# Memorandum

**To:** Friends of Ariel Investments

**From:** John W. Rogers, Jr., Chairman, Co-CEO and Chief Investment Officer
Mellody Hobson, Co-CEO and President

**Date:** May 6, 2022

**Re:** Ariel Small, Small Concentrated, Small/Mid and Mid Cap Value 1Q22 Client Letter

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| ARIEL SMALL CAP VALUE TAX-EXEMPT COMPOSITE PERFORMANCE | | | | | | |
|---|---|---|---|---|---|---|
| | | | | | | As of March 31, 2022 |
| Inception date: September 30, 1983 | | Annualized | | | | |
| | 1Q22 | 1 Year | 3 Years | 5 Years | 10 Years | Since Inception |
| **Gross of Fees** | **-3.58%** | **0.51%** | **14.57%** | **11.07%** | **11.47%** | **12.83%** |
| **Net of Fees** | **-3.82%** | **-0.49%** | **13.44%** | **9.97%** | **10.36%** | **11.71%** |
| Russell 2000® Value Index | -2.40% | 3.32% | 12.72% | 8.57% | 10.54% | 10.68% |
| Russell 2000® Index | -7.53% | -5.79% | 11.74% | 9.75% | 11.04% | 9.39% |
| S&P 500® Index | -4.60% | 15.65% | 18.92% | 15.99% | 14.64% | 11.57% |

| ARIEL SMALL CAP VALUE CONCENTRATED COMPOSITE PERFORMANCE | | | |
|---|---|---|---|
| | | | As of March 31, 2022 |
| Inception date: April 30, 2020 | | Annualized | |
| | 1Q22 | 1 Year | Since Inception |
| **Gross of Fees** | **-1.63%** | **1.13%** | **34.98%** |
| **Net of Fees** | **-1.88%** | **0.13%** | **33.64%** |
| Russell 2000® Value Index | -2.40% | 3.32% | 36.38% |
| Russell 2000® Index | -7.53% | -5.79% | 28.38% |
| S&P 500® Index | -4.60% | 15.65% | 27.90% |

| ARIEL SMALL/MID CAP VALUE COMPOSITE PERFORMANCE | | | | | | |
|---|---|---|---|---|---|---|
| | | | | | | As of March 31, 2022 |
| Inception date: December 31, 2000 | | Annualized | | | | |
| | 1Q22 | 1 Year | 3 Years | 5 Years | 10 Years | Since Inception |
| **Gross of Fees** | **-6.86%** | **4.72%** | **14.78%** | **11.02%** | **13.23%** | **10.06%** |
| **Net of Fees** | **-7.09%** | **3.68%** | **13.64%** | **9.93%** | **12.11%** | **8.97%** |
| Russell 2500® Value Index | -1.50% | 7.73% | 12.97% | 9.19% | 11.04% | 9.57% |
| Russell 2500® Index | -5.82% | 0.34% | 13.79% | 11.57% | 12.09% | 9.42% |
| S&P 500® Index | -4.60% | 15.65% | 18.92% | 15.99% | 14.64% | 8.05% |

| ARIEL MID CAP VALUE COMPOSITE PERFORMANCE | | | | | | |
|---|---|---|---|---|---|---|
| | | | | | | As of March 31, 2022 |
| Inception date: March 31, 1990 | | Annualized | | | | |
| | 1Q22 | 1 Year | 3 Years | 5 Years | 10 Years | Since Inception |
| **Gross of Fees** | **-4.45%** | **4.68%** | **13.11%** | **9.47%** | **11.74%** | **11.71%** |
| **Net of Fees** | **-4.69%** | **3.64%** | **11.99%** | **8.39%** | **10.63%** | **10.61%** |
| Russell Midcap® Value Index | -1.82% | 11.45% | 13.68% | 10.00% | 12.02% | 11.61% |
| Russell Midcap® Index | -5.68% | 6.92% | 14.89% | 12.62% | 12.86% | 11.72% |
| S&P 500® Index | -4.60% | 15.65% | 18.92% | 15.99% | 14.64% | 10.70% |

After posting barnburner gains last year, the stock market has retreated in 2022—with negative index returns masking intensifying volatility. For the quarter, strength amongst our consumer names was not enough to overcome poorer performing economically and interest rate sensitive areas. Although our portfolios trailed their primary value indices during the three-month period, they managed to outpace their core benchmarks and the broad market. The exception was our Small/Mid Cap Value Composite which underperformed its primary and secondary benchmarks as well as the S&P 500—as the lagging Financial and Industrial sectors took a bigger bite out of returns.

