



Small Cap Value Equity

Overview

U.S. markets performed well in the third quarter, propelled by strong corporate profits and economic growth. Marking a reversal from trends witnessed earlier in the year, large capitalization stocks outpaced smaller ones and market volatility abated. The Russell 2000® Value Index (RUJ) saw positive gains, building on its very strong showing last quarter. Beneath the surface, though, the Energy sector saw both absolute and relative weakness following pronounced strength in Q2, while Real Estate holdings also surrendered a portion of last quarter's gains in response to rising interest rates.

Portfolio Performance & Developments

After a difficult second quarter, Cooke & Bieler's Small Cap Value portfolio generated a total return of 5.64% gross of fees (5.38% net of fees), outperforming the RUJ's 1.60% return for the third quarter. Sector allocation decisions were additive, with underweight positions in Real Estate and Energy and an overweight in Industrials benefitting relative results. But the majority of the strategy's outperformance in the quarter related to stock selection in what we view as a less sentiment-driven market. Particular strength among the portfolio's Consumer Discretionary and Industrials holdings stood out, but so did meaningful price appreciation from holdings in Real Estate and Energy, among the Index's weakest sectors.

Five Largest Contributors/Detractors

	Avg Weight (%)	Total Return (%)	Contrib. to Return (bps)
Helen of Troy	4.8	33.0	138
Steelcase Inc.	3.2	38.0	111
Fox Factory	1.5	50.5	73
Colfax Corp.	3.5	17.7	58
Donaldson Co.	1.9	29.6	53

	Avg Weight (%)	Total Return (%)	Contrib. to Return (bps)
Varex Imaging	2.4	-22.7	-55
Winnebago Industries	2.9	-18.1	-54
Schweitzer-Mauduit Int'l	3.8	-11.4	-46
Nautilus Inc.	2.7	-11.1	-33
United Natural Foods	0.9	-29.8	-33

Source: FactSet

Past performance is not indicative of future results. The performance attribution is an analysis of a representative Small Cap Value institutional portfolio's gross of fees return relative to the Russell 2000® Value Index. The holdings identified do not represent all of the securities purchased, sold, or recommended for Cooke & Bieler's Small 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.

Largest Contributors

Helen of Troy (HELE), a diversified consumer goods company with leading positions in various niche categories, was the largest contributor for the quarter. HELE had been unfairly penalized in the first half of the year following the publication of a poorly-researched short thesis that misunderstood the company's distribution channels, ignored its very attractive valuation, and discounted its significant balance sheet flexibility. The stock price has been steadily recovering since.

Steelcase Inc. (SCS), a leading manufacturer of office furniture and systems, was the second largest contributor. SCS delivered earnings results that were considerably above expectations, driven by an improving environment, better traction for the company's new offerings, and good expense leverage.

Fox Factory (FOXF), a designer and manufacturer of high-performance, premium suspension systems for high-end mountain bikes and powersport vehicles, was the third largest contributor. FOXF posted a good quarter as growth in their bike and powered segments exceeded management's long-term growth targets. The company continues to penetrate the lower price points in the premium mountain bike category and win new programs and content for powersport vehicles.

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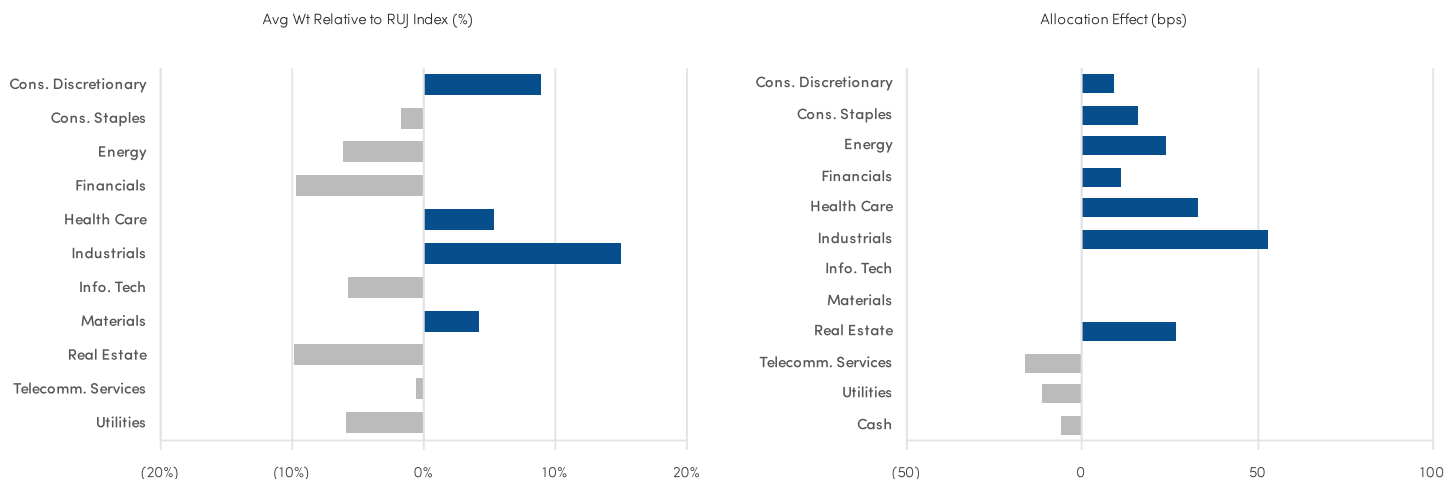
Largest Detractors

