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THIRD QUARTER 2021

Small Cap Value Commentary

Market Summary

The Russell 2000® Value Index (the "Benchmark" or the "Index") declined 3.0% in the third quarter for a year-to-date gain of 22.9%. As the economy continues to run hot, inflation, interest rates, and energy prices shot higher. Investors sung back to value stocks as is typical in early stages of economic upswings.

This quarter, Communication Services (-16%) was the Benchmark's largest decliner due to AMC's 33% loss. AMC's 1.2% weight in the Benchmark was responsible for -51bps for the Benchmark this quarter. Healthcare declined 7%, which is meaningful as it is now the fourth largest sector after reconstitution of the Index. While hospital stocks declined only modestly, some of the largest biotechnology and healthcare technology stocks fell sharply after experiencing big gains earlier this year. Consumer Discretionary stocks fell 8%, led down by the auto component manufactures which are hindered by auto manufacturers' inability to secure key parts and ramp production. Consumer durables continue to see supply chain constraints in both materials and logistics, while consumer services and retail were impacted by the resurgence of COVID in August, causing a sharp decline in consumer traffic. Materials declined 5% on double digit declines across metals and mining stocks partially due to a slowdown in China demand.

The Financials sector was a leading gainer, up 2% as investors moved into banks anticipating stronger net interest margins with recently rising interest rates. The Energy sector was the other notable positive sector this quarter, up 3% thanks to significantly higher oil and gas prices.

Performance Summary - Quarter

For the quarter, our small cap value strategy (the "Strategy" or "Portfolio") outperformed the Benchmark.

Communication Services' outperformance was largely driven by continuing to avoid AMC and good performance from Nexstar, owner of TV stations reaching 40% of US households. Viewership and advertising are up as people spend more time at home.

Industrials saw strong performance from Atkore, maker of electronic components and cables used in commercial buildings. Commercial construction is picking up again as Covid recedes, and that supports increased demand for Atkore products. SkyWest was another notable outperformer as investors anticipate higher travel trends ahead, but, anticipating that, we added to our position at the quarter's bottom in early August.

Energy outperformed the Index thanks to big gains from Range Resources, producer of natural gas and natural gas liquids which have seen sharp increases in price in recent months, now at levels not seen since 2014. Magnolia Oil & Gas performed well thanks to its unhedged position in energy, so they reaped the full benefit of higher energy prices. In addition, the company's debt is low, and it is shareholder friendly with free cash flow distribution prioritized to dividends and share repurchases. Most of the Benchmark's energy stocks declined this quarter.

Real Estate is the third largest sector in the index; we are slightly underweight. One noteworthy REIT posting strong performance this quarter was fast growing Innovative Industrial Properties, provider of facilities used to grow cannabis. Apartment building owner Independence Realty's stock also performed quite well – its stock has gone steadily higher since the sharp Covid-related market collapse. Independence buys dilapidated properties and upgrades them for higher rents. It's been a great strategy and has generated better return on invested capital than its peers.

Materials outperformed the Index thanks to Advansix, which produces specialty chemicals used in the manufacture of nylon. Their end markets include carpets, electronics, and agriculture. Each of their end markets is strong and should remain so through 2022. Utilities (+14bps) was led by Otter Tail, a provider of gas and electricity in Minnesota and the Dakotas which also has a nicely growing manufacturing and plastics business making this an industrial company in a utility sheep's clothing. Consumer Staples saw good gains from Hostess Brands as it is gaining market share and is benefiting from rising snacking trends from stay-at-home customers. Financials saw banks outperform, led by Triumph (see detail below), debit card leader and specialty lender Bancorp, and West Coast community banks Umpqua, Preferred Bank, and Banc of California. The sector's detractors included Florida based Heritage Insurance, but we also did not own the strong performing pawn shop stocks nor companies that lend to subprime borrowers.

Besides cash, Information Technology was the only notable performance detractor driven by weakness at Methode Electronics and Vishay Intertechnology, two companies struggling to keep up with demand for vehicle components. Advanced Energy supplies electronic components for power management, and they've also struggled to meet end demand due to a shortage of parts as Asian suppliers struggle to deal with Covid restrictions.

Other Contributors for the Quarter

Triumph Bancorp was a strong performer in the Financials sector. The bank has steadily been growing its payment services business that allows the largest shippers in the country to automate the payment process to truckers, a method that has been paper-, fax- and email-based for years. This fintech arm of Triumph is quite valuable and could be worth a sizable amount over the next few years.

Booking trends at timeshare owner Hilton Grand Vacations are now higher than in 2019, and investors are expecting a snapback in the company's earnings. The stock got an additional charge with the company's recent acquisition of Diamond Resorts, which added 92 new resorts and 400,000 owners in 20 new markets. The deal is earnings accretive and free cash flow additive.

Other Detractors for the Quarter

We believe Modine Manufacturing lagged this quarter because it is incorrectly classified as an auto parts manufacturer, an industry that is suffering from supply chain issues. Modine sold this business and what remains is an industrial company mostly providing heat transfer products for heavy duty vehicles and airflow systems for data centers, buildings, and commercial locations. A reclassification should be coming soon. We believe that would move the stock's multiple higher in line with its peers.

Flexion's product is Zilretta, an injectable drug that eases knee pain for a longer period than alternative drugs, but it also costs more. The stock underperformed this quarter, like many other biotechnology stocks.

Performance – Year-to-Date

The Strategy has outperformed the Index year-to-date. Our largest outperformer has been Financials led by non-traditional banks Bancorp, Triumph, and Meta Financial. These banks are less dependent on interest rates because they are more tied to fee income businesses like debit card issuance and transportation finance. Pinnacle Financial was a big performer due to its presence in fast growing Tennessee, and New York based Sterling Bank moved higher upon receiving an acquisition offer.

Industrials saw Benchmark beating performance from Aktore, utility contractor MYR Group, wood processing equipment and parts supplier Kadant, technology staffing company Kforce, and industrial distributor Wesco. Each of these companies is experiencing strong demand for their products and services in the economic rebound.

Energy companies Range Resources, Magnolia Oil & Gas, PDC Energy, and Champion X all performed exceptionally well thanks to much higher energy prices but also because of their capital allocation policies that prioritizes shareholder capital returns over growth.

Consumer Discretionary's strong performance was driven by skyrocketing Boot Barn and big gains from American Eagle, Scientific Games, Kohl's, and Asbury Automotive Group. Utilities performed well thanks to Otter Tail.

Cash was a detractor to performance – we typically have 2-3% cash at all times. Healthcare underperformed because of biotechnology stocks Flexion and Kyropharma. Despite healthy gains from specialty chemicals companies Ferro, H.B. Fuller, and Avient, Materials performance was dragged down from our lack of investment in steel stocks. Communication Services was dragged down from not owning AMC but we almost offset that with strong gains from Nexstar and Tegna.

Portfolio Positioning

Our themes laid out in last quarter's report continue to be expected drivers for 2022 outperformance. Higher inflation and stronger loan demand have us overweight banks. We have significant investments in housing, construction, and infrastructure in anticipation of delayed projects getting started and much needed investment post-Covid. Travel and vehicle spending should pick up markedly in 2022 with supplies catching up to demand. Within the real estate sector, we are overweight hotels, healthcare, and retail which should snap back in a post Covid world.

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