Q1 2024 - Small Cap Value Quarterly Update

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Evan Fox: Hi, I'm Evan Fox, one of the portfolio managers on Pzena Investment Management's Small Cap Focus Value Portfolio. We're now at the end of the first quarter, and we came through a first quarter where markets were overall up, really led by large cap and growth companies, leaving both value and small behind. Despite that, in this quarter, what we did see is that our small cap product did quite well against its value benchmark, as well as the broad small cap benchmark. When you look at what drove that, the top contributing sectors were Industrials, Consumer Discretionary, and Energy. The name that drove the most outperformance was actually Masonite, which is a door manufacturer that we've owned for a number of years. This is a company where, back in December, they had announced plans to acquire a window competitor, a window company that was based in Florida, for a valuation that we viewed as too rich and one that would have stretched the balance sheet. So, we had trimmed the position at that point. We then engaged with management and told them why we did not want them doing this deal. In January, a different company came in and bid more for that window company. Ultimately, Masonite did not raise their bid; they did not acquire the company, and we took that as an opportunity to buy more of the stock. Soon after, a larger company, Owens Corning, actually announced acquiring Masonite at a healthy premium. So, with that, we've been trimming our Masonite position, and the stock did quite well between no longer buying the window company and getting acquired itself.

Another top contributor was Gap, which is the apparel company that owns Gap, Banana Republic, Athleta, and especially Old Navy. What we've seen over the last couple of quarters is they're finally seeing good same-store sales growth in Old Navy, which is their most important brand in terms of the economics that it brings to the business. The CEO that they hired at some point last year has been doing a nice job refocusing the business and putting them in a much better position to succeed.

When you look at what some of the detractors were for the quarter, Consumer Staples, Basic Materials, and Financials were the weakest sectors, with the biggest individual detractor being tobacco leaf merchant Universal. This is one where not much changed during the quarter. If anything, it was just a reversal of some of the strength that it had in the fourth quarter. What we are seeing is that they have an ingredients business that's been doing quite well, and we feel good about the positioning of this company overall.

Another detractor was Columbia, which is a bank based in the Pacific Northwest. When they went through an acquisition last year and merged with Alcoa, they're now coming through the anniversary. They've done a nice job taking out a whole bunch of costs, but their net interest income guidance for next year has come down quite a bit. The reason for that is they have quite a few CDs that are repricing at much higher rates than they had been before, and so, because of that, they had done a poor job communicating what their expected earnings are for the future, and the market responded negatively to that. We don't view this as a fundamental change in the business, but it is one that led to underperformance in the quarter.

One new name we added is Concentrix, which is an outsourced contact center company. People think of this as call centers, but they've expanded into chat content moderation and a range of other uses. This is one that really has gotten hurt, especially on AI concerns. The stock is down 40% in the last couple of months, down 70% from its highs in 2022. When you think about what's going on here, the fear is that, as generative AI takes over the market, we're going to see that all of this is automated. Well, in reality, it's not that simple. This is one where we really do feel the market is overreacting on a combination of factors. One is that they're implementing AI themselves and using it as a tool to make their agents much more productive. What's interesting is especially people think of lower-paid employees as ones where it's easiest for AI to replace them, but what you sometimes find is the cost of replacing them with AI can be high relative to the low cost of employees in the Philippines and places like that. So instead, it actually just makes them much more productive and makes it a better experience.

It's also worth noting that only about less than 30% of the contact center market is outsourced, so there's a lot of room for growth. As we see more companies realizing there's a way of making their contact centers more efficient, an outsourced player who can harness AI is better positioned than each company trying to do it in-house themselves. Given that, there is a wider range of outcomes on this name, but it's a very depressed name at very discounted valuations.

So, as we work through the rest of the year, we're seeing quite a few opportunities, and they are definitely concentrated in more of the economically cyclical names, just the nature of what we're seeing in today's environment. But given the performance we've seen of small cap and of value and value within small cap, we feel very positive about the outlook from here.

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