Large Cap Value Update – 1Q2025 with Dan Babkes

[Music] hello I'm Dan Babkes I'm a portfolio manager on the large cap strategies at Pzena and today I wanted to share a brief update about Q1 and also share a little bit of insight about what we're doing in the very early days of Q2, given the rapidly changing environment after the recent tariff announcements.

So in the first quarter, the broad market was down, but actually most sectors were higher in the quarter, and the technology sector drove more than 100% of the decline in the S&P 500. I think this partly was a reflection of some broader economic fears, but also likely reflects a bit of a change in sentiment for that group in particular. You've probably heard us talk about this in the past, but recently the broad market index had reached record-high levels of concentration, and this one particular cohort of stocks had really been benefiting from optimism around AI. I suspect at least part of last quarter's reaction were just some fundamental concerns starting to weigh on the share prices of this group that was not really at a cheap starting point on valuation, so I think that's part of the broader market story.

As far as our universe—value stocks—value did outperform growth in the broader market in the quarter, and we offer multiple large cap strategies. All of our large cap strategies were higher in the quarter, some slightly more, some slightly less than the overall value index. Our single biggest contributor from an individual stock perspective was CVS, the diversified healthcare services company, and we gave a detailed description of our thesis on a recent podcast, so I won't go through that in detail here. But the key component of our thesis is that Aetna, the life insurance subsidiary within CVS, has been really under-earning because they mispriced one portion of that insurance book. When they reported earnings this quarter, the market took that as a positive data point that the turnaround in Aetna is starting to gain steam. We weren't personally that surprised by the numbers that were reported this quarter, but the stock did appreciate in response to that data point. We still think CVS shares are deeply undervalued, even after the recent rally.

A key detractor that we had in the quarter was Delta Airlines. Basically, the company warned that the current macroeconomic uncertainty has started to weigh on demand for the airline industry. Our thesis around Delta has really been more about a supportive supply picture, as opposed to having any particular view on demand, and we also like Delta's company-specific positioning. But demand destruction in the short term is clearly a negative for the airlines more broadly.

Let me now shift and talk a little bit about what we're doing and seeing in real time during all this volatility in the early days of Q2 in response to the tariff announcements. As far as what we're seeing in the market, there have been some sharp declines, particularly in the more economically sensitive stocks, driven by a kind of broad-based fear that tariffs are going to cause some kind of economic shock. And really, if we think back to where the market had been, this represents a pretty rapid shift in sentiment—from optimism on a more extreme basis to extreme pessimism very quickly. That's kind of what we're seeing market-wide.

So let me share with you what we're doing in response, and I think about it in two different buckets: there's portfolio actions and there's research efforts. As far as portfolio actions, you've heard me talk in some recent quarters that we'd been shifting our exposures around based on some of the new opportunities we'd been finding. So we'd had a portfolio that had been significantly overweight financial services, as an example, and as those stocks had really outperformed in recent quarters, in part driven by economic optimism, we've been finding even cheaper opportunities across a range of sectors—but one that stands out is healthcare. So after this recent drawdown that we've seen over the last few days in some of the more economically sensitive sectors, that rotation that we've been in the process of executing on over multiple quarters has paused for the moment. We're not seeing big enough dispersion yet to start rotating back into some of those economically sensitive positions that we had recently been trimming, although that is something we're continuing to evaluate on a real-time basis.

As far as research efforts, I really think of that as two different workflow streams that our team is hard at work on. One is portfolio resilience, and the other is hunting for new opportunities. Regarding portfolio resilience, one point I would make is if we started thinking about the resilience of our portfolio after everybody else in the world is already worried about a recession, I'd say we've done something horribly wrong. The good news is, that's not the way we invest. We have some very robust practices built into our research process to make sure that every new investment we make, we're always thinking about how those businesses can perform in a range of economic environments. That's not to predict short-term stock price moves in any individual period, but we feel quite good that one part that's inherent to our process is we don't assume uninterrupted economic growth; we're always considering a wide range of outcomes, and we typically only invest in new companies once we've made the assessment that we're comfortable with the balance sheet and the company's ability to weather a range of economic outcomes. With that said, the work we're doing right now on portfolio resilience is really about incorporating new details of what tariff shocks could mean to specific industries or how the economic environment may be changing in response to the current news flow. We're trying to apply that new information to our holdings, but the starting point is a portfolio of businesses that we feel quite good about from a resilience perspective.

As far as new opportunities, one thing that's a little exciting about the current environment is that some of the changes being discussed around tariffs and different economic outcomes across industries and companies are not going to be uniform. So we think this is potentially creating a very robust opportunity set for us in the future for really interesting company-specific investments, which is what we at Pzena Investment Management think we're excellent at: company-specific analysis. We do a lot of detailed work; we don't underwrite new investments in two days, but we are hard at work looking at the new research pipeline, which is hopefully building a great opportunity set for the future.

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