This year's trading feels somewhat reminiscent of 2008, when the intra-day swings stunned and often defied logic. There are days when a plummeting market completely reverses itself before the close. Other times, an uneventful day goes bad at the bell. Since we are disciplined, patient investors (not day traders), we do not sit glued to a screen tracking minute-by-minute stock prices. And yet, we cannot help but to acknowledge that these days, a few minutes at the "water cooler" can mean the difference between portfolio-wide gains or losses.

Against this jumpy backdrop, we seek to use the volatility to our advantage. Yes, there is no denying that the world is unstable as the pandemic lingers, inflation swells, war in Ukraine rages and China's lockdown expands. The supply chain bottleneck that was expected to resolve itself remains entangled. US consumers are buying, but their confidence is falling. Many expect their willingness to absorb escalating prices to wane as well. With these challenging and well-telegraphed conditions increasingly priced in, our job is to focus on mining value from the uncertainty by looking past the near-term drama and instead, taking a long-term view.

## For the Record

As 2022 takes shape, we are clear-eyed and unemotional. Our views on some of the big issues of the day—including inflation and the future of growth stocks, as well as some of our highest conviction names, are playing out as we anticipated.

*On inflation*— Given the amount of stimulus that poured into global economies, inflation was to be expected. The looming questions were: "how much" and "how long?" As *The New York Times* noted, "While central bankers were hesitant to react to rapid inflation last year, hoping it would prove 'transitory' and fade quickly, those expectations have been dashed."[1] In our third quarter 2021 letter we wrote, ". . . some see growing inflation as 'transitory,' we do not completely agree. While we expect supply chain disruptions and shortages will soon pass, once large numbers of people receive wages to induce them to return to work, there is no cutting pay. We expect wage inflation to stick."[2]

Now a "hawkish" Fed has declared its intentions to attempt to slow escalating inflation with a heavier hand. By rapidly raising interest rates and suspending its bond buying program, "Fed officials are making money more expensive to borrow and spend in a bid to slow shopping and business investment, hoping that weaker demand will help tame prices, which are now climbing at the fastest pace in four decades."[3]

While there is much market handwringing over the Fed's intensifying policy efforts, we too remain skeptical

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[1] Smialek, Jeanna. "'Many' at the Fed Supported Big Increase in Rates." *The New York Times*. April 28, 2022. Pg. B1.
[2] Ariel Investments Small, Small/Mid and Mid Cap Portfolio Manager Letter. September 30, 2021.
[3] Smialek, Jeanna. "'Many' at the Fed Supported Big Increase in Rates." *The New York Times*. April 7, 2022. Pg. B1.

that inflation can be so easily tamed. As we wrote in our December 31, 2021 letter, ". . . we are observant students of history and do not believe rising inflation is easily subdued with quick fixes. Nor do we think the Fed has practiced many 'perfect landings' when it comes to managing money supply. If the Fed sets rates too low, inflation can continue to run away. If rates are too high, it could trigger a recession. Like Goldilocks, 'just right' can be a temperamental temperature." To this point, one economist recently quipped, "It's like trying to land during an earthquake."[4] This difficulty has led a growing number of market watchers to begin considering recession scenarios.

While we are not ones to speculate on economic outcomes, we do recognize today's US executives have little-to-no experience with 40-year inflation. And managing inflation is not a one quarter company fix. Much of the price escalations are completely out of a CEO's control (i.e. chip shortages, COVID-induced labor shortages, product availability). Inflation can cause margin slippage as prices react slower than changing costs. Although we seek to dampen negative inflationary effects by investing in companies whose strong brands and franchises command pricing power, simply matching price to cost increases is exceedingly difficult in the short run. This is true of even the best run franchises with superior pricing power in the long run. Share price reactions have been brutal despite the widespread awareness of the challenge at hand. This unique environment requires sturdy patience.

*On growth stocks*—In that same year-end letter, we reminded our investors that, ". . . there are consequences to Fed actions."[5] We doubled down on our view that, "When it comes to stocks—particularly growth stocks selling at high multiples—inflation acts as gravity. As interest rates are likely hiked to dampen inflation, a dollar earned today becomes more valuable than a dollar earned in the future. This is the exact opposite of the most recent low interest rate, growth stock heyday where the value of a dollar is not different than one earned in the future."[6] Our expectations of growth's comeuppance and value's resurrection are playing out in real-time. Look no further than the tech-laden Nasdaq—which is having its worst start to any year in its 51-year history.

We hold no ill will against growth stocks. In fact, our view has been that "some of today's growth stocks are great businesses—but they are priced for near-perfection and an assumption that the current environment will last forever."[7] As the great Artist Formerly Known as Prince once sang, "Forever is a mighty long time." All of a sudden, the road is becoming littered with wreckage. When the stock formerly known as Facebook and now called **Meta Platforms, Inc. (FB)** plummeted -26% in a single day in February, its market capitalization fell $251 billion in what has been called the "biggest wipeout in history."[8] Other high-flyers like **PayPal Holdings Inc. (PYPL)** nosedived -25% after announcing disappointing earnings—losing $50 billion in market value in hours. Then debt-laden **Netflix Inc. (NFLX)** fell -35% in one session and is now pondering the advertising-based business model it once shunned. Inevitably, stocks trade on fundamentals. The math is the math.

