



Small Cap Value Equity

Market Commentary

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

Since its February trough, the Russell 2000[®] Value Index (RUJ) has been on a tear. It is up 31%, including a nearly 9% gain in the third quarter, and has now returned over 15% YTD. With volatility low, the "risk-on" trade remained powerful this quarter. Small cap outperformed mid which outperformed large, and smaller companies within each group tended to outperform their larger peers. Even the smallest of the small could inexpensively tap the credit markets: high yield spreads dropped below 5%.

In addition, given the market's growing appetite for risk, low quality and high beta were very much in favor. Ranked by quintile, companies with the worst return on invested capital profiles, a group that includes all the non-earners, returned over 4% more than companies with the best return on invested capital. The highest beta quintile in the RUJ outperformed the lowest quintile by more than 1300 basis points. In the Health Care sector, for example, Biotech companies appreciated by 24%, outperforming the sector as a whole by 1000 basis points. Similarly, cyclical industries such as Information Technology and Materials also outperformed the broader Index. Not surprisingly, this risk-on bias was more pronounced in small cap than large cap.

Portfolio Performance & Developments

The low-quality surge that has dominated since the early-year swoon reminds us of several past periods immediately following recessions or corrections. These types of rallies generally do not play to our strengths. So while the Cooke & Bieler Small Cap Value portfolio's absolute performance this quarter was strong, it lagged that of the benchmark. As was largely the case in the second quarter as well, the environment just did not reward proven business models, tenured managements, and strong balance sheets, putting us in the company of the majority of other small cap value managers who failed to match the return of RUJ for either the quarter or YTD periods.

Sector positioning was a bright spot, as Utilities, Telecommunication Services and Real Estate – three sectors in which the portfolio has been zero weight for some time – all underperformed. This development marked a reversal from trends witnessed during the first half of the year, when declining interest rates pushed many investors toward high-yielding stocks. Given the headwinds facing our style, stock selection results were relatively weak across most economic sectors. But importantly, there were no meaningful fundamental disappointments in the portfolio.

For the year-to-date period, the portfolio's very strong performance during the initial downturn has so far been eclipsed by the 31% low-quality-driven surge since February. Sectors in which the strategy's holdings performed well, such as Consumer Discretionary, have been overshadowed by tremendous strength in areas such as generally commodity-driven Materials companies, which are underrepresented in the portfolio and are up 68% since the market's February trough.

Market Outlook

In summary, whether looking at cap size, sector weights, or quality characteristics, the portfolio remains quite different from the Index. We are comfortable with such differences as they are often a prerequisite for outperformance. Long-term success is built by owning businesses with attractive fundamentals, and we are excited to find our holdings increasingly attractively priced relative to the lower-quality group that has done so well this year.

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 Small 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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