



SMID Cap Value Equity

Market Commentary

After a relatively quiet summer, the fourth quarter was anything but. The Russell 2500™ Value Index (R25IV) trended down slightly until the election, and then jumped almost 13% in the final seven weeks, putting an exclamation point on a very good year for the U.S. market. Donald Trump's surprising win sent shockwaves through the market as investors rushed to position their portfolios for the new political order. For the quarter, the R25IV rose by 9.3%, its best quarterly performance in over three years. And for the full year, the R25IV returned a strong 25.2%.

Portfolio Performance & Developments

Against this backdrop, the Cooke & Bieler SMID Cap Value portfolio outperformed the Russell 2500™ Value Index. Gains were widespread across sectors and stocks, but the primary driver of relative performance – accounting for more than half the portfolio's excess return – was its underweighting in Real Estate and Utilities. We have frequently marked our concern with the overvaluation of these sectors, which comprised over 20% of the Index heading into the quarter, along with the lofty prices of other bond proxies. Early steps toward interest rate normalization called investors' attention to this reality.

Along with the flagging high-dividend trade, companies with high returns on invested capital, a good proxy for business quality, greatly outperformed their low-ROIC counterparts, reversing a trend and strong headwind for our style throughout the first nine months. Here, top quintile outperformed low- and non-earners after lagging them in the first three quarters.

Financials stocks were the biggest contributors to the portfolio's absolute return. As investors pushed the yield on the 10-year Treasury Note up by 85 basis points, the portfolio benefitted from both its overweight positioning and the strong performance of its holdings.

For the full year, the portfolio's return exceeded that of the benchmark. Strong outperformance during the early-year correction and again in the fourth quarter offset a lag during a long mid-year, low-quality rally. After several puts and takes among the sectors, stock selection accounted for the bulk of the portfolio's 2016 outperformance. Particularly strong stock selection in the Information Technology and Consumer Discretionary sectors stood out.

It is worth pausing here and noting that U.S. equities have outperformed virtually every other asset class in the past decade. Since the end of 2008, the R25IV has posted double digit returns in five of eight years. We have been very pleased that the portfolio has outrun the Index over this span, as these sorts of extended bull markets, frequently driven by macro themes (Quantitative Easing in this case) and unbridled optimism, can outshine our more fundamental, data-driven approach to investing.

Market Outlook

Mid-teens percentage equity returns are not sustainable over the long run. Historically, equities have offered high single-digit returns and the inexorable math of reinvestment rates and returns on equity suggests a similar level going forward. This is not to say the market is due for a significant correction – the last eight years included a recovery from a deep recession – but we are well past the point where investors can count on a tailwind from depressed operating conditions or conservative valuations. Taking the long view forward, we believe returns will be more modest and hope the market will even more fully reward a detailed understanding of fundamentals and a 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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