Memorandum

To: Friends of Ariel Investments

From: Charlie Bobrinskoy, Vice Chairman and Portfolio Manager

Date: April 28, 2022

Re: Ariel Focused Value 1Q22 Client Letter

ARIEL FOCUSED VALUE COMPOSITE PERFORMANCE						
						As of March 31, 2022
Inception date: March 31, 2005		Annualized				
	1Q22	1 Year	3 Years	5 Years	10 Years	Since Inception
Gross of Fees	4.19%	8.39%	15.10%	10.44%	10.98%	8.12%
Net of Fees	4.02%	7.69%	14.35%	9.72%	10.20%	7.23%
Russell 1000® Value Index	-0.74%	11.67%	13.02%	10.29%	11.70%	8.24%
S&P 500® Index	-4.60%	15.65%	18.92%	15.99%	14.64%	10.44%

Sticking with Our Four Themes

Despite a tough environment, the Ariel Focused Value Composite enjoyed strong first quarter 2022 performance gaining +4.19% gross of fees (4.02% net of fees) compared to a loss of -0.74% for the Russell 1000 Value Index and a loss of -4.60% for the S&P 500. Last quarter, we outlined four themes for this year's economy and equity markets that are playing out with positive implications for many of our largest holdings.

As a reminder, we believe equity markets will be dominated by 1) high and persistent inflation, 2) rising interest rates, 3) a strong reopening economy and 4) outperformance of value over growth stocks. These factors are related and reinforcing. A strong economy will augment inflation. Higher inflation should drive higher interest rates. Higher rates should be relatively good for value versus growth.

Inflation

Of all these themes, we have been the loudest and most consistent in forecasting higher inflation. Manufacturing supply-chain disruptions, dramatic increases in the money supply, trillion-dollar deficit spending (from both political parties), an accommodative Federal Reserve (still), and a historically tight labor market all push up prices.

Economists from different "schools" of economic theory often disagree. Today, all can point to their own favorite cause to explain rising inflation. Monetarists (whom we currently find particularly persuasive) believe inflation comes from excessive increases in the money supply and point to a 40% increase in M2 (a measure of the money supply that includes cash, bank deposits and certain money market accounts). Meanwhile, Keynesian economists have taught generations of students that fiscal policy in the form of deficit spending will drive inflation as labor markets approach full employment. With trillion-dollar federal deficits and a 3.6% unemployment rate, they believe higher inflation is inevitable. Finally, Supply Side economists say constraints in manufacturing capacity from supply-chain disruptions overseas and labor shortages at home have "too much money chasing too few goods." Remarkably, different schools of economic thought all come to the same conclusion today: prices are going up.

Interest Rates

Higher inflation should lead to higher interest rates. Presumably, lenders will insist loans carry interest rates high enough to offset the loss of purchasing power. Normally fixed income markets would add a "time value of money" premium to the expected inflation rate to produce higher nominal rates. We say "should" because until recently, higher rates had not materialized. Interest rates remained stubbornly and surprisingly low, with the 10-Year Treasury ending 2021 at 1.52%, well below historical averages and below visible inflation. Lately, there has been a marked reversal as rates have moved substantively higher. As we go to print, the 10-year Treasury sits at 2.83%, which has driven the Barclays Fixed Income Aggregate Index down -7.88% this year. At long last, the Federal Reserve has acknowledged high and non-transitory inflation. While the increases in the federal funds rate are getting most of the attention, we would emphasize the end of its bond-buying program of $120 billion a month, which ballooned its balance sheet to $9 trillion. Ever since the Great Financial Crisis, bond investors have been able to buy long-term bonds at surprisingly low interest rates, confident the Fed would keep prices high (and yields low) through aggressive open market purchases. "Don't fight the Fed" meant don't be a seller of bonds when the Fed was a buyer. Now the situation has flipped with bond investors seeking to exit through the same narrow door ahead of $9 trillion of "Quantitative Tightening." In February, *Barron's* ran an article with the subtitle: "Why Warren Buffett Hates Bonds." We agree with Warren.

