Ariel Small Cap Value

Quarter Ended June 30, 2024

The bull market powered through the second quarter fueled by investor enthusiasm for artificial intelligence (AI) themed stocks. This narrow, momentum-driven, rally helped the S&P 500 eke out a modest gain, even as Mid- and Small-Cap companies declined. The resulting bifurcation has been extreme, as the non-AI companies in the S&P 500 Index lost 1.2%.[1] This limited market breadth likely reflects weakening economic growth and inflation in the U.S. With many investors cautiously optimistic the Federal Reserve will successfully engineer a soft landing, interest rate cuts may be at hand in the coming months. Still, the turmoil surrounding the U.S. election is becoming a new focal point. Although uncertainty is high and volatility will likely remain elevated, we view these risks as short-term noise within the context of our long-term investment horizon. Against this backdrop, the Ariel Small Cap Value Tax-Exempt Composite decreased -3.80% gross of fees (-4.04% net of fees) in the quarter, falling slightly short of both the Russell 2000 Value Index and the Russell 2000 Index, which returned -3.64% and -3.28%, respectively.

Several stocks in the portfolio had strong returns in the quarter. **OneSpaWorld Holdings Ltd. (OSW)** is a provider of wellness services onboard cruise ships and destination resorts. Its shares advanced during the quarter following a top- and bottom-line quarterly earnings beat and subsequent raise in full year guidance. Robust consumer demand, higher onboard spend levels and strong free cash flow generation all contributed to this performance. Additionally, management announced a new buyback program, meaningful debt reduction and a new cruise line contract. At today's valuation, we continue to believe OSW's risk/reward skews to the upside.

Logistics and cash management services provider, **Brink's Company (BCO)** traded higher following strong quarterly earnings results, highlighted by double-digit organic revenue growth and margin expansion. Fueling this performance was newer offerings in digital retail solutions and outsourced ATM services as well as continued execution of cost productivity initiatives. Meanwhile, BCO is returning capital to shareholders through both dividends and share repurchases. Additionally, shares of oil services company, **Core Laboratories, Inc. (CLB)**, increased following a top- and bottom-line earnings beat. Strong international demand for laboratory services and completion diagnostic solutions boosted results. Although the macro environment remains volatile and U.S. onshore drilling and completion activity is expected to remain flat year-over-year, management is projecting international growth from projects in the Middle East, Asia Pacific and West Africa. Meanwhile, the company remains laser focused on generating positive free cash flow, reducing debt and improving its return on invested capital.

In contrast, U.S. direct-to-consumer pool and spa care services company, **Leslie's Inc. (LESL)**, underperformed following another consecutive quarterly decline in earnings resulting from soft consumer demand. Importantly, management confirmed a material improvement in traffic and is forecasting an earnings recovery over the second half of the year. Although we have been deeply disappointed with this investment to date, trends have improved as weather conditions normalized. Meanwhile, we believe LESL is truly differentiated by its loyal client base, vertically integrated supply chain, scale advantage and seamless customer experience. At today's valuation, LESL appears to have more upside than downside.

Shares of live entertainment, media and technology company, **Sphere Entertainment Co. (SPHR)** also traded down on mixed earnings results, giving back some of its strong first quarter gains. Although residency demand is robust and the venues' original content experience and Exosphere remain popular, some investors expect near-term utilization will slow due to Las Vegas seasonality. Meanwhile, international expansion remains the company's priority, with management suggesting a major announcement soon. Although we believe it will take time for Sphere to reach its full potential, the company is well on its way to having events 365 days a year. It is ramping up the scale of its concert residencies, securing marquee sporting and corporate events, and creating more original content for *The Sphere Experience*. In our view, the new experiential immersive venue in Las Vegas and its potential franchise opportunities alongside the company's two regional sports and entertainment networks present a long-

[1] Sindreu, Jon. "The Second Quarter Split the Market." *The Wall Street Journal*, July 1, 2024, p. B9.

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term opportunity that remains meaningfully underappreciated at current trading levels.

