COOKE & BIELER

Q2 2022

# SMID Cap Value Equity

## Overview

The investing environment went from challenging to nearly universally negative during the second quarter as markets struggled to digest rising interest rates, unexpectedly high levels of inflation, and signs of economic deterioration. This troublesome combination caused sentiment to turn overwhelmingly negative as it resurrected unhappy memories of the stubborn stagflation that hampered stocks much of the 1970s. Indeed, the -20% return posted by the S&P 500® Index for the first half of 2022 was its worst since 1962. The damage would have been worse were it not for a late quarter rally spurred by views that the Federal Reserve might turn less hawkish in the face of continuing economic weakness.

The breadth of the decline was all-encompassing, with all major benchmarks showing double digit declines and every sector across those benchmarks down as well. As in the first quarter, rising interest rates continued to negatively impact Growth indices most and market turbulence continued to affect smaller capitalization stocks the most. Among sectors, Consumer Staples, Utilities, and Energy held up relatively well across the market cap spectrum, while Information Technology and Consumer Discretionary stocks tended to lag.

## Portfolio Performance & Developments

Cooke & Bieler's SMID Cap Value Strategy provided some downside protection during the difficult market environment of the second quarter, returning -10.41% gross of fees (-10.62% net of fees) against a -15.39% return for the Russell 2500™ Value Index. This outperformance was primarily driven by strong stock selection effect, with positive results in seven of the eight sectors in which the portfolio had weight, while sector allocation effect also added to relative performance. Consistent with first quarter trends, Financials holdings led the way, with insurance companies such as RenaissanceRe and Alleghany continuing to provide the greatest benefit. Additionally, after posting markedly negative selection results in the first quarter, the portfolio's Industrials holdings – particularly defense-adjacent companies such as Huntington Ingalls and BWX Technologies – posted strong returns in the second quarter and recouped some lost ground. Stock selection within the Utilities sector posed a slight headwind to results.

## Five Largest Contributors/Detractors

| | Avg Weight (%) | Total Return (%) | Contrib. to Return (bps) |
|---|---|---|---|
| Perrigo | 2.5 | 6.3 | 22 |
| Huntington Ingalls | 1.7 | 9.8 | 13 |
| BWX Technologies | 2.1 | 2.7 | 4 |
| Amdocs | 1.2 | 1.8 | 3 |
| Ingredion | 1.2 | 1.9 | 2 |

| | Avg Weight (%) | Total Return (%) | Contrib. to Return (bps) |
|---|---|---|---|
| Gildan Activewear | 3.0 | -22.8 | -73 |
| MKS Instruments | 2.1 | -31.5 | -68 |
| Dentsply Sirona | 2.1 | -27.2 | -62 |
| Woodward | 2.2 | -25.8 | -62 |
| Hanesbrands | 1.9 | -30.1 | -61 |

Source: FactSet
Past performance is not indicative of future results. The performance attribution is an analysis of a representative SMID Cap Value institutional portfolio's gross of fees return relative to the Russell 2500™ Value Index. The holdings identified do not represent all of the securities purchased, sold, or recommended for Cooke & Bieler's SMID 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

**Perrigo (PRGO)**, a manufacturer and supplier of over-the-counter and generic pharmaceutical products, was the largest contributor. PRGO's valuation expanded significantly from low levels after the company reported strong first quarter revenue growth, early completion of a highly accretive acquisition, and share gains in the infant formula market, increasing investor confidence in the business.

**Huntington Ingalls (HII)**, a military shipbuilder for the U.S. Navy and the Navy's sole supplier for nuclear-powered aircraft carrier construction, refueling, and deactivation, was the second-largest contributor. HII has continued to make fundamental progress on margin improvement and integrating its acquisition of Alion Science and Technology. Additionally, the stock benefited from investor expectations that domestic defense spending could increase due to rising global geopolitical tensions.

**BWX Technologies (BWXT)**, a provider of nuclear reactors for submarines and aircraft carrier propulsion, was the third-largest contributor. BWXT's defensive demand profile and upcoming free cash flow inflection remain attractive. The company's shares also continue to benefit from a shift in investor views on defense spending due to the ongoing Russia-Ukraine conflict.

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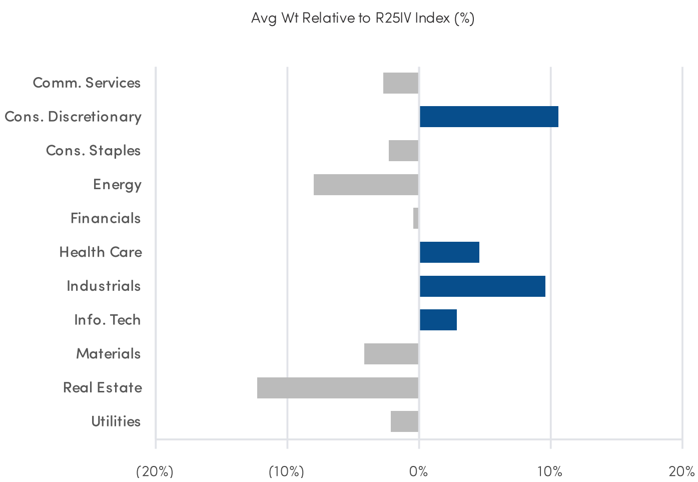
## Largest Detractors

