Ariel investments

Ariel Focused Value

As of March 31, 2023

Charles K. Bobrinskoy
Vice Chairman
Portfolio Manager

Performance (%)

	QTD	YTD	1-Year	3-Year (Annualized)	5-Year (Annualized)	10-Year (Annualized)	Since Inception (Annualized)
Ariel Focused Value							03/31/2005
Gross of Fees	**0.62**	**0.62**	**-11.99**	**20.62**	**6.15**	**8.33**	**6.89**
Net of Fees	**0.46**	**0.46**	**-12.56**	**19.84**	**5.47**	**7.60**	**6.02**
Russell 1000® Value Index	1.01	1.01	-5.91	17.94	7.50	9.13	7.40
S&P 500® Index	7.50	7.50	-7.73	18.62	11.19	12.24	9.34

The Ariel Focused Value Composite returned +0.62% gross of fees (+0.46% net of fees) in the first quarter, modestly trailing its primary benchmark, the Russell 1000 Value Index, which gained +1.01%. Meanwhile, the S&P 500 Index, with its heavy technology and growth stock weighting, grew +7.50% in the quarter. Last year, value stocks outperformed growth stocks by a wide margin. So far in 2023, growth has outperformed value, a headwind to our relative performance given the characteristics of our holdings. Of late, growth stock outperformance has been aided by falling interest rates, a decline we do not expect to continue.

Portfolio Recap

BorgWarner Inc. (BWA) and **Madison Square Garden Entertainment Corp. (MSGE)** were our top contributors in the quarter, while **APA Corporation (APA)** and **BOK Financial Corp. (BOKF)** were our biggest detractors. BorgWarner surged +22% on its growing leadership position in automotive propulsion and powertrains, particularly for electric vehicles. Last December, the company announced a spin-off of its fuel system and after-market parts businesses. Those businesses will focus on internal combustion engine systems, while the remainder of BorgWarner will seek to expand its electric vehicle propulsion business. BorgWarner was Ariel Focused Value's largest holding at quarter end. We view the company as a leader in a growing industry with clear technical barriers to entry, trading at less than ten times our estimate of forward twelve months' earnings.

After a difficult 2022, MSGE was our second largest contributor to performance this quarter jumping +31%. During the recent Super Bowl, the rock band U2 announced they would perform their first concert since 2019 at MSGE's Sphere in Las Vegas this fall, which gave equity markets confidence that the Sphere would open on schedule. The company also announced a spinoff, creating a new separately traded company that will include Madison Square Garden, the Hulu Theater, Radio City Music Hall, The Beacon Theatre, and the Chicago Theatre.

Energy stocks were strong performers in 2022, including our portfolio holding APA Corporation, which leaped +76% for the year. By contrast, APA declined -22% in the most recent quarter. Fears of a global recession, the release of oil from America's Strategic Petroleum Reserves, and a significant drop in US natural gas prices all combined to pressure APA's shares. A recent decision by OPEC to reduce oil production has sent West Texas Intermediate ("WTI") prices back above $80 per barrel from the mid $60s earlier this year. APA trades for less than six times our estimate of the next twelve-month earnings.

BOKF was our second largest detractor, declining -18%. BOKF was pressured by the "double whammy" of falling oil prices and recent difficulties at regional banks. Based in Tulsa, Oklahoma, BOKF is rightly considered a leading lender to the US oil petroleum industry. However, BOKF's exposure to oil and gas has been exaggerated by the market. Energy loans represent only 15% of the company's lending portfolio.

The bank's fortunes are more tied to the health of the general economy in America's southwest region than any industry. Texas, Oklahoma, Arizona, and Nevada will continue to show healthy economic growth with well-publicized increases in population and corporate headquarters. However, the threat of deposit withdrawals at regional banks after the failure of Silicon Valley Bank could be a more serious challenge. Customer deposits represent the least expensive source of funding for most regional banks.