Additionally, leading food equipment manufacturer**,** **Middleby Corporation (MIDD)**, declined in the period following an earnings miss driven by weaker-than-anticipated organic sales across the commercial, residential and food processing businesses. Importantly, management noted conditions are improving with channel inventories returning to normalized levels and order volumes trending in a positive direction. Meanwhile, profitability remains solid and MIDD continues to generate strong free cash flow. In our view, MIDD's differentiated brands and kitchen innovations offer the latest in automation and advanced cooking technologies, positioning the company for growth and margin expansion as it serves the rapidly evolving needs of the food service industry.

Also in the quarter, we initiated a position in entertainment company, **Paramount Global (PARA)**. Shares tumbled amidst merger talks, which coincided with leadership changes at both the executive and Board level. Continued pressures around the linear TV ecosystem and competition in streaming further drove the stock to new lows. We have held steadfast to our PARA holdings in other portfolios amidst the merger saga and this further price decrease presented an attractive buying opportunity, particularly as the company expects to deliver significant earnings growth in 2024 and to reach Paramount+ domestic profitability in 2025. In our view, the underlying value of the company's proprietary content and media assets are not reflected in the recent share price.

By comparison, we exited **Horace Mann Educators Corporation (HMN)**, which is an insurance company focused on the U.S. education marketplace, to pursue more compelling opportunities.

AI-themed stocks continue to dominate markets this year. Escalating geopolitical tensions, the potential timing of the Fed pivot and the outcome of the upcoming U.S. Presidential election also pose risks. As the bull market climbs the proverbial "wall of worry," we consider macroeconomic developments and recent headlines within the context of our long-term investment horizon. We continue to be cautiously optimistic and believe the underlying strength of corporate profits will prove resilient. Consumers are still spending, unemployment remains low and the balance sheets of U.S. financial institutions and households are generally in good shape. As rates begin to subside in 2024 and beyond, we think the gap between mega-cap stocks and their small to mid-cap counterparts will narrow.

Meanwhile, we remain focused on the underlying fundamentals and opportunities market dislocations can provide to long-term, actively patient investors. We strongly believe the disciplined investor that stays the course and consistently owns differentiated, quality business models with robust balance sheets will deliver superior returns over time.

Investing in small-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. The portfolio is often concentrated in fewer sectors than its benchmarks, and its performance may suffer if these sectors underperform the overall stock market. Investing in equity stocks is risky and subject to the volatility of the markets.

Past performance does not guarantee future results. Performance results are shown net of the highest management fee charged to any client in the Composite during the performance period. Net returns reflect performance returns after the deduction of advisory fees and transaction costs and assume the reinvestment of dividends and other earnings. For the period ended 6/30/24 the performance (net of fees) for the Ariel Small Cap Value Tax-Exempt Composite for the 1-, 5-, and 10-year periods was +3.69%, +7.90%, and +6.15%, respectively. For the period ended 6/30/24 the performance for the Russell 2000 Value Index and the Russell 2000 Index for the 1-, 5-, and 10-year periods was +10.90%, +7.07%, and +6.22%, and +10.06%, +6.94%, and +7.00%, respectively. 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 Small Cap Value Tax-Exempt Composite differs from its primary benchmark in that it has 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. There is no guarantee that any of the views expressed will come to fruition or any investment will perform as described.

As of 6/30/24, OneSpaWorld Holdings, Ltd. constituted 5.9% of the Ariel Small Cap Value Tax-Exempt Composite (representative portfolio); Brink's Company 5.6%; Core Laboratories, Inc. 3.2%; Leslie's, Inc. 2.7%; Sphere Entertainment Company 1.7%; The Middleby Corporation 2.5%; Paramount Global 0.5%; and Horace Mann Educators Corp. 0.0%. 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 Ariel Small Cap Value Tax-Exempt Composite.

A glossary of financial terms provided herein may be found on our website at www.arielinvestments.com.

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. Russell® is a trademark of London Stock Exchange Group, which is the source and owner of the Russell Indexes' trademarks, service marks and copyrights. 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 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.

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