Q4 2023 - Small Cap Value Quarterly Update

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Hi, I'm Evan Fox, the portfolio manager at Pzena Investment Management. At Pzena, we are a long-only deep value investment management firm focused on finding undervalued companies. Right now, it's the end of the fourth quarter of 2023, and we came out of a quarter where all major markets in the US were up double digits. In that period, we did see that small cap slightly outperformed its large cap peers, but for the full year, large cap still was the stronger performer.

In that environment, we saw that value underperformed growth, although our portfolios did have strong relative performance during the quarter and for the year. When you look at what drove that performance, on the positive side, a few sectors that really were substantial were consumer discretionary, financials, and industrials. Two of the top names are both apparel companies. One is Gap, which many people are familiar with—not just Gap, but also Old Navy, Banana Republic, and Athleta. This is a company that had traded down quite a bit after a number of operational issues. What we saw in the quarter was that Old Navy turned to positive same-store sales for the first time in nine quarters, and as they worked through some of these operational issues and we saw positive signs, the stock nearly doubled in the quarter.

Another top contributor was PVH, which owns Calvin Klein and Tommy Hilfiger, two very strong brands. These brands have historically done well around the world but actually really benefited from tourists coming to the US. What's interesting is that those brands in North America turned to double-digit margins and strong profitability, even though inbound tourism to the US is still about 30% below pre-COVID levels. Their profitability has improved, management has done a nice job with the business, and they've brought down some of their inventory levels, so they're well-positioned going forward.

When you look at what was detracting, overall the portfolio was up double digits, so there weren't many detractors. But two that are worth touching on are Belden, a signal transmission company, and Masonite, a leading door manufacturer. For Belden, they make signal transmission components—wires, connectors—and have really focused on a few key end markets that have had good structural growth. These include broadband and 5G, industrial automation, and smart buildings. What we saw in the quarter, after they had very strong results for the last couple of years continuously, was destocking at their end customers, which led to weakness in sales. That sales decline drove the stock down pretty substantially. When we look at the business, we feel they are still very well-positioned in what they do. They will see recovery from here, the future growth looks very positive, and it was an opportunity for us to buy more.

Masonite is a slightly different story. This is one of two companies, Masonite and Jeld-Wen, that are really a duopoly for interior molded doors. We actually have investments in both of them. Masonite, in mid-December, announced they are acquiring a large window manufacturer, PGTI, for a very high valuation. Because of that, the company is going to be very levered. We looked at this and feel they're spending too much to do this acquisition. I think the market agreed, as the stock declined. We sold part of our position, as it's no longer as attractively valued because of that. What's interesting since then is that another player, a private company, is looking at buying PGTI, and as they get into a bidding war, we've been very vocal with Masonite's management and board of directors, saying they should not be increasing what they're willing to pay at all. To be honest, we won't be upset if they do not get the deal, as that will put them in a much better cash flow and leverage situation.

In this quarter, we added two new names. One is Korn Ferry, a leading headhunter firm for executive search. This is C-suite—finding CEOs and CFOs for companies. They also have a consulting business that focuses on cultural consulting and other advisory services, which cross-sells very well with the executive search because of their relationships with boards of directors and CEOs of companies. They were a bit above trend in terms of hiring over the last couple of years, and now, as that normalizes, the stock has traded down in excess of what we feel the valuation should have come down to. They have a very strong balance sheet with net cash relative to the amount of debt they have, so we're very optimistic about the valuation from here.

The other name we added is Marcus & Millichap, a commercial real estate broker. This is a company involved as a broker when buying large office buildings, retail, or anything else. As you can imagine, over the last year and a half, with higher interest rates, work-from-home, and everything else, real estate values went down. More importantly, the volume of turnover went down. A real estate broker makes a commission on turnover. This is one where 90% of their business, earning commissions, came down substantially. Their profitability fell, but they have a very strong balance sheet with a lot of cash to work through challenges, and they're well-positioned for recovery. Interestingly, throughout the fourth quarter, as interest rates stabilized and came down a little, the stock performed very well. We didn't get a full position as it's no longer as attractive as when we first started buying it.

Looking into 2024, what's particularly notable is that small-cap stocks are at a very wide discount compared to large-cap stocks. They're at nearly a 30% discount on price-to-earnings ratios. These are levels that were only reached in the early 1970s during the Nifty Fifty era and then during the dot-com bubble 20–25 years ago. What's especially notable is that, from periods when the valuation dispersion is this wide, small-cap stocks have outperformed in the ensuing five years every time, averaging 10%+ annualized outperformance. As we look at our portfolio and the opportunities from here, we're very positive on the valuations of value stocks versus growth and especially of small-cap versus large-cap. We're excited for 2024 and look forward to speaking with you again soon.