While tariff fears and economic volatility are testing markets, our systematic risk framework allows us to evaluate exposures and identify resilient companies amid global trade uncertainties.

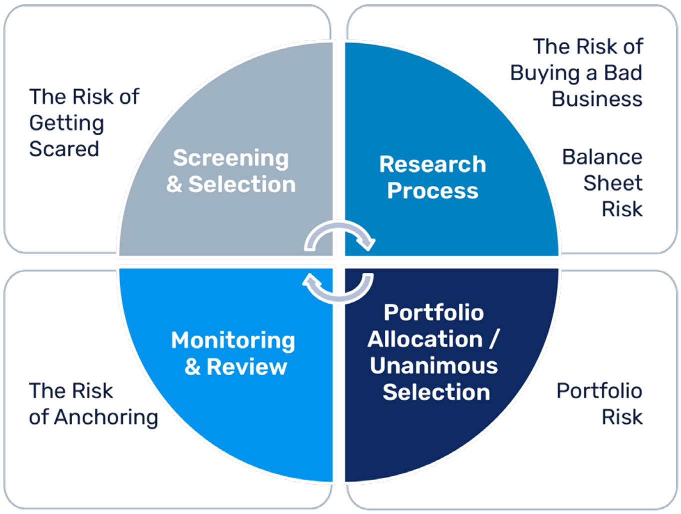
Volatility in global markets ticked up in the first quarter as investors grappled with uncertainty. Tariff fears have been at the forefront since President Trump won the U.S. presidential election in November of last year, exacerbated by the broad-based tariffs announced in April. In this essay, we discuss the following:

- Pzena's risk analysis framework
- The unprecedented tariffs announced at the beginning of April
- How we assess both the tariff and broader economic risks within our risk framework

PZENA'S RISK FRAMEWORK

Having an appropriate risk framework is critical to successful investing, to avoid what we believe is the ultimate impediment to long-term portfolio performance: permanent impairment of capital. As value investors, we seek opportunities among cheap stocks—where there is controversy and/or something has gone wrong, and the risk of impairment is low. This tension—buying cheap stocks versus avoiding permanent capital loss—is central to our process. The cost of safety is paying a premium for businesses with fewer issues, reducing potential returns; however, taking excessive risks can quickly impair performance. To manage this balance, among the many risks we consider, we focus on five key categories of risk: getting scared, buying a bad business, balance sheet events, portfolio construction, and anchoring on deeply researched positions (Exhibit 1).

Exhibit 1: Pzena Risk Analysis Framework



RISK OF GETTING SCARED

A central tenet of our philosophy as value investors is that you only get the opportunity to buy good businesses at a substantial discount when there is a problem. The challenge this presents to human beings with emotions is that the instinct is often to avoid problems and find something less scary. We avoid this bias by focusing our screens only on companies likely to be in the cheapest quintile. Focusing on the cheapest quintile ensures we look at the most promising names and maintain our valuation discipline.

Our starting point is a company's previous 10 years of history, which we use in a systematic process to forecast future earnings. This ensures the forecast is based on the company's history and not the current fear.

RISK OF BUYING A BAD BUSINESS

We seek to develop a deep understanding of the economics of the underlying business we are considering. We have several formal touchpoints where we gather as a team to debate, probe, and deepen our understanding. During this process, we seek out the bear thesis and other contrarian views to bring different perspectives. We research each position as if we were buying the entire business and try to understand the underlying economic drivers, the industry's competitive dynamics, management's plans, supplier/customer behavior, and other key factors.

Once we have a fully baked investment thesis, we visit the management team on-site. These visits are intentionally done at the end of the process, so we have an informed view and are not just listening to management's standard pitch. We do a final review, debating the company's normal earnings power. When a research project completes this process, there have been multiple formal opportunities for everyone to debate the issues, ensuring we understand the business, its earnings potential, and the possible range of outcomes.

RISK OF A BALANCE SHEET EVENT

Equally, if not more important, is whether the business has a liquidity profile that allows it the flexibility to reach that long-term potential. This involves looking at the level of debt and its maturity dates, in the context of our assessment of the company's cash flow profile. Leverage is the enemy of the value investor, as being right about the long-term outcome is meaningless if a liquidity event substantially dilutes the equity on its path to recovery.

