



# SMID Cap Value Equity

## Market Commentary

U.S. equity indices posted positive returns in the second quarter, with small capitalization stocks outperforming larger ones by a meaningful margin. The Russell 2500™ Value Index (R25IV) returned 5.80% for the quarter, with the late-quarter rise in oil prices – up 14% in the quarter – driving outsized returns among the benchmark's Energy constituents and a flattening yield curve propelling its REITs. That said, market strength was broad within the smid cap value universe, with every economic sector generating positive returns at the benchmark level.

## Portfolio Performance & Developments

For the second quarter of 2018, Cooke & Bieler's SMID Cap Value Strategy posted positive absolute returns, but underperformed the R25IV on a relative basis. The favorable impact of stock selection decisions was more than offset by negative sector allocation. While disappointing, this quarter's performance is not unusual given the portfolio's high active share and our focus on long-term results. Cooke & Bieler's underperformance in a very strong up market – not typically our strong suit – is not surprising either. However, the composition of the market's performance drivers within smid cap equities this quarter does surprise us a bit. The broad-based strength in smid stocks seems on one hand to indicate a generally optimistic economic outlook, while on the other hand seems incongruent with rising energy prices and expectations for a sustained period of low interest rates.

Sector allocation resulting from our bottom-up fundamental investment process was a headwind primarily due to the strategy's significant underweight in the Index's best performing sectors – Energy and Real Estate – which together comprised one-half of the Index's total return for the quarter. The drag from this underallocation accounted for more than the entirety of the portfolio's relative shortfall in the second quarter. More generally, companies with the lowest returns on capital and highest levels of debt performed best. Such conditions are typically adverse to Cooke & Bieler's investment style.

Stock selection was positive for the quarter with strong returns in Industrials and Consumer Discretionary. In Industrials, companies with greater exposure to the Energy-related industries benefitted as energy markets stabilized and gradually recovered. Recently, we have gained exposure to energy markets through companies that, in our opinion, are better able to compound value over a full cycle while having the balance sheet flexibility necessary to weather an extended downturn. Our holdings contributed positively in the Consumer Discretionary sector after underperforming in the prior quarter. Partially offsetting these positive results, the strategy's packaging holdings in the Materials sector suffered during the quarter as investors incorrectly conflated the weakness of certain branded customers with similar weakness in broader end markets.

## Market Outlook

The portfolio is now more attractive on a forward P/E basis than it was at the start of the year. More importantly, the market has moved toward a place more conducive to active management. For instance, the positive point-to-point total return for the second quarter disguised considerable underlying intra-quarter volatility. We welcome such volatility as related potential mispricings provide opportunities for skilled stock pickers. As always, we at Cooke & Bieler believe that returns ultimately track fundamentals. We remain confident in our investment team's proven and experienced stock picking ability underpinned by a disciplined process, rigorous research effort, and unique culture.

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

The material presented represents the manager's assessment of the SMID 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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