



SMID Cap Value Equity

Market Commentary

Stocks continued their upward path in the first quarter, though the drivers of these gains differed from those of late 2016. Markets struggled to process and predict the impact of legislative outcomes across a variety of industries. Sectors that did well in the post-election surge, including Energy and Financials, took a step back, and others, particularly Health Care and Information Technology, advanced. Similarly, the style characteristics that propelled equities higher in November and December shifted. Investors rewarded size this quarter, and displayed a renewed interest in higher quality businesses with good growth prospects. Companies with the highest return on capital profiles tended to outperform those with the lowest and growth outperformed value, standing in clear contrast to the patterns that drove markets in Q4 2016.

Portfolio Performance & Developments

After strong stock-selection-driven outperformance in 2016, the Cooke & Bieler SMID Cap Value portfolio continued to perform well this quarter. Contributions were broad-based: the strategy added value relative to the Russell 2500™ Value Index (the Index) in six of the nine sectors in which it had weight. Sector positioning stemming from our bottom-up process was additive, with significant contributions from the portfolio's underweight in Energy and overweight in Health Care more than offsetting the drag from its zero weight in Utilities. The overall impact of stock selection was modestly negative, though very good results among most of the portfolio's Information Technology, Health Care, and Industrials holdings offset the relatively poor performance of several of its Consumer Discretionary companies.

Portfolio activity during the quarter mostly centered on existing holdings. We trimmed some of the portfolio's Financials and Industrials positions early in the quarter after their valuations rose sharply in many of those areas post-election. Additionally, we exited four positions entirely, three of which were the subjects of takeover offers and one of which had reached our estimate of fair value. We added to some Consumer Discretionary holdings as we continue to see good opportunities there. The portfolio remains underweight in Energy, where we continue to see limited investment opportunities from our bottom-up vantage point for a combination of fundamental and valuation reasons, despite our view that oil prices likely will rise a bit going forward as supply and demand dynamics cyclically change. We also initiated one position during the quarter.

More significantly, the portfolio continues to have relatively little exposure to higher-yielding securities in what is being called the "RUST" group: Real Estate, Utilities, Staples, and Telecommunications Services, which generally remain overvalued despite their marked underperformance over the past year or so. Overall, we were pleased with the fundamental performance of the portfolio's holdings and are optimistic about their ability to compound value at an attractive rate.

Market Outlook

The Index has returned 23.1% over the last 12 months as investors anticipate growth in overall corporate profits for the first time in three years. Gains from here, and indeed support for current valuations, will depend on that optimism being borne out. However, after years of sub-par growth and with a generally favorable macro-economic outlook, there is room for positive surprises as well. Regardless, our investment decisions will be based on a detailed understanding of fundamentals and our 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 SMID 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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