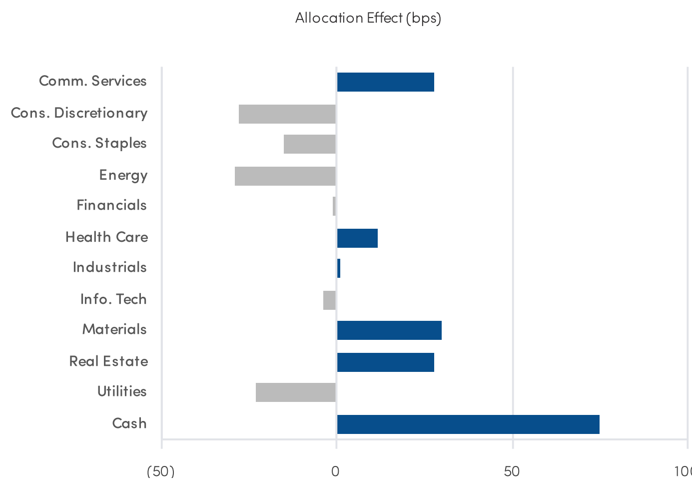
**Gildan Activewear (GIL)**, the largest basic apparel manufacturer, was the largest detractor. GIL has lagged the overall market as Consumer Discretionary stocks in general have fallen out of favor. However, we believe that investors are failing to sufficiently appreciate the company's improved earnings potential.

**MKS Instruments (MKSI)**, a supplier of components and subsystems to companies in the semiconductor capital equipment industry, was the second-largest detractor. Investors were disappointed with the company's pause in increasing cell phone component capacity, while concerns that the semiconductor capital equipment cycle may have peaked also weighed on the stock's valuation.

**Dentsply Sirona (XRAY)**, a manufacturer of dental equipment and products, was the third-largest detractor. XRAY's results were negatively affected by reductions of excess dealer inventory in the United States, volume declines in China related to the country's zero-COVID policy, continued supply chain disruption, and cost inflation. An investigation into past management's use of sales incentives in the second half of 2021 increased investor uncertainty, but we believe the company's conservative balance sheet, consistent free cash flow generation, and attractive valuation should mitigate downside scenarios.

## Sector Positioning




Source: FactSet
Past performance is not indicative of future results. The performance attribution is an analysis of a representative SMID Cap Value institutional portfolio's gross of fees sector return relative to the Russell 2500™ Value Index. Please see additional performance disclosures at the end of this document.

Sector allocation effect was additive for the second quarter. The portfolio's underweight positions in Materials, Communication Services, and Real Estate were additive to relative performance as all three sectors turned in some of the benchmark's worst results. An overweight to Health Care was an additional tailwind. Conversely, the strategy's underweight to Energy and Utilities, two of the best performing sectors within the Index, as well as an overweight in Consumer Discretionary, were the biggest detractors.

## Initiations

**ESAB (ESAB)** is a leading global provider of welding equipment and consumables. The company was spun off from long-time portfolio holding Colfax during the quarter.

**Hasbro (HAS)** is a leading global play and entertainment company with a broad and deep portfolio of brands and entertainment properties spanning toys, games (mostly traditional but increasingly digital), licensed products, and television and film entertainment. Retailer liquidations, tariffs, and COVID-19 limited fundamental progress during the 2017-2020 period. We believe that the company's results should improve as these headwinds fade, thanks to its strong position as well as growth opportunities in the global play and entertainment industry.

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## Eliminations

There were no eliminations this quarter.

## Notable Stock Updates

**Enovis (ENOV)** is the successor entity to long-time portfolio holding Colfax following the spin-off of their welding business. ENOV is a medical technology business selling orthopedic reconstruction, prevention, and rehabilitation products.

## Outlook

The end of the second quarter leaves investors worse off and facing the same set of uncertainties that bedeviled them in April. Widespread supply chain disruptions persist, the war in Ukraine seems no closer to resolution, and inflation remains stubbornly high, forcing the Federal Reserve to raise interest rates even as the economy slows. The odds of recession are rising – though the timing and severity remain unclear – and investors' minds are naturally drawn to speculation about when the tide of events will turn. Never long-term oriented or fundamentally focused by nature, most market participants are prone to guessing at geopolitical and economic developments.

We think these inclinations are mistaken. We agree that the Fed's window to engineer a soft landing is shrinking. With the economy already slowing, further monetary tightening risks tipping us into a recession. But with inflation still at multi-decade highs, easing policy too soon risks further embedding inflation and increasing the costs of later action. The Fed's success depends on a myriad of factors mostly out of its control, making their task extremely difficult and investor efforts to predict the outcome futile.

We think it is better to adopt Warren Buffett's mantra of buying good businesses when they go on sale. The trick of course is to distinguish good businesses with low share prices from those that have merely been kept aloft by investor optimism or those that face serious existential threats. This differentiation is the focus of our research: finding businesses that can prosper far into the future regardless of the short-term path of the economy. Recently, this research has led us to find value in Information Technology and Consumer Discretionary companies – businesses left behind as investors worry about rising rates or slowing demand, but which remain poised to earn solid returns over a full cycle. Regardless of the industry or sector, these businesses share strong competitive advantages, conservative capital structures, and talented management teams that we believe can generate attractive returns over the long run. And while their fundamental prospects are largely unchanged, they are all substantially – often 30% or more – cheaper than they were at the beginning of the year. While short-term bumps are inevitable and the market's bottom will only be clear in retrospect, we believe our long-term approach, supported by the conviction that comes from detailed independent research, will add value through this cycle.

Sources: APX, Bloomberg, CNBC, The Economist, FactSet, The New York Times, The Wall Street Journal



Additional Cooke & Bieler SMID Cap Value Performance Disclosures