



# Small Cap Value Equity

## Market Commentary

After retreating slightly and struggling to gain traction most of the summer, the U.S. stock market rallied strongly in September with smaller cap and Energy stocks leading the charge. In the end, Q3 was another positive quarter for stocks – the eighth consecutive one for the market as measured by the S&P 500 Index. On the strength of a September surge seemingly driven by the prospect of tax reform, the Russell 2000<sup>®</sup> Value Index (RUJ) returned 5.1%, well ahead of the Large Cap Value and Mid Cap Value indices.

## Portfolio Performance & Developments

Against this backdrop, the Cooke & Bieler Small Cap Value strategy again performed well, outpacing the benchmark and building on very strong year-to-date and trailing twelve months' results. Unlike the trend witnessed in the first half of the year, though, stocks of high quality companies did not noticeably outperform others during Q3. Instead, businesses with weak returns on invested capital fared better this quarter, leaving the company-specific fundamental performance of the strategy's holdings as the primary driver of its excess return.

The impact of both stock selection decisions and sector allocation was additive. Stock selection was particularly strong in Information Technology and Industrials, partially offset by weakness in Healthcare and Financials. Not surprisingly, the most notable drivers of allocation effect were the sectors in which the strategy differs most from the Index: Real Estate, Industrials and Consumer Discretionary. The C&B Small Cap Value strategy's underweight in Real Estate and more specifically its zero weight in REITs benefitted relative results as stocks of these companies were among the quarter's weakest performers. The strategy's meaningful overweight in Industrials was also beneficial. And although the strategy's Consumer Discretionary stocks were generally solid performers, the sector did not perform well at the Index level, making the strategy's outsized positioning here a drag.

In summary, it was another good quarter in which the C&B Small Cap Value strategy outperformed a strong Index. Year-to-date and longer-period outperformance is also favorable with the strategy well ahead of the benchmark since its inception. Just as importantly, the third quarter also saw the underlying fundamentals of the strategy's holdings continue to progress. And in the world of small cap investing this is no mean feat, as approximately one third of the Index constituents have failed to earn a profit over the trailing twelve months.

Our focus on long-term fundamentals in a world dominated by maximization of short-term performance continues to unearth attractive opportunities. In our view, stock prices are much more volatile than business fundamentals and we remain steadfastly committed to deploying our research resources and experienced judgment to capitalize on unwarranted dislocations. Accordingly, diligent research helped us add five new companies to the strategy in the quarter, offsetting the sale of only one which had reached our price target.

## Market Outlook

During the quarter, the Fed announced it would begin shrinking its balance sheet, marking the latest installment in this slowly ebbing period of extraordinary monetary stimulus. This transition away from stimulus brings with it a set of concerns, but also of opportunities. As we have written before, the various forms of quantitative easing have supported many companies of questionable quality. As monetary policy becomes more restrictive and rates potentially rise, weaker companies will find it increasingly hard to compete with their higher-quality peers. As a result, returns should be increasingly based on more divergent company specific fundamentals rather than on macro factors.

Sources: Bank of America Merrill Lynch; Bloomberg; FactSet; Russell Investments; Strategas

The material presented represents the manager's assessment of the Small Cap 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. Past performance is no guarantee of future results.

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