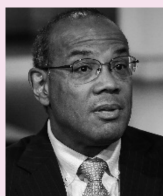
Ariel investments

Ariel Small, Small Concentrated, Small/Mid and Mid Cap Value

As of March 31, 2023



John W. Rogers, Jr.
Chairman, Co-CEO & Chief Investment Officer

Mellody Hobson
Co-CEO & President

Performance (%)

	QTD	YTD	1-Year	Annualized 3-Year	5-Year	10-Year	Since Inception
Ariel Small Cap Value Tax-Exempt							09/30/1983
Gross of Fees	**7.07**	**7.07**	**-7.22**	**23.96**	**6.94**	**8.61**	**12.27**
Net of Fees	**6.80**	**6.80**	**-8.14**	**22.73**	**5.88**	**7.54**	**11.16**
Russell 2000™ Value Index	-0.66	-0.66	-12.96	21.03	4.55	7.22	10.01
Russell 2000™ Index	2.74	2.74	-11.61	17.52	4.71	8.04	8.80
S&P 500® Index	7.50	7.50	-7.73	18.62	11.19	12.24	11.03
Ariel Small Cap Value Concentrated							04/30/2020
Gross of Fees	**6.97**	**6.97**	**-11.39**	**-**	**-**	**-**	**16.84**
Net of Fees	**6.71**	**6.71**	**-12.27**	**-**	**-**	**-**	**15.69**
Russell 2000™ Value Index	-0.66	-0.66	-12.96	-	-	-	16.92
Russell 2000™ Index	2.74	2.74	-11.61	-	-	-	12.96
S&P 500® Index	7.50	7.50	-7.73	-	-	-	14.36
Ariel Small/Mid Cap Value							12/31/2000
Gross of Fees	**7.19**	**7.19**	**-7.97**	**24.27**	**7.14**	**10.11**	**9.18**
Net of Fees	**6.92**	**6.92**	**-8.88**	**23.04**	**6.08**	**9.02**	**8.10**
Russell 2500™ Value Index	1.40	1.40	-10.53	21.82	5.61	7.72	8.57
Russell 2500™ Index	3.39	3.39	-10.39	19.43	6.65	9.07	8.44
S&P 500® Index	7.50	7.50	-7.73	18.62	11.19	12.24	7.29
Ariel Mid Cap Value							03/31/1990
Gross of Fees	**2.02**	**2.02**	**-5.82**	**21.43**	**6.57**	**9.14**	**11.14**
Net of Fees	**1.77**	**1.77**	**-6.75**	**20.23**	**5.52**	**8.06**	**10.04**
Russell Midcap® Value Index	1.32	1.32	-9.22	20.71	6.54	8.80	10.92
Russell Midcap® Index	4.06	4.06	-8.78	19.21	8.06	10.05	11.03
S&P 500® Index	7.50	7.50	-7.73	18.62	11.19	12.24	10.09

The positive quarter-end gains posted by US stocks as of March 31, 2023, masked an increasingly volatile undercurrent fueled by the unintended consequences of rising interest rates which affected everything from regional banks to money market funds and tech shares. Despite the erratic backdrop, our small- and mid-cap value portfolios performed well—with our small, small concentrated and small/mid cap value portfolios meaningfully outperforming both their primary and secondary benchmarks. These strategies were buoyed by strong returns among our holdings in Consumer Discretionary, Financials and Industrials. These names easily overcame marginal weakness in the Real Estate, Basic Materials and Technology sectors where our weightings significantly trail those of our value benchmarks. Meanwhile, our mid cap portfolios edged out the Russell Midcap Value Index but fell short of their secondary Russell Midcap Index. When compared to the value benchmark, strong stock picking in the Consumer Discretionary sector was dampened by our Financials overweight, which was the worst-performing sector in the index.