Value Over Growth

Higher inflation and interest rates are directly impacting stock valuations. Until this year, low interest rates have fueled the outperformance of growth stocks over the value stocks we prefer. Our holdings earn a higher percentage of their current stock price in nearer term cash flows. Growth stocks, by definition, are priced to value earnings and cash flow often in the distant future. The weighted average years into the future of a company's cash flows is called its expected "duration." Just as rising interest rates hit long-term bonds harder than short-term bonds, increases in discount rates hit long-duration growth stocks harder than short-duration value stocks. Currently, our two largest holdings are **APA Corporation (APA)** and **The Mosaic Company (MOS)** trading at forward p/e multiples of 6.3x and 7.6x, respectively. In simple terms, both will earn more than half their current valuation in the next four years (if earnings stay flat). As a result, increases in interest rates and discount rates will have comparatively little impact on their valuations, just as an increase in rates has little impact on a short-term bond.

By contrast, many growth stocks are popular technology companies trading at 30 to 45 times next year's earnings. They are being valued on cash flows projected in the distant future. The Nasdaq Composite is trading at 27 times forward earnings. Rising interest rates disproportionately impact these companies whose earnings are far away, just as an increase in rates hits the price of long-term bonds harder than short-term bonds.

Now that rates are moving up, value is outperforming. The growth stock heavy Nasdaq Composite has fallen -9.10% this year. While the Russell 1000 Value is down -0.74%, the Russell 1000 Growth Index has dropped -9.04%. With our portfolio trading at only ten times forward earnings at the end of the first quarter, Ariel Focused Value could be well positioned for a period of value outperformance.

Consumer Demand

Although we are increasingly confident higher inflation and higher rates will drive outperformance, recent events have made us more cautious around the final theme, a strong economy based on pent-up consumer demand. While predicting future recessions is notoriously difficult, we cannot deny a change in certain inputs that are likely to reduce growth. Dramatically higher energy and food prices negatively impact consumer confidence. Higher interest rates push mortgage rates up and tend to reduce demand for housing. Europe represents approximately 20% of the global economy and will feel the impact of the Russian invasion of Ukraine through higher energy prices. Renewed COVID lockdowns in parts of China will delay supply chain normalization, keeping US manufacturing levels below what we would otherwise have expected. Perhaps most important, US consumers have previously expressed confidence based on strong personal balance sheets, a robust job market and federal stimulus checks. With inflation outpacing wage increases, spending could slow. Although we remain optimistic about the long-term outlook for the US economy and are investing accordingly, the next 18 months could be bumpy.

Contributors and Detractors

It is a rare but happy occurrence when our largest holdings contribute most to positive performance. Such was the case in the first quarter. Our second largest position, Mosaic, surged +69.61% during the period. The company owns and operates fertilizer mines in Florida and Saskatchewan, Canada with obvious advantages in supplying the wheat fields of Kansas and the cornfields of Iowa. This geographic proximity was less important during the past decade as record low shipping rates (coming at least in part from record low energy costs) brought competition from Moroccan phosphates and Belarus potash. Since fertilizer increases crop yields on a cost-efficient basis, it is a critical farming ingredient in the long term as improved diets around the world drive demand for food from finite arable land. We did not expect the dramatic acceleration in our thesis as the war simultaneously cut off major exports of grain from Russia and Ukraine while sanctions suppressed fertilizer shipments from Belarus. Mosaic was performing extremely well before the war. We expect concerns around reliance on Russian suppliers to accelerate growth trends for the foreseeable future.

APA Corp., the parent company of Apache Inc., was our largest position at the start of the year and was the second biggest performance contributor, jumping +54.32% in the quarter. Like Mosaic, APA had already benefited from the rising commodity prices prior to the Ukraine invasion. Those inflationary pressures were exacerbated with the sanctions against Russian oil. Poor performance of oil and gas exploration and production companies over the last decade have simultaneously reduced capital expenditures in the industry as well as caused significant selling of US energy stocks. We believe an insufficient amount of capital has been invested to meet the global energy demand for petroleum products for at least the next five years. In our view, the current share price of APA represents less than the value of the company's proven reserves with only an option value assigned to its exploratory wells off the coast of Suriname. If these Suriname properties prove productive, our investment in APA will be worth significantly more than today.

Meanwhile, our largest detractor was flooring manufacturer **Mohawk Industries, Inc. (MHK)** which declined -31.83% in the quarter. Mohawk faced the triple headwinds of higher petroleum input cost, concerns about declining housing activity and modest Russian operations. Additionally, **Lazard Ltd. (LAZ)** fell -19.97% during the period on expectations of lower M&A activity.

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 3/31/22, the Ariel Focused Value Composite (representative portfolio) held the following positions referenced: APA Corporation 7.54%; The Mosaic Co. 6.83%; Mohawk Industries, Inc. 3.15% and Lazard Ltd. 2.97%. 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.