Q4 2023 - Mid Cap Quarterly Update

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Hi, I'm John Flynn, a portfolio manager here at Pzena Investment Management, here to give a quick update on the fourth quarter of 2023 for our mid-cap value strategies.

When you look at what happened in the market in, in the fourth quarter, we really saw, especially towards the end of the quarter, kind of more conviction in a soft landing and kind of an end to the FED cutting rates, sending stocks higher. Our portfolio participated in this, and we actually outperformed both the value and the growth benchmarks in the, uh, in the mid-cap space. Um, so finishing off a pretty strong year overall for the mid-cap portfolio.

When you look at what was really working in the portfolio in the quarter, um, it's a number of things that are really a combination of self-help and kind of a consumer recovery as well. So the biggest contributor during the quarter was the Gap, specifically within the Old Navy division. Um, for the first time in nine quarters, we actually saw positive, uh, positive comps, and that's really been a long-standing turnaround effort on the part of the Gap. It started with some fashion misses several years ago, um, there's been new leadership brought in, um, and that seems to be taking hold, uh, and the stock reacted, uh, quite nicely to that news.

Similarly, on the consumer side, we saw PVH, which owns Calvin Klein and Tommy Hilfiger, uh, have a very strong quarter in, in North America, which has been probably the toughest, uh, operating environment for them. A lot of the business in, in the, uh, North American business for them has historically been driven by outlet sales and driven by tourism. Um, and even without the tourism from Asia coming back fully, the fact that they saw strong margins in that division, uh, was really positively received, and that stock was strong as well.

And then the last self-help I'd kind of highlight here would be Jeld-Wen. This is the window and door manufacturer, and again, we saw margins beat here versus expectations. Uh, for quite some time, there's been a number of self-help initiatives on the cost-cutting side, offsetting some of the inflationary pressures that they've been seeing that have finally come through and, and are being realized through the financials. So again, the stock was strong there.

If you look at the other side of the ledger—kind of the things that I wouldn't say were necessarily detractors but kind of were laggards in the portfolio—they were flattish for the quarter. Um, Fresenius, the kidney dialysis company, would come up. Uh, really there was some news around GLP-1s, the, the weight loss drugs, coming in and the impact that might have on kidney dialysis patients and their lifespan. You know, I think it's less black and white than the market reacted. Uh, the market saw this as potentially very negative for Fresenius. It's unclear whether this extends the life of kidney dialysis patients and potentially even, uh, increases the, the potential market for Fresenius. Um, but we think that the reaction was overdone in that stock.
Another name that was weak in the quarter was Newell Brands, where they took down their full-year guidance and kind of tamped down expectations for 2024 in terms of topline growth. And so that stock

was pretty tepid on that news. Then the other name I'd mention is NOV, the oil services company. Here we saw actually strong operating results from the company, but the, the broader weakness in oil prices kind of weighed on the stock, and the stock, uh, kind of got caught up with the commodity. But I would say in all three cases of those three names, the names we still have full conviction in, and not really a change in kind of our thesis or long-term outlook for the stocks.
This also was a very, uh, productive quarter for us in terms of new names in the portfolio. We added five new names. I'm not going to go through all of them, but let me highlight a couple, uh, just to give a little bit of flavor of where we're finding opportunities.

Uh, first is Baxter. This is the medical device company. Uh, Baxter has a leading position in IV bags and hospital beds. Um, they actually have a kidney dialysis business as well. Um, and when you look at what's gone on with Baxter, um, a lot of their products and contracts where they're selling to hospitals are on longer-term contracts through group purchasing organizations. So if you go back and look, um, through this inflationary, uh, period, Baxter really hasn't been able to get pricing, and so margins have come under pressure. As a result, you know, the stock has been weak. If you look a couple years ahead, over the next several years, two of the three major GPO, uh, contracts actually will get renegotiated, and we expect them to be able to get pricing through those renegotiations and see the margin expansion that that should come with that.

Uh, staying in the healthcare theme where, you know, we've been seeing some opportunities would be Universal Health Services. This is an operator of hospitals and behavioral health facilities. Similar story here, where you've seen real wage inflation on both the, the doctor side and also on the nurse side, uh, for some time that's been weighing on margins with reimbursements lagging there. And we expect over time for that balance to come in, also with some self-help measures there as well.
One last name I'd mention in a different vein, uh, in terms of a new name in the portfolio, would be Concentrix. This is a call center, uh, company, so an outsourcing company that really benefited a lot through COVID where people were scrambling to figure out what to do with customer service. They were pretty price agnostic, um, and so Concentrix had a very nice boom in business kind of through COVID and in the depths of COVID. One of the things that's happened since is that, uh, people have been afraid that that business rolls off and goes away. When you peel it back a little bit, actually a lot of those contracts have already repriced. The majority of them have already repriced, so it's already in the numbers in terms of that reset. Um, there has been some weakness just kind of as fears of an economic slowdown—people have slowed down some of their spending, so that's also weighed on the stock. And the third issue we see here is really, uh, fears around AI taking over the, the outsourcing, uh, business. Uh, and, and when again, when we get more into it, the scale that a player like Concentrix has and their ability to deploy an AI solution at scale, we actually think it's an advantage for them long term versus a competitive threat. Um, but for a combination of all these reasons, we had the opportunity to pick up the stock at a very attractive valuation and add that to the portfolio.

Um, so that gives you a sense of where we've been finding opportunities. Uh, in terms of how we've been funding them, we exited several positions in the quarter: AIG, the insurer; Skechers, the shoe, uh, manufacturer; Wabtec, uh, which makes locomotive engines—all for the good reason that the, the prices were up and the valuation, uh, was full, and so we exited those positions.

I would say as we look ahead to 2024, um, we still see pretty wide dispersion in terms of the valuations in the marketplace, um, and think the portfolio remains very attractively positioned, um, with, with, with pretty compelling valuations across the board. Uh, and we look forward to updating you on, uh, the first quarter, uh, in due time in April. Thank you.