To mitigate liquidity risk, we model equity issuance for each company to reduce its net debt to net working capital. This forces many of the most leveraged names—where cheapness of the equity may be a function of excessive balance sheet debt—out of the first quintile. If a name makes it through the process with high leverage, and we choose to invest, we will typically hold a smaller position in the portfolio than we might otherwise.

PORTFOLIO CONSTRUCTION RISK

We regularly assess portfolio construction to manage industry and country exposures. Portfolio decisions require unanimous agreement among the portfolio managers, which sets a high bar, ensures thorough debate, and eliminates individual biases. When a stock underperforms, we ask: should we buy more, hold, or exit? We may increase our stake if incremental data supports our thesis, but the stock drops. If new data contradicts our thesis, we reduce or exit the position.

We also utilize external tools to monitor whether our perceived risks align with actual exposures. This helps ensure the portfolio remains balanced and diversified while maintaining our valuation discipline. It is also consistent with historical research highlighting that, over the longer term, the richest rewards lie in investing in the cheapest quintile of market valuations.

RISK OF ANCHORING

Deep research can lead to emotional attachment. To counteract this, we enforce a strict sell discipline. Stocks are sold when their valuation reaches the market midpoint, with gradual trimming as they appreciate. This constant recycling into cheaper stocks maintains portfolio discipline.

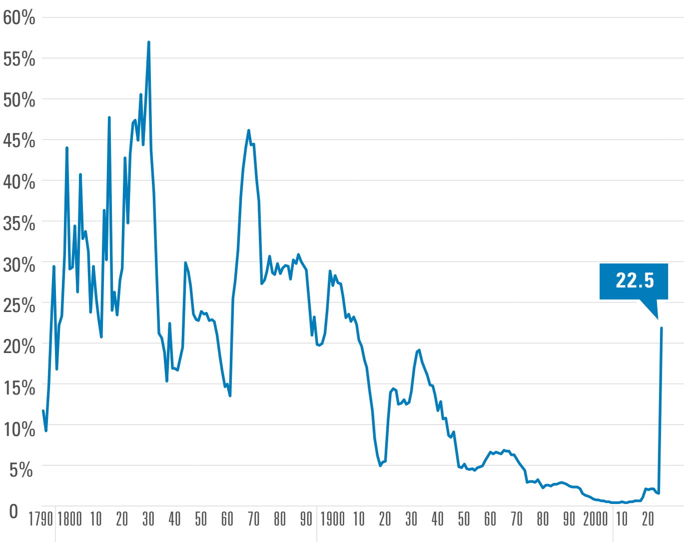
We continuously monitor industry news, earnings, and macro events to assess whether new information aligns with our original thesis. Contradictory data prompts re-evaluation and potential position adjustments. We also speak with management periodically and meet with them at least annually to stay informed.

We rotate industry coverage among analysts every 3–5 years to prevent cognitive biases. This fresh perspective helps avoid anchoring and complacency, while enhancing team development.

TARIFFS

Our investment process is focused on identifying and analyzing all the risks of a potential investment before it enters the portfolio, while ensuring a company has the market position and financial wherewithal to absorb unforeseen risks that inevitably arise. Broad-based tariffs and trade concerns have emerged as a significant market risk over the past six months, particularly after the April 2nd announcement (see Exhibit 2).

Exhibit 2 – Proposed US Tariffs: Highest Level in Over 100 Years
The US Effective Tariff Rate on Dutiable Imports 1790 Through 2025



Source: Empirical Research Partners
Data as of April 9, 2025.

Global markets sold off sharply following the announcement, on fears that the tariff war would trigger a global recession. We've previously written extensively about the impact of recessions ([2Q22 Commentary).](#) We found the following to be true:

- It is incredibly hard to predict recessions. Paul Samuelson, a Nobel Prize winner in Economics, famously said, "The stock market has predicted nine out of the last five recessions."
- Successfully trading around recessions requires not only calling the recession itself but timing both exit and re-entry points.
- By the time a recession is declared, the pain has already been felt, and the outlook for equity investors is typically attractive.
- Value tends to underperform in the sell-off leading into a recession, but significantly outperforms coming out of a recession, ultimately well ahead of the market for the period starting from the pre-recession peak.