Unintended Consequences—Regional Banks in Crisis

To tame stimulus-induced inflation, the Federal Reserve began the tedious effort of raising interest rates on March 2, 2022. They started slowly with a +0.25% move that immediately stepped up to +0.50% by May—with three consecutive +0.75% hikes in quick succession in July, September and November. By year-end, a +0.50% increase began to signal a shift, with two less aggressive +0.25% nudges this February and March. With the economy cooling and inflation decelerating, *The Wall Street Journal* noted, ". . . many bet that would lead the Federal Reserve to switch quickly from raising interest rates to cutting them."[1] All seemed well.

And then a banking crisis came out of nowhere. Silicon Valley Bank (SVB), the 16th largest bank in the country, suffered a bank run and became the second-largest bank failure in US history. Given the tech industry concentration, the bank's demise was as fast as any viral phenomenon on the internet. A run that started on a Thursday ended when the bank was taken into receivership and did not re-open on Monday. With investors and the market on edge, the US Treasury, Federal Reserve and FDIC issued a late Sunday joint press release guaranteeing SVB's $209 billion in deposits—even those with account values over the $250,000 insured limit. That tripartite move helped, but did not stop the domino effect. Just two days later, Signature Bank became the third-largest bank failure ever in the United States. With financial stocks getting hit hard and confidence quickly eroding, big banks took matters into their own hands—raising $30 billion in deposits amongst themselves to stabilize the next weakest link, First Republic Bank (FRC).

While many agree some structural misses contributed to the recent bank failures—including industry and customer concentrations as well as less robust regulation for regional players—the bigger culprit was the banks' supposedly safe fixed income securities known as their hold to maturity portfolios (HTM). As interest rates rose, these bond issues were quickly devalued and would need to be marked to today's sagging prices to fund an avalanche of deposit outflows. It is worth noting that were these bonds held to maturity as intended, they would be paid out at "par" or 100% of their paper value. In short, the Fed's recent rate hikes drove the need for more capital as bond prices fell and account holders fled. In the absence of that capital, SVB and Signature are gone. In Europe, Credit Suisse was hastily absorbed by its country cousin, UBS Group AG, with special dispensation from the Swiss government. And, First Republic was just acquired by JPMorgan Chase (JPM).

As these banks were teetering, the biggest banks in the US were working around the clock to digest a rush of new customers. Unlike the 2008-09 crisis, the health of the overall banking industry is not in question. Large bank balance sheets have been stress tested for the most extreme conditions and are in great shape. And yet, regional banks in need of more capital remain under a cloud despite being the "essential workers" when it comes to lending to local communities. Plus, that lending is likely to tighten given growing capital requirements. As a result of a stingier credit environment, some of the biggest losers are expected to be the commercial real estate developers who need regular financing and subsequent refinancing. Another unintended consequence.

It is worth noting that our sole regional bank, Tulsa-based **BOK Financial (BOKF),** traded down in the recent financial sell off. While we believe government actions were well constructed and have proven effective in staving off more contagion, we acknowledge BOKF may be impacted by reduced earnings in the near-to-medium term. That said, asset quality remains sturdy as the company continues to exhibit solid loan growth, healthy net interest margins, strong capital levels and balance sheet liquidity. We therefore continue to believe BOKF remains well positioned for long-term success given its high underwriting standards, proven credit discipline, diversified business model and experienced management team.

[1] Otani, Akane. "Stocks Cap Wild Quarter to Notch Big Gains." *The Wall Street Journal*. April 1-2, 2023. Page A1.

Unintended Consequences—Popularity at Opposite Ends of the Risk Spectrum

Just as rising interest rates are settling in, ". . . investors are wagering that a general slowdown and tighter lending conditions stemming from the turmoil in the banking sector will force the Federal Reserve to loosen monetary policy sooner than expected."[2] These contrasting factors—today's higher rates and the prospect of lower future rates—are driving two disparate and increasingly crowded trades: one into money market funds and the other into large company tech shares. With yields now in excess of 4%, "Investors have added $336 billion to US money market funds this year . . . a shift from last year when the funds suffered nearly $46 billion in outflows."[3] Meanwhile, in a falling interest rate environment, investors are more willing to pay up for future earnings. Growth stocks that trade at higher multiples of earnings suddenly look more attractive. As such, 2022's downtrodden technology shares are now amongst some of 2023's biggest winners—driving up the tech heavy Nasdaq composite which soared +17% in the first quarter.

