

Memorandum

To: Friends of Ariel Investments
From: Charlie Bobrinsky, Vice Chairman and Portfolio Manager
Date: January 31, 2020
Re: Ariel Focused Value 4Q19 Client Letter

ARIEL FOCUSED VALUE COMPOSITE PERFORMANCE						
As of December 31, 2019						
Inception date: March 31, 2005	Annualized					
	4Q19	1 Year	3 Years	5 Years	10 Years	Since Inception
Gross of Fees	8.48%	27.33%	8.85%	6.25%	9.81%	7.14%
Net of Fees	8.30%	26.51%	8.15%	5.57%	8.95%	6.23%
Russell 1000® Value Index	7.41%	26.54%	9.68%	8.29%	11.80%	7.76%
S&P 500® Index	9.07%	31.49%	15.27%	11.70%	13.56%	9.32%

In the fourth quarter of 2019, the Ariel Focused Value Composite outperformed its primary benchmark returning +8.48% gross of fees (+8.30% net of fees) compared to +7.41% for the Russell 1000 Value Index. Likewise, Focused Value posted an impressive absolute return of +27.33% gross of fees (+26.51% net of fees) in 2019—modestly falling in line with the benchmark which gained +26.54%. The S&P 500 Index outperformed our portfolio and the value index for the quarter and the year, as large cap technology stocks enjoyed another year of excellent returns. This is a good time to look back at 2019; what we got right and what we got wrong. As it turns out, there was plenty of both.

“Be greedy when others are fearful” is a well-known investment mantra attributed to Warren Buffett. We entered 2019 believing markets were excessively pessimistic. An inverted yield curve told many to expect an imminent recession. Brexit would be messy and force corporate executives to postpone investment. A trade war with China would escalate a global slowdown. A stalling Chinese economy would reduce demand for industrial products. Rising Middle East tensions would threaten energy infrastructure. A contentious Democratic primary and Presidential election would be bad for business. All of this pessimism pummeled stocks in the fourth quarter of 2018. Cyclical companies as well as those exposed to the general economy were hit hard.

At Ariel, we do not believe we are particularly good at predicting the near-term direction of the economy. Frankly, we don't think others are either. But we do believe markets can become overconfident in a macro consensus that is either too optimistic or, in this case, pessimistic. As a result, “value can cluster” meaning certain securities can become attractive at the same time. At the beginning of 2019, a number of our favorite cyclical stocks traded at significant discounts to our calculation of their intrinsic value. Most were reporting good operating results with excellent long-term trends; but saw their prices decline on short-term economic fears. Alternative asset managers **KKR & Co. Inc.**



(KKR) and **Blackstone Group, Inc. (BX)** experienced growth in their new investment funds. Their shares, however, were beaten down at the end of 2018 due to investor concerns about a bear market. Although **Zebra Technologies Corp. (ZBRA)** reported growing interest from retailers for its inventory tracking technology, its stock pummeled as investors anticipated falling consumer spending.

While cyclical and economically sensitive stocks started 2019 cheap relative to our calculation of intrinsic value, not all were attractive. "Safe stocks" (those predicted to hold up well in a recession) traded at high PE multiples, often over 20. Bond substitutes (REITS, high dividend paying utilities, etc.) were bid up as interest rates stayed unusually low. And of course, large capitalization technology holdings such as Apple (AAPL), Amazon (AMZN), Facebook (FB) and Alphabet (GOOGL) continued to soar.

Our focus on beaten down cyclical stocks was generally helpful to 2019 performance. From December 31, 2018 through December 31, 2019, KKR, BX and ZBRA returned +51.57%, +96.29% and +60.42% respectively. As we go to print in 2020, the market is not nearly as pessimistic about the outlook for the economy. The appreciation in these cyclical companies has brought their share prices close to or even above our calculation of private market value. We will likely trim these holdings if current market optimism persists.

While our assessment of the excessive pessimism proved correct in hindsight last year, our expectation of rising inflation did not. At Ariel, we like to buy what others are selling. In 2019, we believed the market was too confident about continued low inflation. Companies that stood to benefit from higher inflation (such as energy companies or fertilizer suppliers) traded well below our calculation of their value. At the beginning of 2019, shares of leading energy equipment manufacturer **National Oilwell Varco (NOV)** were down -46.73% from its price the previous summer. **Apache Corporation (APA)**, a large oil and gas exploration company with excellent reserves in the North Sea and exciting new discoveries in the Permian Basin, also appeared attractive. In past letters, we have written extensively about the opportunities in natural gas, particularly its discounted price relative to oil. Both NOV and APA would have benefited from rising natural gas prices which did not materialize in 2019. In contrast, disappointment in the lack of cash flow from oil and gas production companies forced many to curtail capital spending which further pressured the shares of NOV. Early this year, APA announced a major discovery in South America and its shares began to climb. Stay tuned.

Perhaps our biggest disappointment in 2019 was our investment in **Mosaic Company (MOS)**. MOS is the largest and lowest cost producer of agricultural fertilizers in the United States. The company was owned for many decades by the Cargill Company, one of the largest and most successful private agricultural businesses in America. In 2004, MOS was spun out of Cargill and began to trade as an independent public company. It is an industry leader with an excellent cost position, in a business with highly predictable long-term demand. Fertilizer applied to farmland improves yields well above the cost of the product. As global population continues to increase, demand for food and agricultural products is almost certain to grow. In 2019, none of these long-term trends were evident. Unusual spring rain caused flooding and reduced planting in the Midwest. A strong U.S. dollar made Mosaic's U.S. production less competitive overseas. The trade war reduced Chinese purchases of U.S. agricultural products. The company's stock price declined -25.28% for the year. As we enter 2020, the trade agreement with China calls for significantly more grain and livestock purchases from the U.S. We continue to believe in our long-term thesis.

As we begin 2020, the market outlook is remarkably different from where we started in 2019. Last year's pessimism about the economy has been replaced by unmistakable bullishness. We track a number of surveys of investor



sentiment. All show a dangerous rise in confidence; dangerous because such confidence can lead to overpriced securities and reduce future returns. The clustering of value in cyclical stocks is gone. Today's opportunities generally lie in value stocks, those trading at low multiples to their projected earnings. As we go to print, we calculate Ariel Focused Value is trading at about 14 times our calculation of forward earnings compared to a forward multiple of 19 for the technology heavy S&P 500. Value investing is clearly out of favor. Herein lies the opportunity.

Investing in equity stocks is risky and subject to the volatility of the markets. 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 portfolio invests may never be recognized by the broader market. A focused portfolio may be subject to greater volatility than a more diversified investment.

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 the Ariel Focused Value Composite has been reduced by the amount of the highest fee charged to any client in the Composite during the performance period. Actual fees may vary depending on, among other things, the applicable fee schedule and portfolio size. A complete fee schedule 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. The Ariel Focused Value Composite differs from its benchmark with dramatically fewer holdings concentrated 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 12/31/19, Ariel Focused Value held the following positions referenced: KKR & Co. Inc. 5.43%; Zebra Technologies 4.10%; Blackstone Group, Inc. 3.05%; Mosaic Company 3.03%; Apache Corporation 1.74% and National Oilwell Varco 1.46%. The portfolio holdings are subject to change. The performance of any single portfolio holding is no indication of the performance of other portfolio holdings of Ariel Focused Value Composite.

Index returns reflect the reinvestment of income and other earnings. Indexes are unmanaged, and investors cannot invest directly in an index. The Russell 1000® Value Index measures the performance of the large-cap value segment (companies with lower price-to-book ratios and lower expected growth values) 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.

