Q4 2022

Small Cap Value Equity

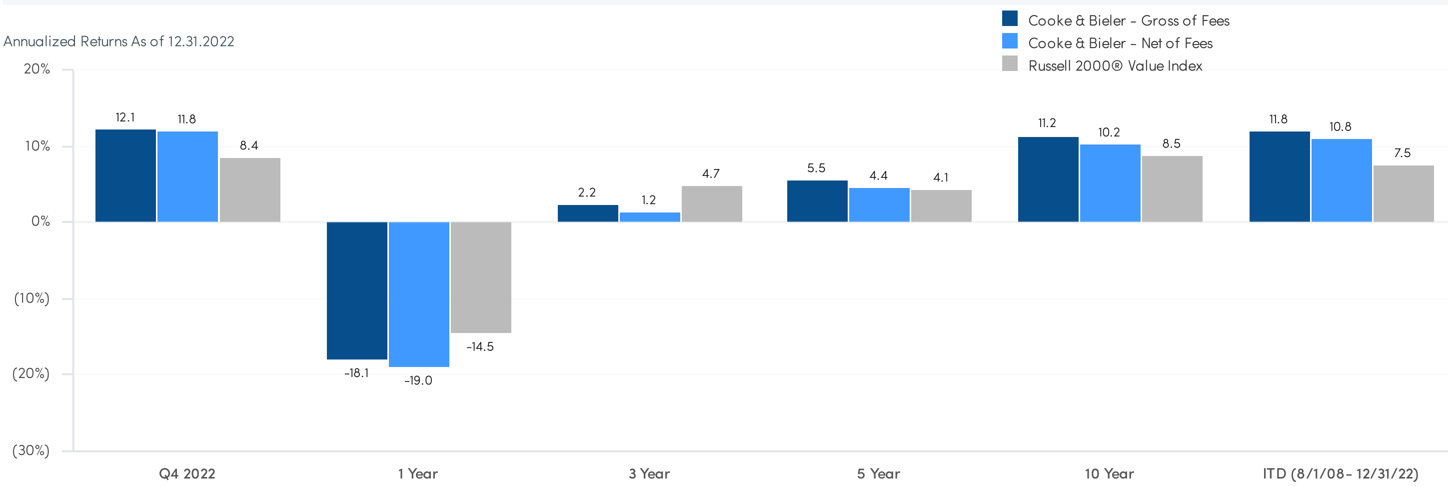
Overview

Stocks recovered strongly in the fourth quarter, but the rally was not strong enough for major indices to avoid their worst calendar year returns since 2008. Improved sentiment was driven by the slower pace of Fed tightening and signs inflation pressures had peaked, with markets also skirting any significant macroeconomic shocks. Oil prices and long-term interest rates ended the quarter broadly flat and the main geopolitical development – China's decision to relax its Covid Zero policy – bodes well for global growth. Domestically, both employment data and consumer spending appeared healthy despite the sharp tightening of monetary conditions since the start of the year, bolstering hopes for a soft landing. Against that backdrop, Energy continued its reign as the best performing sector, while value outperformed growth across the capitalization spectrum for the quarter and the year. Conversely, the most speculative areas of the market, including unprofitable technology companies, cryptocurrency related businesses, and small biotech, posted weak and at times catastrophic returns.

Portfolio Performance & Developments

Cooke & Bieler's Small Cap Value Strategy generated strong relative and absolute results in the fourth quarter, though still lagged for the full year. During the quarter, the strategy posted a 12.06% return gross of fees (11.79% net of fees) versus an 8.42% return for the Russell 2000® Value Index. Both stock selection effect and sector allocation effect were additive, though stock selection drove most of the outperformance. Stock selection was additive in six out of eight sectors where the portfolio had weight, with particularly strong performance from Health Care companies. As has been true throughout the year, selection effect was also strong among the strategy's Financials companies. Conversely, the portfolio's Consumer Discretionary stocks continued to struggle as investors weighed potential recession scenarios. Industrials holdings also underperformed the benchmark's sector constituents.

Small Cap Value Equity Composite Performance



Source: Factset and Russell®
Past performance is not indicative of future results. All investing involves risk, including loss of principal.
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Contributors & Detractors

Largest Contributors

ESAB (ESAB), a manufacturer of welding and gas control equipment and consumables, was the largest contributor. ESAB reported solid earnings, easing investor concerns regarding the impact of a global economic slowdown. Management is executing well as a newly spun-off and independent business, investing in R&D, driving innovation, and making attractive bolt-on acquisitions.