*On orphaned value stocks*—While losing money is never pleasant and we try to avoid it as best we can, we also know our weakest holdings and/or sectors are often the source of future gains. Last year, as large cap

[4] Casselman, Ben. "Economy is Booming, but Some Worry a Bust is Coming." *The New York Times*. April 7, 2022. Pg. B7.
[5] Ariel Investments Small, Small/Mid and Mid Cap Portfolio Manager Letter. December 31, 2021.
[6] Ariel Investments Small, Small/Mid and Mid Cap Portfolio Manager Letter. September 30, 2021.
[7] Ariel Investments Small, Small/Mid and Mid Cap Portfolio Manager Letter. December 31, 2021.
[8] Adinarayan, Thyagaraju and Barnert, Jan-Patrick. "Meta Erases $251 Billion in Value, Biggest Wipeout in History." *Bloomberg Radio*. February 3, 2022.

growth stocks continued to trounce value shares, we underscored our core belief that, "pessimism yields value and optimism is pricey."[9] Throughout the long run of recent growth stock domination, we have consistently spotlighted misunderstood values that we felt held great promise. Much like the recent pandemic shock, our sharpened focus on balance sheet strength following the 2008 financial crisis has largely taken financial stability and leverage concerns off the table—allowing us to focus on fundamental company developments without the added stress and volatility of weak balance sheets.

In September, we highlighted **Nielsen Holdings plc (NLSN)** after the stock shed -22% during the quarter. We laid out our investment thesis for the business and explained why "unrealized upside embedded in our portfolios was boosted as the stock was oversold."[10] While acknowledging the company's checkered past, we stayed focused on the uniqueness of its franchise as the "*only* independent provider of unbiased comprehensive [television] viewership data."[11] We also expressed our enthusiasm for the new management team's plan to "create the only true cross platform media measurement solution."[12] Jumping to the present, the stock was a top performer during the quarter as its shares climbed +40% on news of its takeover by a private equity consortium in an all-cash transaction valued at approximately $16 billion including debt—effectively demonstrating that value can realized in public as well as private markets. As we write, another portfolio favorite, **Mattel, Inc. (MAT)**, is making headlines as a potential private equity target. Last quarter, broadcast, digital media and marketing services company, **TEGNA, Inc. (TGNA)**, was purchased by a strategic buyer. In all instances, we are pleased and not surprised.

*On memes*—Despite the fact that the high-flying meme stocks continue to defy gravity, we remain skeptical of their long-term prospects. Our view has been that "meme stocks are akin to a market virus—infectious, contagious and dangerous . . . lacking in fundamentals and inflated by whims."[13] Thus far, these issues continue to attract retail interest—crowdfunded by a pile-on effect that is likely to crumble under its own weight. Even as these names charge on, we continue to believe a day of reckoning will come.

## Portfolio Comings and Goings

In periods of market stress, we are less likely to immediately add brand new positions because we start first with the names we know the best, have the highest conviction, and have vetted value and quality already: our existing portfolio holdings. In that vein, we have been actively repositioning our portfolios to the new dynamic.

While we did not initiate any new positions in our small cap value portfolios during the quarter, we successfully exited broadcast, digital media and marketing services company, TEGNA, Inc., upon the announcement of its acquisition by Standard General. This name was also eliminated from our small concentrated and small/mid cap portfolios. In small cap, we sold sand supplier, **U.S. Silica Holdings, Inc. (SLCA)**, on valuation and longer-term concerns regarding its balance sheet strength.

Meanwhile, we added two new stocks to our small cap value concentrated portfolios: leading supplier of automatic-dimming mirrors for the automotive industry, **Gentex Corporation (GNTX)**, and **Norwegian Cruise**

[9] Ariel Investments Small, Small/Mid and Mid Cap Portfolio Manager Letter. June 30, 2021.
[10] Ariel Investments Small, Small/Mid and Mid Cap Portfolio Manager Letter. September 30, 2021.
[11] Ariel Investments Small, Small/Mid and Mid Cap Portfolio Manager Letter. September 30, 2021.
[12] Ariel Investments Small, Small/Mid and Mid Cap Portfolio Manager Letter. September 30, 2021.
[13] Ariel Investments Small, Small/Mid and Mid Cap Portfolio Manager Letter. December 31, 2021.

Line Holdings Ltd. (NCLH).

