Q2 2024 - Small Cap Value Quarterly Update

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Hi, I'm Evan Fox, one of Pzena Investment Management's portfolio managers on our Small Cap Focus Value portfolio. It is now the end of the second quarter of 2024, and what we saw in the second quarter was a continuation of some of the trends we've seen recently, with the mega-cap growth companies really driving the market and leaving behind many of the other companies. When we look at some of the benchmark performance for the second quarter, the Russell 1000 Growth was up high single digits, while the 1000 Value, the small-cap indices, the mid-cap indices were all slightly negative for this quarter.

Given that environment, what we actually have seen is that, for the last 12 months, our portfolio has outperformed pretty handily against its benchmark, but we did underperform during this second quarter. And when you look at what drove that, it really wasn't any common theme, but instead, what we saw was pretty aggressive sell-offs on quite a few companies that reported earnings below expectations or lower guidance at all. Some of which were disproportionate, and that created opportunities for us to add more to the companies.

When we look at what sectors detracted, some of the ones were consumer discretionary, industrials, and basic materials. The largest individual detractor was door and window manufacturer Jeld-Wen. This is a company that we've owned for quite a few years, and they're well-positioned in their industries because the door industry is really a two-player duopoly. Windows have a few more players, but it's still quite concentrated. It was really an overreaction to some weak volumes that we're seeing that were largely macro-driven, and perhaps part of it was a loss of takeout premium because, as a reminder, their largest door manufacturer, Masonite, was acquired in the first quarter. And there might have been some optimism in the market that they would be acquired as well by somebody else.

As there was weakness, this is an opportunity for us to add more of it during the quarter. Another detractor was Adient, which is a seat manufacturer for automobiles. What's interesting about the seat space in automobiles is a lot of the disruption is around the transition to electric vehicles from internal combustion engines. Seats are needed regardless of the type of technology that you're using to propel the vehicle, and so this is a company that's really well-positioned for any of these transitions. But what we did see during this quarter is that throughout the course of this year, a lot of the OEMs were expecting much more adoption of the electric vehicles than have actually occurred. Consumers have been staying with the internal combustion longer and more than expected, and so that just led to some disruptions as they were really focusing on this product proliferation of new products that weren't getting adequate volumes. So in dealing with that weakness, it's really a temporary issue and nothing structural as we look at this business.

When we look at some of the contributors, the sectors that contributed the most were financials, technology, and energy, but really, it was a range of names that were in there. When we look at the largest individual contributor, it was actually a company, Fibro Animal Health, which is a company that makes nutritional supplements for livestock. So this is feed additives that will be given to keep poultry, swine, and cattle healthy. What happened during the quarter is they actually acquired a business that was very complementary to what they make from Zoetis Allerg, a competitor of theirs. They got it at a very attractive valuation. Part of what Zoetis admitted is that they didn't want to upset their customers, so they wanted to go to a company that was well-positioned and wouldn't lead to any disruptions, and so Fibro was really the natural player. The stock was up pretty substantially, and the earnings power of the company went up because of this attractive buy that they were able to get.

Another contributor was Axis Capital. This is a Bermuda-based insurance company. They do property and casualty insurance as well as some reinsurance. And what we're seeing is broad and hardening in the pricing cycle, meaning the pricing is going up across the board for many of their competitors and for them. And they brought in a new CEO over the last couple of years, who's been doing a good job of fixing some of the operations and putting them in a better position for the future.

What's really interesting in terms of some of the trading we did during this quarter is we actually added five new names during the quarter. It was a particularly active period for us to find names across a wide range of sectors. One I'll call out as an example is Shift Group. This is a company that makes step-in trucks and other specialty vehicles. What that means is the trucks that you'd see for FedEx, for UPS, bakery trucks, uniform rental trucks—everyone sees them on the road. And the way you can tell that this company makes them is if the windshield wipers open from the bottom and they go back and forth with a pivot on the bottom, they're made by Shift. If they pivot from the top, then they're made by their competitor. But it really is largely a duopoly of these two players.

What we're seeing here is two things that have driven the stock down. One is actually just really temporary, that there's been some disruption on some of their big customers. They lost a large Amazon contract, but also FedEx has been figuring out how to combine some of their networks and has reduced some of their spend. UPS had a strike at some point last year that disrupted some of their orders. The other side is that the company historically has really taken the chassis, which is the engine, the frame, and the steering wheel, made by somebody else, and builds the whole box around it. They've been investing in making an EV version of that—an electric vehicle version—that they think has a lot of potential for the future, but they've been spending quite a bit of money on that. They've been losing money on that side of part of their business, which effectively makes it look like they're only half as profitable as they are because of all the losses there.

We're now at a point where they've developed the vehicle. They haven't launched it because of some supplier issues on the battery side, but either it is successful and we start seeing that take off and be really positive, or if it's not, they're cutting back their spend on it substantially. They're going to see losses on that decline, and we're going to see the core earnings of the main business really flow through. So this is really one of these misunderstood companies we were able to take advantage of.

So as we look to the second half of the year, we're really excited by the range of opportunities that we're seeing. Some of the dispersions in the market are creating so many different opportunities where we can add new names. And given how undervalued small caps are generally, it's a pretty attractive opportunity set that we see today.

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