Q3 2024 - Small Cap Value Quarterly Update

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Hi, I'm Evan Fox, one of the portfolio managers at Pzena Investment Management on our small cap products. It's now the—we just finished the third quarter of 2024, and we came through a quarter where across the board equity markets were up and small cap stocks did outperform large caps, although continue to, uh, lag the large cap peers on a year-to-date basis and on a trailing one-year basis.

Within small caps, we saw that value did outperform growth, although again not offsetting the underperformance that we had earlier on in the year. For our performance for this quarter, we did underperform the benchmark, and what we really continued to see was pretty punitive reactions to any stocks that lowered guidance or missed on earnings, but it didn't fundamentally change how we think about these businesses.

When you look at the sectors that detracted the most, it was energy, consumer discretionary, and basic materials. The top individual detractor was the company Advanced Auto Parts, which is a company that sells aftermarket auto components. A lot of people have been to Advanced Auto Parts. Their competitors, uh, NAPA, O'Reilly, AutoZone—it's really a nice industry structure where you have four players who dominate the market, but what's interesting about Advanced is that they've really underperformed their peers. They have much weaker margins and they've gone through some execution issues during the quarter. They did have lower margins than they expected, and part of this is that they've reset some of their pricing to be even more competitive against their peers.

When we look at this, they're really in a good position going forward because they also sold one of their businesses called WorldPac. It gives them a much cleaner balance sheet, a lot of capital to be able to invest in this business, and you really don't have to believe in much margin gap closure versus their competitors for this to be an incredibly cheap name.

Another company that detracted was Orion Engineered Carbons. This is a company that makes carbon black that's used in tires and making anything black in terms of consumer products and other things. Uh, there were really two issues in the quarter. One that was related to their largest customer, which is Michelin—the tire manufacturer. What you saw is that Michelin was actually very responsible in taking out some capacity from the market to help with higher pricing, but because Orion is overweight them, it led to just weaker sales for the company.

The other part that's particularly frustrating that is really a one-off is that they fell for a cyber security, um, situation where they sent $60 million to cyber criminals. There's no excuse for this, and they're working to recover what they can and working with insurance, but it was certainly a frustrating development for the company.

When you look at some of the stronger performers for the quarter, the top contributing sectors were financials, industrials, and real estate. And the top couple individual names were both financial companies where it really was driven by just strong execution and lack of bad news for stocks that were

already at pretty depressed valuations. For example, there's CNO Financial, which is a life insurance company where they saw improved net investment income in terms of interest rates. We saw pretty encouraging mortality trends and doing a nice job with expenses.
Similarly, when you look at Columbia Banking, which is a regional bank in the Pacific Northwest, this is a bank where we saw a couple of quarters ago the stock had underperformed as they lowered some of their forward guidance. As they've continued to hit that guidance and they've had, uh, more credibility with the market, the stock did quite well.

During the course of this quarter we added a few new names, and I'll highlight one of them that's particularly interesting, which is Haverty's Furniture. This is a chain of, uh, furniture, uh, stores that's mainly in the Southeast and a little bit in the Midwest, and it's actually a very nice franchise that they have here that's over 100 years old. And what we're really seeing now is depressed sales not because of anything that's their fault but because of low housing turnover. We've seen very low housing turnover in the United States. Obviously, the time people buy the most furniture is when you move, when you go into a new house, so part of it is tied to housing construction, but even more it's tied to just people moving generally in that turnover.

What's really interesting here is not only is the company under-earning, but they have no debt, and if you actually look at just the value of the cash they have in the balance sheet plus their real estate, it makes up about half the market cap. So, we feel really good about the downside protection here. We like the business a lot—it's clearly under-earning and it's a very attractive opportunity for us to add.
So, what we're really seeing throughout the course of this quarter is we continue to find attractive opportunities. We've been taking advantage of some of the underperformers by buying more of them, and we continue to feel that the value spreads are quite attractive in terms of the opportunity set going forward.

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