Varex Imaging (VREX), the world's leading independent manufacturer of diagnostic imaging system components for medical and industrial applications, was the largest detractor for the quarter. VREX reported a disappointing quarter due to customer delays in shipments and orders, primarily in China, in part owing to the uncertainty created by tariffs.

Winnbago Industries (WGO), a leading manufacturer of motorhomes and towable units in the U.S., was the second largest detractor. Investors have all but abandoned the stock as the recreational vehicle industry sees a deceleration from double digit retail volume growth to mid-single digit growth. We still believe WGO is a share-gaining franchise with a sizeable margin improvement opportunity as well.

Schweitzer-Mauduit (SWM), a leading supplier to the tobacco products industry, was the third largest detractor. SWM reported encouraging fundamental earnings results but will incur higher interest expense as it refinanced some acquisition-related debt.

Sector Positioning



Source: FactSet

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In contrast to the second quarter, portfolio positioning was a tailwind as the strategy's significant overweights in the Industrials and Health Care sectors and its underweight in Real Estate were additive. Conversely, the underweights in the Telecommunication Services and Utilities sectors posed a relative performance drag.

Initiations

Entegris (ENTG) is a former portfolio holding that we have followed for years. The company provides products and systems that purify, protect, and transport critical materials used in semiconductor fabrication. Their focus on product and system purity enables semiconductor manufacturers to make smaller and faster microchips with greater yield. ENTG benefits from high market share in older technologies as well as new opportunities at the leading edge, with manufacturers engaging them in the early stages of process design. Although always a high-quality business, the stock was eliminated in Q4 2017 after reaching our estimate of fair value. Positive revisions to our long-term outlook and recent volatility in the semiconductor space allowed us to re-initiate a position.

Extended Stay America (STAY) is the largest owner and operator of extended stay hotels in the U.S. Their hotels provide an affordable alternative to traditional lodging – particularly for business travelers – featuring in-room kitchens and limited housekeeping services. The extended stay market is attractive on a long-term basis, and STAY has an opportunity to improve margins and returns by divesting less profitable properties and selectively building in markets with better economics. Valuation is compelling as some investors are disappointed management has not moved faster to formally separate its property ownership from its franchise functions. We think this is likely over time, and in the near-term believe STAY's portfolio transformation should create significant value for shareholders.



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Outlook

As we enter the final quarter of 2018, we continue to see pockets of value in a market that as a whole has grown more exuberant. Consumer Staples, Utilities, and Energy in particular seem more than fairly valued, and the strategy remains underweight these areas. We find more compelling value in the Industrials, Consumer Discretionary, and, increasingly, the Information Technology sectors. The economy appears to be growing robustly and corporate profits are benefiting from lower taxes, which should provide support for stock prices. However, after an extended period of extraordinary monetary stimulus, the Federal Reserve has been steadily moving toward a more neutral stance – raising rates seven times since December 2016. Rising interest rates will put pressure on companies and business models that have grown dependent on cheap financing and should slow the economy over time. The risks of a more significant crisis, while not high, are rising as well. Against this backdrop, the strategy continues to be positioned in conservatively financed, high-quality businesses.

Sources: Bank of America Merrill Lynch; Bloomberg; FactSet; Russell Investments; Wall Street Journal

Past performance is not indicative of future results. 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 security or sector. The above commentary and portfolio attribution are based on a representative Small Cap Value institutional portfolio for the quarter ending 9/30/18. The portfolio attribution is gross of fees. 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 2000® Value Index. The holdings identified do not represent all of the securities purchased, sold, or recommended for Cooke & Bieler's Small Cap Value clients. To obtain the calculation's methodology and a list showing very 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.

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