Q2 2024 - Large Cap Value Quarterly Update

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Hi, I'm Dan Babkes. I'm a portfolio manager on the US large cap strategies here at Pzena, and I wanted to give a brief update on what we observed in Q2, both in terms of the broader market environment and our portfolios. So, the broader market was a pretty unusual environment in the second quarter, and really the performance continues to be driven by a small number of mega-cap growth stocks. So, just to put some perspective around that, in the quarter, the six largest market cap companies in the US drove more than 100% of the total return of the overall index. So, the broad index was up, um, but actually excluding those six largest companies, the market had been down. We did see the value indices down, most sectors were actually down, and the value indices underperformed growth by over a thousand basis points. So, so basically the good performance of a small number of stocks that are deemed to be AI winners is really masking a lot of volatility in the underlying market. So, that's—that's really the story we saw from the broader perspective, and what we saw in our portfolio was really outside stock price moves in reaction to very small changes to near-term earning expectations, or in certain cases, actually no change to earnings expectations, but incremental reasons for folks to perceive uncertainty in—in the range of outcome. So, our portfolio did underperform in the quarter, and just to give you a couple examples of some of the outsized moves that we saw that impacted our performance, I'll start with our two largest detractors. So, the—the first one was Baxter, which—which is a healthcare equipment company, and this is a portfolio that we—this is a position that we've added to the portfolio over the last couple of years, years, because it's a pretty good stable business. But the earnings in the stock price had collapsed as inflationary pressures impacted the earnings stream. Um, our thesis around Baxter is that over time they should be able to claw back some of the margin pressure that they've seen because they price a lot of their products on long-term contracts with their customers. So, when the inflationary pressures hit, they couldn't immediately take price, but we think they can slowly recoup the margin pain that they've seen over a longer period of time. And our interpretation of the first quarter results that they reported were actually fairly positive. We think that the company's growing, um, we think the company is showing signs that they're clawing back their margins, um, and despite that, the stock was down actually more than 20% in the quarter, really because of poor performance in one of their segments. So, in aggregate, the business is performing reasonably well, uh, but some uncertainty around one business, um, within a portfolio of several businesses, and—and we don't think that's necessarily a sign of any deteriorating fundamentals longer term. Uh, another stock that detracted in the quarter was Lear, which is an auto supplier, that's the market leader in seating. Uh, the auto industry overall has had a lot of volatility over the last few years, in particular because they've been dealing with supply chain challenges and the semiconductor shortage, which is—which—which has limited production volumes and weighed on the overall margin profile in the industry. We've been expecting to see improvement in Lear's margins as the supply chain starts to normalize, and that is actually starting to happen. So, margins were actually up in the quarter, the earnings have been growing for Lear, um, however, their outlook, their outlook implied that margin expansion will be a little bit slower for the rest of the year than what consensus had been anticipating. Now, the reason for that is

Lear, along with other auto suppliers, have been making investments to gear up for growing demand of electric vehicles, and the demand for electric vehicles has just been a bit softer than the market had anticipated. So, those investments are weighing on the overall margin profile. We don't think that's a permanent state of affairs. We think either the demand for electric vehicles will start to increase from here or Lear will start reallocating the investments to other car models that people want to buy. So, uh, we—we think this is more likely a temporary effect than it is something structural, and we think the valuation is so attractive that even if we're wrong, uh, we still think Lear is an attractive investment. So, just to put some perspective around that, in the current challenging environment where the slower EV adoption is weighing on their results, we are still trading at under eight times the current earnings. So, if the environment does not improve from here, we think you still collect a 13% yield on owning Lear shares at this price. So, we think that's a pretty, pretty attractive risk/reward. Um, what we've been doing in the portfolio is we've been trying to take advantage of some of these outside stock price moves. So, you've seen us trim some of our holdings in financial services stocks that have performed quite well over the past year in order to—to buy companies like the—like the, uh, like Baxter and Lear that I've referenced earlier. Um, in addition to some others where we—we felt that we had outsized, um, outsized declines that created an opportunity to add to our positions. Um, as far as the outlook for our portfolio, we feel quite good about how we're positioned. The—there's been a lot written about the starting point on valuations for the broad market in the US, um, however the US value stocks are, um, at the same valuation levels as they've been over, over long history. So, we think our starting point on valuation is attractive, um, it's in line with the long-term history. So, as best we can tell, the expected forward returns should be, should be quite good, and—and similar to what, what value has done over longer histories. Um, and we think the opportunity set today is quite broad. So, we're—we're seeing opportunities in—in healthcare and some other sectors where we haven't had as much exposure in recent years, um, and the opportunity set is—is, um, broad across different idiosyncratic opportunities.

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