In our small/mid cap value portfolios, we bought shares of the leading supplier of residential thermal, comfort and security solutions, Resideo Technologies, Inc. (REZI). We also sold out of America's largest ski resort operator, Vail Resorts, Inc. (MTN), as it surpassed our private market value estimate.

We did not initiate or exit any holdings in our mid cap value portfolios during the period.

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Investing in small- and mid-cap companies is more risky and volatile than investing in large cap companies. The intrinsic value of the stocks in which the portfolios invest may never be recognized by the broader market. The portfolios are often concentrated in fewer sectors than their benchmarks, and their performance may suffer if these sectors underperform the overall stock market. A concentrated portfolio may be subject to greater volatility than a more diversified portfolio. Investing in equity stocks is risky and subject to the volatility of the markets.

Past performance does not guarantee future results. Performance results are net of transaction costs and reflect the reinvestment of dividends and other earnings. Net performance of each Composite has been reduced by the amount of the highest fee charged to any client in each Composite during the performance period. Actual fees may vary depending on, among other things, the applicable fee schedule and portfolio size. Fee information is available upon request and may also be found in Ariel Investments LLC's Form ADV, Part 2. Returns are expressed in U.S. dollars. Current performance may be lower or higher than the performance data quoted. Any extraordinary performance shown for short-term periods may not be sustainable and is not representative of the performance over longer periods. Ariel's small, small concentrated, small/mid and mid cap portfolios differ from their primary benchmarks with fewer holdings and more concentration in fewer sectors.

The opinions expressed are current as of the date of this commentary but are subject to change. The information provided in this commentary does not provide information reasonably sufficient upon which to base an investment decision and should not be considered a recommendation to purchase or sell any particular security.

As of 3/31/22, the Ariel Small Cap Value Composite (representative portfolio) held the following positions referenced: Mattel, Inc. 4.87%; Resideo Technologies, Inc. 3.16%; Nielsen Holdings plc 2.98%; Norwegian Cruise Line Holdings Ltd. 2.68% and Gentex Corporation 2.52%. As of 3/31/22, the Ariel Small Cap Value Concentrated (representative portfolio) held the following positions referenced: Mattel, Inc. 6.28%; Resideo Technologies, Inc. 4.06%; Norwegian Cruise Line Holdings Ltd. 3.67%; Nielsen Holdings plc 3.25% and Gentex Corporation 2.74%. As of 3/31/22, the Ariel Small/Mid Cap Value Composite (representative portfolio) held the following positions referenced: Mattel, Inc. 4.14%; Gentex Corporation 2.74%; Resideo Technologies, Inc. 1.72% and Nielsen Holdings plc 1.22%. As of 3/31/22, the Ariel Mid Cap Value Composite (representative portfolio) held the following positions referenced: Mattel, Inc. 4.01%; Gentex Corporation 1.68%; Nielsen Holdings plc 1.52% and Vail Resort 0.98%. Portfolio holdings are subject to change. The performance of any single portfolio holding is no indication of the performance of other portfolio holdings of the Composites. Portfolio holdings mentioned do not represent all holdings purchased or sold for the Composites.

Index returns reflect the reinvestment of income and other earnings. Indexes are unmanaged, and investors cannot invest directly in an index. The Russell 2000® Value Index measures the performance of the small-cap value segment (companies with lower price-to-book ratios and lower forecasted growth values) of the U.S. equity universe. The Russell 2000® Index (a subset of the smallest 2000 companies of the Russell 3000® Index) measures the performance of the small-cap segment of the U.S. equity universe. The Russell 2500™ Value Index measures the performance of the small to mid-cap value segment (companies with lower price-to-book ratios and lower forecasted growth values) of the U.S. equity universe. The Russell 2500™ Index (a subset of the smallest 2500 companies of the Russell 3000® Index) measures the performance of the small to mid-cap segment of the U.S. equity universe. The Russell Midcap® Value Index measures the performance of the mid-cap value segment (companies with lower price-to-book ratios and lower forecasted growth values) of the U.S. equity universe. The Russell Midcap® Index measures the performance of the mid-cap segment (a subset of the smallest securities Russell 1000® Index) of the U.S. equity universe. Frank Russell Company ("Russell") is the source and owner of the trademarks, service marks and copyrights related to the Russell Indexes. Russell® is a trademark of Frank Russell Company. Neither Russell nor its licensors accept any liability for any errors or omissions in the Russell Indexes or underlying data and no party may rely on any Russell Indexes and/or underlying data contained in this communication. No further distribution of Russell data is permitted without Russell's express written consent. Russell does not promote, sponsor or endorse the content of this communication. The S&P 500® Index is the most widely accepted barometer of large cap U.S. equities. It includes 500 leading companies.