ReniassanceRe (RNR), a Bermuda-based property and casualty reinsurer, was the second-largest contributor. Investor sentiment improved meaningfully in the quarter as investors began to expect notably higher earnings in 2023, driven by higher interest rates and significant rate improvement within the property catastrophe reinsurance market.

American Eagle Outfitters (AEO), a leading teen and young adult retailer operating through the American Eagle and Aerie brands, was the third-largest contributor. AEO showed progress clearing excess inventory while protecting margins. The stock had been trading at depressed valuations and even modest good news generated a sharp rally in the stock price.

Largest Detractors

Syneos Health (SYNH), a leading provider of outsourced pharmaceutical clinical trial and commercialization services, was the largest detractor. The stock's valuation contracted sharply in response to very disappointing new business awards during the quarter and management's cautious outlook for improvement.

PGT Innovations (PGTI), a leading manufacturer of laminated, impact-resistant residential windows, was the second-largest detractor. The shares outperformed in the third quarter on the prospect of robust hurricane-driven demand in its Florida markets, but saw that enthusiasm retreat somewhat this quarter despite continued strong volume, pricing, and margin trends.

Armstrong World Industries (AWI), the leading North American manufacturer of non-residential ceiling systems, was the third-largest detractor. AWI posted solid revenue growth, but volume performance in its Mineral Fiber segment was disappointing due to project delays. In addition, margins were weaker than anticipated owing to an unexpected spike in natural gas prices. Backlogs remain strong for non-residential construction. We believe that any pullback in activity is unlikely to be severe given the already dramatic industry correction that occurred during COVID and that earnings should prove resilient in a recession thanks to the company's significant pricing power.

Sector Positioning

Sector allocation effect was broadly positive for the quarter, with the majority of sectors contributing to relative performance. The portfolio's significant overweight to Industrials, one of the benchmark's best performing sectors, was the largest performance tailwind. An overweight to Consumer Discretionary and underweight to Communication Services also added to results. The strategy's underweight to Energy, one of the benchmark's best performing sectors, continued to weigh on relative performance, making it the largest detractor for the quarter and the year. Underweight positions in Materials and Utilities also hindered results.

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Initiations & Eliminations

Initiations

Arrow Electronics (ARW) operates two businesses: electronic components distribution and the provision of information technology products to Value Added Resellers (VARs) that service small businesses. Several other Cooke & Bieler strategies held ARW at the beginning of the quarter, and we were able to initiate the position at an attractive valuation as ARW's market cap fell into the range of the Small Cap Value strategy. This multiple contraction was primarily due to investor concerns that the industry could be entering a cyclical downturn and that the company's margins would degrade as supply chain constraints eased.

Dentsply Sirona (XRAY) is the largest manufacturer in the still fragmented global dental products and technologies market. This is an attractive and secularly growing market driven in part by aging demographics in developed markets and rising standards of living in emerging markets. XRAY's brands, scale, distribution, and stickiness with over 600,000 dental professional end users allow the company to earn attractive returns on capital, and relatively low capital requirements lead to consistent and substantial levels of free cash generation. New management appears well equipped to enact fundamental improvement in profitability, organic growth, and free cash flow conversion.

Eliminations

Huntington Ingalls Industries (HII) and **Plexus (PLXS)** were eliminated to make room for better opportunities.

Outlook

With an ostensibly better line of sight on the end of the Fed's tightening cycle, investors seemed to focus more on longer-term fundamentals as the year drew to a close. The related underperformance within more speculative areas of the market and greater strength among enterprises with proven business models were steps in the right direction for Cooke & Bieler's style of investing. Similarly, it seems many investors who were concerned about a recession are now anticipating a soft landing – a shift in sentiment that benefited many of the portfolio's more cyclical holdings. That said, prevailing macroeconomic forces are likely to keep inflation higher and financial conditions tighter in 2023 and 2024 than they were in the middle part of the last decade, in which case the investing environment will remain challenging, particularly for highly valued stocks. However, we believe the portfolio should be positioned well for either a soft or hard landing due to the strong profitability and healthy balance sheets of our holdings. In addition, many of the more economically sensitive holdings had discounted a long and severe recession going into the fourth quarter. Favorable absolute and relative returns in the fourth quarter represented only a partial reversion to normal valuations for many of the portfolio's egregiously undervalued holdings. Remaining latent value and solid long term fundamentals are reasons we remain optimistic about the portfolio's future prospects.

Sources: Bloomberg, CNBC, CNN, FactSet, NBC, Reuters, U.S. Department of the Treasury

Additional Cooke & Bieler Small Cap Value Performance Disclosures