Looking Forward

Should rates fall, our value bias and underweight to the tech sector could be a drag on our near-term results. Still, with technology stocks now "trading at 24.7 times projected earnings over the next 12 months, while the broader index has a multiple of 18.2," these stocks remain pricey, which could dampen their future ascent.[4] Meanwhile, "value stocks are 'dirt cheap' relative to growth, now more discounted than they have been four-fifths of the time in the U.S. stock market history, according to Rob Arnott, founder and chairman of Research Affiliates."[5] It is also worth acknowledging that when inflation is elevated, value tends to outperform growth since higher levels of near-term cash flow are worth more today than in the future.

While monetary policy is driving recent market volatility, we remain focused on bottom-up stock picking. As the market swings from one scenario to another, our sole consideration of recent events and macroeconomic developments is to consider their effect on the long-term intrinsic worth of our names over the next five-to-ten years. Given our "slow and steady" approach, we remain confident in our portfolio positioning, especially with our small- and mid-cap portfolios trading at a discount to their respective value indices. With our small cap portfolio selling at a -35.7% discount to our estimate of private market value (PMV); small concentrated at a -39% discount; our small/mid cap strategy at a -32.8% discount; and our mid cap portfolios now at a -29.6% discount—our portfolios are on sale and poised to benefit as their full potential is realized over time.[6] Looking ahead, we firmly believe the actively patient investor that consistently owns differentiated businesses with robust balance sheets will likely achieve strong returns over the long run.

Portfolio Comings and Goings

In our small cap value portfolios, we initiated a position in a former holding, **Dun & Bradstreet Corporation (DNB)**, which is the leading provider of commercial credit data and analytics. After returning to the public markets during the pandemic, shares traded materially lower as the early stages of the company's turnaround efforts have yet to result in improving organic revenue growth. With a new management team focused on delivering profitable and sustainable growth, we can own a wide moat business with a strong brand, market-leading share, scalable products and excellent free cash flow generation, protected by high barriers to entry. Meanwhile, we successfully exited tool innovator, **Snap-on Inc. (SNA)** and marketing communications company, **Interpublic Group of Companies, Inc. (IPG)**, as their market caps grew beyond our small cap portfolios.

In our small/mid cap value portfolios, we initiated a position in **Leslie's Inc. (LESL)**, the leading direct-to-consumer pool and spa care services company in the US. Shares recently sold off on near-term operational issues as well as concerns around the sustainability of the company's growth profile in a normalized, post-pandemic environment. Although new pool installments will likely slow down, the install base has materially increased and approximately 80% of Leslie's business is tied to recurring maintenance. We also successfully exited Interpublic Group for the same reasons as above.

We did not add or exit any positions in our small/mid cap portfolio in the quarter. However, in our mid cap value portfolios, we initiated a position in long-time Ariel holding **Jones Lang LaSalle, also known as JLL (JLL)**, which is a leading professional services firm that specializes in real estate and investment management.

[2] Pitcher, Jack. "Stocks Mostly Fall on Slowdown Fears." *The Wall Street Journal*. April 6, 2023. Page B11.
[3] Ge Huang, Vicky. "Tech, Money-Market Funds are Havens." *The Wall Street Journal*. April 3, 2023. Page B9.
[4] Singh, Hardika. "S&P's Resilience Amid Turmoil is Due to Tech." *The Wall Street Journal*. April 4, 2023. Page B10.
[5] Wallerstein, Eric. "Stocks Haven't Looked This Ugly In Years." *The Wall Street Journal*. April 4, 2023. Page A1.
[6] Discount to Private Market Value is the percentage discount the portfolio's holdings trade relative to Ariel Investments' internal estimate of the portfolio's holdings' private market value (PMV). There is no guarantee that the companies we invest in will achieve our PMV.