Were depositors to move a substantial portion of their deposits from regional banks to the large money center banks known as the Systemically Important Financial Institutions, bank earnings could be severely impacted, certainly in the short term.

We think the best explanation of the current woes of regional banks came from George Bailey during the bank run scene in *It's a Wonderful Life*; "You're thinking of this place all wrong. As if I had the money back in a safe. The money's not here. Your money's in Joe's house...right next to yours. And in the Kennedy house, and Ms. Macklin's house, and a hundred others. Why, you are lending them the money to build, and then, they are going to pay it back to you as best they can." Just as the fictional Bailey Building & Loan depositors could have forced George to close his doors, a bank depositor run can cause a liquidity crisis for even a well-capitalized bank such as BOKF. So far, we do not see evidence of outsized deposit withdrawals at BOKF. However, we remain cautious and have not added to our position, even at today's lower share price.

Reversal of Fortunes: The End of Declining Rates

The chart below is from St. Louis Federal Reserve Bank. It shows the market yield on 30-year Treasuries from April 1980 through February 2023. This graph explains why certain financial asset classes have outperformed over the last 40 years. The chart also explains why the previous 40 years have been challenging for traditional value managers and why this might be about to change.

First, the graph shows a dramatic decline in interest rates over the last 40 years. The 30-year Treasury declined from over 15% in 1981 to 0.99% in 2020. While the totality of this decline is well understood among market participants, what is less noted is how consistent this decline in rates has been. From 1981 to 2021, every rolling 10-year period ended with 30-year rates lower than when the period began. This four-decade winning streak for lower rates was only recently snapped when 30-year Treasuries ended 2022 at 3.97%, higher than their 2.9% yield at the end of 2012.

This consistent decline in rates is important as some asset classes benefit more from falling rates than others. Leveraged companies benefit more than companies without debt. Long-term bonds benefit more than short-term bonds. Notably, growth stocks and technology stocks benefit more than value stocks. On the last point, growth stocks are like long-term bonds in that they have a long duration, meaning their cash flows are farther in the future than value stocks. A growth stock investor may be counting on earnings 30 years from now, earnings whose present value increases with a lower time value of money. A value stock will earn a much larger percentage of its stock price in the near term, cash flows whose present value will be less impacted by lower discount rates. Just as a drop in interest rates will have a more significant positive effect on a 30-year bond than a 6-month treasury, a drop in interest rates will have a greater positive impact on a portfolio of growth stocks than on a comparable portfolio of value stocks.

This is important because the consistent decline in interest rates over the last 40 years has been a continuous positive factor for growth stocks and a persistent negative factor for value stocks, at least on a relative basis. While growth stocks have had a steady wind at their backs; value stocks have faced a steady headwind.

We believe this extraordinary period of consistently declining rates is ending. At a minimum, interest rates cannot decline over the next 40 years as they have over the past four decades. There is nowhere further for long-term rates to go. In a crisis, 30-year rates could drop temporarily back to the 0.99% they reached during the Covid crisis of 2020. But rates cannot steadily decline in the future as they have in the past.

When I attended business school in the 1980s, academicians agreed on the existence of a "Value Anomaly." Value stocks beat growth stocks by much more than any valuation model would predict. This Value Anomaly has disappeared, particularly over the last 25 years. We believe value's underperformance owes much to reduced interest rates. We also believe this period of steady declining rates is over. Perhaps rates will not steadily increase, but they are not likely to steadily fall. With a more level interest rate playing field, value may return to its rightful place atop the asset class pyramid. We believe Ariel Focused Value should be well positioned for the future with its emphasis on companies trading at low prices relative to their expected earnings.

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.

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As of 3/31/23, the Ariel Focused Value Composite (representative portfolio) held the following positions referenced: BorgWarner, Inc. 6.99%; APA Corporation 5.54%; BOK Financial Corporation 5.40% and Madison Square Garden Entertainment Corporation 3.36%. 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.

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