



# Small Cap Value Equity

## Market Commentary

By October 1st, small cap value stocks had already posted impressive year-to-date results, outpacing both large cap value and mid cap value equities. After an early-quarter pause, though, the Russell 2000<sup>®</sup> Value Index (RUJ) roared even higher, appreciating by 17.6% in the final seven weeks of the year. Donald Trump's surprising win sent shockwaves through the market as investors rushed to position their portfolios for the new political order. For the quarter, the RUJ rose by 14.1%, outpacing all other major style and size indices by a wide margin. Investors seeking exposure to the domestic economy under the new administration seized on small cap value companies in particular, with the RUJ outpacing the Russell 2000<sup>®</sup> Growth Index by over 1000 basis points. For the year, the RUJ returned an incredible 31.7%.

## Portfolio Performance & Developments

Against this backdrop, the Cooke & Bieler Small Cap Value portfolio finished the year ahead of the Russell 2000<sup>®</sup> Value Index, posting its best absolute quarter in over five years. Given Cooke & Bieler's historical pattern of performance – our strategies typically fare better in less energetic markets – we were particularly pleased with the portfolio's results.

Smaller companies continued to outpace their larger counterparts during this "risk-on" quarter, which was a modest headwind for the portfolio given its slightly higher relative capitalization currently. Offsetting this impediment, however, a renewed appreciation for quality emerged as companies with high return on invested capital profiles strongly outpaced low- and non-earners. In addition, the high-dividend trade that dominated sentiment in the previous nine months reversed, benefitting relative results.

Stock selection decisions were additive in the quarter, as were sector allocation decisions, excluding the impact of cash. From an allocation perspective, the portfolio's zero-weighting in Utilities and Real Estate was the biggest driver. Stock selection was both strong and broad, with the portfolio outperforming in six of eight sectors in which it had weight. Information Technology and Financials stood out, and together included four of the portfolio's top five performers. For the full year, sector allocation decisions were the primary driver of the portfolio's small relative shortfall. While our meaningfully underweight positioning in Utilities, Real Estate, and Telecommunication Services was additive, our large overweight in Consumer Discretionary was an offset. That said, stock selection decisions within Consumer Discretionary were particularly effective.

It is worth pausing here and noting that U.S. equities have outperformed virtually every other asset class in the past decade. Since the end of 2008, the RUJ has posted double-digit returns in five of eight years. We have been pleased with the strategy's outperformance over this span as these sorts of extended bull markets, frequently driven by macro themes (Quantitative Easing in this case) and unbridled optimism, can outshine our more fundamental, data-driven approach to investing.

## Market Outlook

Mid-teens percentage equity market returns are not sustainable over the long run. Historically, equities have offered high single-digit returns, and the inexorable math of reinvestment rates and returns on equity suggests a similar level going forward. This is not to say the market is due for a significant correction – the last eight years included a recovery from a deep recession– but we are well past the point where investors can count on a tailwind from depressed operating conditions or conservative valuations. Taking the long view forward, we believe returns will be more modest and hope the market will even more fully reward a detailed understanding of fundamentals and a disciplined approach to quality and valuation.

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

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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