



SMID Cap Value Equity

Market Commentary

After retreating slightly and struggling to gain traction most of the summer, the U.S. stock market rallied strongly in September with smaller cap and Energy stocks leading the charge. In the end, Q3 was another positive quarter for stocks – the eighth consecutive one for the market as measured by the S&P 500 Index. The Russell 2500™ Value Index (R25IV) returned nearly 4% in the quarter, bringing its year-to-date performance to just under 6%.

Portfolio Performance & Developments

Against this backdrop and after a year of very meaningful outperformance, the Cooke & Bieler SMID Cap Value strategy posted solid absolute results, but lagged its benchmark, the R25IV. Unlike the trend witnessed in the first half of the year, stocks of high quality companies did not noticeably outperform others during Q3. Instead, businesses with weak returns on invested capital fared better this quarter.

From an attribution standpoint results were mixed. The biggest single contributor to relative performance was very good stock picking within the Consumer Discretionary sector. In total, the C&B SMID Cap Value strategy's holdings in this sector comprised roughly 30% of the strategy's total return for the quarter compared to only 8% for the sector within the Index. The strategy's diverse collection of Industrials stocks performed very well, primarily due to continuing strong fundamental results. Also contributing to relative performance was the combination of favorable stock selection and underweight positioning in two sectors that underperformed the benchmark – Consumer Staples and Real Estate.

Two items at the stock selection level more than offset these contributions. The first was a small number of company-specific issues, none of which we believe are permanent or reflective of broken investment theses. The second was a stylistic sin of omission. The strategy's holdings in the Materials sector noticeably underperformed their Index peers, many of which are highly levered to commodity prices that surged off low levels in the quarter. We try to avoid these typically lower-quality businesses, where durable competitive advantages are scarce and underlying economics are a function of inherently volatile and unpredictable commodities prices. We prefer to invest in Materials companies that have structural competitive advantages, plentiful reinvestment opportunities, and generate high returns on invested capital – all drivers of an attractive value-compounding algorithm not reliant on rising commodity prices for success. Though this quarter's showing illustrates that no approach works all the time, underlying economics dictate that ours should add value over the long-run.

Our focus on long-term fundamentals in a world dominated by maximization of short-term performance continues to unearth attractive opportunities. In our view, stock prices are much more volatile than business fundamentals and we remain steadfastly committed to deploying our research resources and experienced judgment to capitalize on unwarranted dislocations. Accordingly, diligent research helped us add three new companies to the C&B SMID Cap Value strategy in the quarter, offsetting the sale of two holdings one which had reached our price target and the other made room for more attractive opportunities.

Market Outlook

During the quarter, the Fed announced it would begin shrinking its balance sheet, marking the latest installment in this slowly ebbing period of extraordinary monetary stimulus. This transition away from stimulus brings with it a set of concerns, but also of opportunities. As we have written before, the various forms of quantitative easing have supported many companies of questionable quality. As monetary policy becomes more restrictive and rates potentially rise, weaker companies will find it increasingly hard to compete with their higher-quality peers. As a result, returns should be increasingly based on more divergent company specific fundamentals rather than on macro factors.

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

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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