Although the first half of 2023 will likely be choppy given macro-uncertainty, the company's leadership is highly confident about the medium- and longer-term revenue outlook for both transactional and recurring revenue streams. JLL is also making efforts to streamline operations and increase efficiencies to generate higher profit over time. We successfully sold personal auto insurer, **Progressive Corporation (PGR)** as it surpassed our estimate of its private market value.

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. Effective August 1, 2010, the Ariel Mid Cap Value Composite was redefined to exclude pooled funds due to differences in performance calculation methods. 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. Views and opinions are as of the date of this commentary and can change without notice. There is no guarantee that any expressed views will come to fruition or any investment will perform as described.

As of 3/31/23, the Ariel Small Cap Value Composite (representative portfolio) held the following positions referenced: Leslie's, Inc. 2.84%; Jones Lang LaSalle, Inc. 2.51%; BOK Financial Corporation 2.45% and Dun & Bradstreet Holdings, Inc. 1.41%. As of 3/31/23, the Ariel Small Cap Value Concentrated Composite (representative portfolio) held the following positions referenced: Jones Lang LaSalle 4.32%; BOK Financial Corporation 4.25% and Leslie's, Inc. 3.69%. As of 3/31/23, the Ariel Small/Mid Cap Value Composite (representative portfolio) held the following positions referenced: Interpublic Group of Companies, Inc. 3.32%; Jones Lang LaSalle 3.07%; BOK Financial Corporation 2.83% and Snap-on, Inc. 1.06%. As of 3/31/23, the Ariel Mid Cap Value Composite (representative portfolio) held the following positions referenced: Interpublic Group of Companies, Inc. 3.15%; BOK Financial Corporation 2.70%; Snap-on, Inc. 1.31% and Jones Lang LaSalle 0.75%. 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. The 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 of the U.S. equity universe. It includes those Russell 2000 companies with lower price-to-book ratios, lower forecast growth and lower sales per share historical growth. Its inception date is June 1, 1993. The Russell 2000® Index measures the performance of the small-cap segment of the U.S. equity universe. The Russell 2000 Index is a subset of the Russell 3000® Index representing approximately 10% of the total market capitalization of that index. It includes approximately 2,000 of the smallest securities based on a combination of their market cap and current index membership. Its inception date is January 1, 1984.

The Russell 2500™ Value Index measures the performance of the small to mid-cap value segment of the U.S. equity universe. It includes those Russell 2500 companies with relatively lower price-to-book ratios, lower forecasted growth values and lower sales per share historical growth. Its inception date is July 1, 1995. The Russell 2500™ Index measures the performance of the small to mid-cap segment of the U.S. equity universe, commonly referred to as "smid" cap. The Russell 2500 Index is a subset of the Russell 3000® Index. It includes approximately 2500 of the smallest securities based on a combination of their market cap and current index membership. Its inception date is June 1, 1990. The Russell Midcap® Value Index measures the performance of the mid-cap value segment of the U.S. equity universe. It includes those Russell Midcap Index companies with lower price-to-book ratios, lower forecasted growth values and lower sales per share historical growth. Its inception date is February 1, 1995. The Russell Midcap® Index measures the performance of the mid-cap segment of the U.S. equity universe. The Russell Midcap Index is a subset of the Russell 1000® Index. It includes approximately 800 of the smallest securities based on a combination of their market cap and current index membership. Its inception date is November 1, 1991.

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The S&P 500® Index is widely regarded as the best gauge of large-cap U.S. equities. It includes 500 leading companies and covers approximately 80% of available U.S. market capitalization. Its inception date is March 4, 1957.