Q4 2024 - Large Cap Value Quarterly Update

Portfolio Manager John Flynn provides an update on the fourth quarter for our Large Cap Value strategies.

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Hi, I'm John Flynn, a portfolio manager on our large cap products here at Pzena Investment Management, and I'm here to talk to you about the fourth quarter of 2024 and give you an update on what's been going on in the portfolios.

2024 was an interesting market where we continued to see a concentration in the market of narrow leadership driving the market. At a big-picture level, that resulted in the large cap growth index beating the large cap value index for the year by 1,900 basis points, of which 900 basis points was just in the quarter alone. It was a very difficult environment even for a value index in this environment.

If you step back and take a look at the decade, large cap growth beat large cap value by 800 basis points annualized, so we've seen a very bifurcated market in terms of what's been going on. Going back to the year, our large cap strategies underperformed relative to large cap indexes, and I'll get into the details there in a minute. In the fourth quarter, we actually outperformed slightly, but it wasn't enough to make up the difference during the entire year.

What we saw in terms of what was leading in the portfolios: financials continued to be strong. Wells Fargo, Capital One, Citigroup were the top three performers in the portfolio, and all that is against a backdrop of rates kind of backing up a little bit and being a little bit stronger. You've had an administration change where there's some hope for maybe a more favorable regulatory environment for the financials, and then just self-help for some of these banks coming through as well—all of that driving the stocks' earnings. Those were a source of strength and a source of funding as we trimmed those positions and moved them into the things that were underperforming.

What we saw really take a leg down in the portfolio in the fourth quarter were the health care stocks, specifically CVS and Baxter being weak in the quarter. Humana has also been weak. I want to take a second and talk about what's been going on in health care and how it's been impacting performance in the short term—which has been negatively—but also prospectively what we've been doing, adding to those positions, and why we think these are such interesting positions.

Taking CVS for example, during the quarter a number of things happened. First, earlier in the quarter they missed their earnings, they took down their guidance, and they fired their CEO. That's something the market never likes. We saw a negative reaction there, and then as the quarter progressed, we saw another leg down as sentiment turned against the health care providers across the board, from both a consumer standpoint and a regulatory standpoint. Lots of stories in the press—all of this really weighed on the stock.

You take something like Humana, which is focused on Medicare Advantage, sort of a pure play there, a similar story here, where costs continued to be greater than expected into the quarter. They also surprisingly lost some of their star ratings—they went from over 90% of their plans being five-star rated to only 24% or mid-20s percent. The reason this is important is the star ratings are a measure of quality, and the reimbursement the plans get is a function of how many stars you get, so you get a bonus if you have a five-star plan. This will actually hit Humana's earnings in 2026, but the news comes out now and obviously was a negative reaction there, and then the sentiment reactions going forward.

What we did as a result of the weakness in these stocks was to add to the positions, so we've actually made them some of the largest positions in the portfolio today, taking advantage of this weakness to really take advantage of the valuation dislocations we're seeing. I mentioned Baxter as well. Baxter is another medical supply company where they've been weak. They actually have an IV plant that was hit by Hurricane Helen—it was taken offline. The cost to get it back online has been a little bit greater and taken a little bit longer than people were anticipating, so the guidance came down there. Again, adding to that position on the weakness because of our view of the long-term prospects of that business versus the short-term challenges they're facing today.

The last name I'd mention in the portfolio as a detractor for the quarter would be Dow Chemical, a commodity chemical manufacturer. A couple things weighing on the stock here: one is we've really seen weak end market demand for the commodity players. A lot of the demand generation for them is related to housing and industrial production, all of which have been weak for several quarters now. Dow also has a presence in Europe, where the continued high cost of energy has weighed on profitability, and we've continued to see capacity additions come online in China, which have kind of weighed on the stock as people sort out a recovery in demand while additional supply is coming online.

That said, we feel very good about the positioning of the portfolio despite the challenges this year in performance. When we look at the portfolio overall, it's sitting at a 25% discount to where the first quintile cheap cutoff is. So if you take where the 20th percentile of stocks is, we're at a 25% discount to that. That's a very healthy discount compared to history, and we think the portfolio is very well positioned prospectively. We look forward to updating you again next quarter.

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