.

Portfolio Performance & Developments

Cooke & Bieler portfolio companies did well on a fundamental basis. Even in terms of price performance – controlled by other investors and always more volatile than underlying developments – the portfolio outperformed in five of the eight economic sectors in which it is invested. Nonetheless, the overall impact of both sector allocation and stock selection decisions was negative. The portfolio's overweight position in the poorly-performing Consumer Discretionary sector – even though its holdings there did quite well – was a detractor, as was its underweight in Utilities and REITs, which were up 8-11% in the RUJ as they benefited from falling interest rates. As to selection, three holdings accounted for most of the drag. We do not believe any of these are fundamentally impaired, and we added to two of them in the quarter. Beyond these, the impact of stock selection was both positive and balanced: The top five contributors to return came from four different 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. In addition to propping up marginal companies with excessive leverage, low and declining rates have created a seemingly insatiable desire for yield. The second quarter once again saw the Index's biggest dividend payers outperform its smallest, with the year-to-date performance of the highest yielding quintile nearly 10% above that of the lowest yielding quintile. While dividends are an important part of an investor's total return, for the most part today the companies with the highest current yields will likely struggle to grow their earnings and cash flow over time, leaving dividend yield as the dominant source of return. Absent further declines in interest rates, the returns generated by these stocks will inevitably prove disappointing to investors.

During the quarter, we were pleased to initiate a position in a leading provider of hospital bed frames, bed surfaces, and patient lifting/moving systems. We are excited by new management's potential to realize acquisition synergies, consolidate the manufacturing footprint, and bring supply chain efficiencies to this increasingly global business. We exited a very successful Health Care holding that had reached its price target; and an Information Technology holding, where we were disappointed with some recent management decisions and yet found a solid exit opportunity.

Market Outlook

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. The financial strength and value compounding ability of the portfolio's holdings uniquely position it to both capture upside in a favorable market environment and protect during an extended downturn.

Sources: FactSet; Bloomberg; Russell Investments

Additional Cooke & Bieler Small Cap Value Performance Disclosures