TARIFFS THROUGH THE PZENA RISK FRAMEWORK

Tariffs and trade wars are always a threat, and we assess these risks on a company-by-company basis under the same framework described above:

- **Bad Business/Balance Sheet** – With the final policy so uncertain, our starting point was to stress-test all portfolio companies to assess the potential impact on normal earnings in a worst-case scenario and ensure each balance sheet was not at risk of impairment.
- **Getting Scared** – There are potentially new companies in the cheapest quintile due to trade fears.
- **Portfolio Construction** – We want to ensure our portfolios aren't overly exposed to any potential tariffs.
- **Anchoring** – N/A

The current iteration of the Trump administration's policies is far more punitive than most had predicted, though the potential impact of tariffs on the global economy remains to be seen. It is crucial to evaluate the impact on a company-by-company basis, considering the core value-add and market position of each relative to competitors. This helps identify which companies or industries may gain or lose market share due to specific tariffs and which have the pricing power to transfer these costs to customers.

We undertook a review of all companies in our portfolios to determine their relative vulnerabilities to tariffs and their strategies for coping. Below, we offer examples:

- Over the past several years, U.S. consumer products company Newell Brands has cut its

Chinese manufacturing down to roughly 15% of the cost of goods sold, with a plan to reduce this number to 10% by the end of 2025. Most of the Chinese exposure is in the baby division, and it is currently exempt from Section 301 tariffs to give relief to young families. Initially, we believed this would give the company a significant cost advantage, but the broad geographic tariffs announced in early April touched geographies the company had shifted to. Additionally, only 5% of the company's cost of goods sold (COGS) is in Mexico, and the Canadian exposure is negligible. With most of its manufacturing and sourcing in the U.S., we believe the company should still likely have a cost advantage over its competitors.

- Tire manufacturing represents a non-discretionary replacement item that should be able to pass through the tariffs to the end user, but this might affect competitors in very different ways. Roughly 60% of U.S. tires are imported. French tire manufacturer Michelin supplies about 75% of its U.S. demand from local production, which is not subject to tariffs. The company could benefit as import tariffs would raise the cost of cheaper, low-end tires produced by Asian competitors. On the cost side, Michelin has manufacturing flexibility to move production longer term, while raw materials for tires are typically sourced locally, so supply chain issues should be manageable.
- Chinese home appliance maker Haier generates about 30% of its revenue in North America, with 50% of that sourced from the U.S., 30% from Mexico, and 10% from China. Tariffs primarily impact the 10% from China, equating to around 3% of revenue. To address tariff pressures, Haier plans to share costs with suppliers, improve manufacturing efficiency, and adjust prices without sacrificing market share. In the case of severe tariffs, Haier would increase U.S. production with additional capital spending, which could be easily accommodated with its strong cash flows. Despite potential downstream economic effects, Haier's appliance business remains stable, as a large portion of revenue is driven by replacements and upgrades rather than new home sales, making it more resilient than other consumer categories.

These are just a few examples, but they are indicative of the broader conversations our research team is having regarding tariff risk. Many of our companies with manufacturing assets in China have downsized their production capacity since the last tariff iteration in 2018–2019, only to see the broad tariffs announced once again impact them. There is still a high degree of uncertainty regarding future and final policies from the Trump administration, especially since they are broad-based. And because we don't know what tariffs may look like, we stress-test our holdings with potential exposure to quantify the earnings impact in a worst-case scenario.

CONCLUSION

While tariffs and trade uncertainties present risks to global businesses, history suggests ingenuity of management and adaptability of business models could mitigate the impact of trade issues. At Pzena, our rigorous risk framework allows us to navigate these uncertainties with discipline and focus. By concentrating on fundamental business quality, balance sheet strength, portfolio construction, and maintaining valuation discipline, we aim to mitigate potential downside and explore potential opportunities created by the uncertainty, positioning for long-term returns. Although the ultimate impact of current trade policies remains uncertain, our investment approach ensures that we assess each company's ability to withstand and adapt to evolving conditions. This disciplined, research-driven methodology enables us to capitalize on opportunities that arise from market fears while attempting to safeguard against permanent capital impairment.

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