

Q3 2024 - Mid Cap Value Quarterly Update

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Hi, I'm John Flynn, a portfolio manager here at Pzena Investment Management, uh, on our midcap product, and I'm here to talk to you about the quarter. Uh, it was a pretty interesting quarter overall. Um, we underperformed even though the value, the value index outperformed, uh, and one of the things we really noticed, uh, this quarter and last quarter as well, is that there have been some pretty big reactions to earnings misses and kind of short-term pain. Um, that we think is oversize, but it certainly has been an impact on near-term performance.

And so I thought I'd start by just talking about the three big detractors in the portfolio in the quarter and kind of addressing what we see going on there, uh, and how we've been reacting. Um, start off with Dollar General. This is the Dollar General store format, and, and what you've really seen in Dollar General over the past couple years, really going back to coming out of COVID, in the inventory and supply chain disruptions is a margin compression. Um, they've gone from high single digits to mid single digits, and they have a number of shrink initiatives in place, uh, that we think over the long term will help restore margins.

When Dollar General reported earnings this quarter, they actually disappointed on the growth side. They took their, their, their same-store sales down by about 100 basis points, um, and the market had a pretty strong reaction to that despite the fact that it was still positive. What they're seeing going on is really a weakness in the low-end consumer, um, and if you go back to the financial crisis when you see overall consumer weakness, you actually get people trading down. Um, but right now it's that low-end consumer being weak and nobody's trading down, and that's kind of weighing on the growth at Dollar General. Um, we think ultimately this is something that the company can manage through, uh, and we took advantage of the weakness there to add to our position.

The next thing I want to talk about is Advanced Auto Parts. This is an auto parts retailer, and it's a story where if you compare Advanced to their competitors like AutoZone or O'Reilly, you'll see that over the past decade, AutoZone and O'Reilly have massively expanded margins, while Advanced has not done much at all. The margins have been pretty flat. We kind of invested on the, on the opportunity that even without much margin expansion, Advanced looks cheap, and a new management team kind of is coming in with a fresh look and an attempt to get those margins up over time.

Um, I think the market got a little bit ahead of itself earlier in the year on kind of the hope of a turnaround because when earnings came out, they were disappointing relative to expectations, and the stock kind of traded back down to where it had been earlier in the year. We actually saw a silver lining in the quarter in that they sold their Worldpac business, which, um, basically gives them cash that will put them in a much healthier balance sheet position and give them the flexibility to experiment as they try to get those margins up. Uh, similar to Dollar General, we also added to the position here on the weakness.

The last name I wanted to talk about is Humana. This is a managed care company really focused on Medicare Advantage, and what we've seen in that space providing the opportunity is that utilization rates post-COVID, uh, you know, seniors going to the hospital is above expectations, and therefore medical costs have come in higher than the company was expecting, and margins have been weak. Um, this takes a couple years to correct because you price for 2024, uh, in early 2020 or late 2022, um, so next year's pricing is already determined. We're now in 2024 pricing for 2026, um, in this enrollment period, so it'll take some time to work through the numbers.

The other thing that happened subsequent to the end of the quarter, but I think important to mention, is that it got leaked Humana would be losing a star rating, um, on a significant portion of their population. Um, star ratings correlate to bonuses that you get from the government for enrollment, and so this will be an impact on 2026 earnings. We expect the company should be able to both mitigate the reasons they lost the stars and ultimately get the star back over time. Um, and so we view this as kind of a 2026 type earnings event, um, but the market had a very strong reaction to it, and again, we took advantage of that weakness to add to the position.

On the other side of the coin, I wanted to talk about a few of the names that worked during the quarter and the top contributors in the portfolio. Universal Health, the hospital network, was our top contributor during the quarter. Uh, Universal Health, uh, benefited from some of the trends that Humana was seeing that was a negative in the higher utilization rates. Universal Health had also seen a lot of wage inflation, weighing on earnings, and that's begun to abate as well. CNO Financial, a life insurance company, was another top contributor where we just had a strong earnings beat, uh, some reserve releases, and just a strong overall picture. And finally, Globe Life, a name that we were adding to earlier in the year in a short report, um, as the internal investigations of their audit committee have found nothing, um, the stock has recovered a bit from the pressure it saw earlier in the year as it looks like the short report's accusations, um, are not as severe as, as once feared.

We did also have a couple new names in the portfolio during the quarter. Um, we added Robert Half, this is a staffing company, has a, a tech staffing company in productivity, and really we've seen a labor environment where job turnover has just been weak, and we've seen a lot of staffing companies screening up. Um, and this was an attractive franchise that we, we thought we could add to, it a very nice valuation. Um, we added an airline to the portfolio. We bought Delta Airlines, uh, the, the whole space has been quite interesting in that, uh, a lot of the ultra low-cost carriers have really come under financial pressure as airlines like Delta have figured out how to sell the premium front part of the cabin as well as offer a basic economy package that's price competitive with the ultra low-cost carriers. And so we thought the capacity reduction that's going to have to come out of the system from these ultra low-cost carriers shrinking their capacity and trying to get their financial house in order really benefits an airline like Delta that's doing very well in this environment and, and will continue to benefit from kind of the tight supply environment.

The last name we added that I wanted to talk about is a commodity chemical company, Huntsman. Um, they play in the polyurethane chain and really when you look at the end markets of this commodity, it's really tied to construction, housing, uh, things that have been pretty weak cyclically. Um, and if you look across the chemical, uh, complex, it's been several quarters now of, of really weak end market demand. Um, we think this is an attractive entry point for the stock, uh, and built up a position in Huntsman in the quarter. To fund these purchases, we sold out of, uh, Exalta, Gildan, and Axos, all on strength. Those names have worked well. Um, we've also trimmed CH Robinson, uh, Title Insurance, Fidelity National, and utility Edison, again, those are all on strength. Um, so we feel really good about where the portfolio is positioned today in the names that we've been adding and, and the things we've been able to add to on weakness, uh, and we look forward to connecting again next quarter to give you another update.

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