Equity Strategies

Executive Summary

During 2017, interest rates bottomed and inflation expectations rose as the labor market tightened and the Federal Reserve ("Fed") began to raise rates. Entering 2018, tax cuts for businesses, and most individuals, seem likely to boost economic growth, placing upward pressure on inflation, and providing cover for the Fed to continue raising short-term interest rates.

Overview

From March 2016 through the end of 1Q 2018 ("1Q"), we witnessed a rise in 10-Year US Treasury rates from 1.77% to 2.83%, paving the way for a tightening of US high yield credit spreads by approximately 375 basis points ("bp") during this same period. This combination signals increasing nominal growth will be constructive for borrowers, allowing them to pay down debt on their balance sheets. Historically, our equity strategies have performed well when either credit spreads tighten or interest rates rise, which we believe is a clearly favorable environment.

Micro Cap Equity

Our Micro Cap Equity strategy underperformed its benchmark, the Russell Microcap Index during 1Q. Top sector contributors in the quarter were the Real Estate and Financials sectors. Underweighting Real Estate benefitted as rising rates and inflationary concerns negatively impacted the sector. Our overweight to financials benefitted from the rising rate environment along with hopes for deregulation in the sector which would likely spur more merger & acquisition (M&A) activity in the future. The top detractors in 1Q were centered within the Healthcare, Consumer Discretionary, and Materials sectors. Healthcare continued its torrid run in 1Q, despite the administration's tone to reduce severe high cost inflation due to escalating drug costs. Our underweight to this group was the most dramatic impact on performance during the quarter. Performance in the Consumer Discretionary sector receded after a strong 4Q 2017 ("4Q"), however, the fundamentals continued to improve for the sector going forward. Many of the 4Q performers surrendered their gains but are still well positioned for the balance of the 2018. The materials sector was negatively impacted as trade wars between China and the US began to surface toward quarter-end. A steel processing company suffered from initial fears of potential trade war impacts, but ultimately, we believe this company would actually benefit from more protectionist steel measures.

Smaller Companies Growth Equity

During 1Q, our Smaller Companies Growth Equity strategy underperformed the Russell 2000 Growth Index. In broad terms, sector allocation negatively impacted performance with the largest impact stemming from our overweight positioning in the Energy and Consumer Discretionary sectors as well as our underweight allocation to the Technology sector. Conversely, stock selection was positive during 1Q with noteworthy contributions from Industrials, Energy, and Technology sectors.

Outperformers for 1Q included an energy services company that benefitted from a timely acquisition which provided the firm with exposure to the reconstruction of the Puerto Rican infrastructure. Additionally, a recent telecommunications IPO continued to outperform as a result of improving top-line growth and attractive valuations. We experienced significant outperformance in an industrial distribution company, that reported a strong 4Q due to strength in their oil and gas segment. A regional TV broadcaster led detractors during 1Q due to a sizeable secondary offering and the absence of M&A activity that has been anticipated by the market. Within the Energy sector, an oilfield service provider struggled due to lackluster 2018 guidance driven by disappointing pricing in their key segments. Lastly, a TV broadcasting company was impacted by weak advertising trends and exposure to Mexico, which was negatively impacted by recent news emanating from Washington.

Small Cap Equity

Our Small Cap Equity strategy underperformed the Russell 2000 Index in 1Q as Technology, Real Estate, and Utility sectors provided positive contributions. The strategy experienced a sizeable lag within the Consumer Discretionary sector in the quarter, principally due to stock selection. Our Healthcare and Materials sectors both witnessed underperformance driven by stock selection versus sector allocations.

Notable outperformers included a fitness management software provider which acquired a wearable technology vendor to integrate with their client base. Another standout performer was a content and learning platform which is optimally positioned to address the student market by improving subscriber growth. Outside of the Technology space, we saw significant outperformance in an industrial distribution company that reported a robust 4Q due to strength in their oil and gas segment. Conversely, on the downside, a regional TV broadcaster detracted due to weaker core advertising growth coupled with a conservative 2018 guidance that pressured shares as a result. In the Materials sectors, a metal producer was affected by the recent tariff announcements and sold off dramatically as a result despite strong long-term fundamentals. Lastly, a pharmaceutical company reported strong earnings in 4Q but provided conservative guidance for 2018 which had negative implications.

Small to Mid Cap Equity

Our Small to Mid Cap Equity strategy modestly underperformed its benchmark, the Russell 2500 Index during 1Q. Top sector contributors in the quarter were the Information Technology, Real Estate, and Consumer Staples sectors. Internet marketplace companies performed strongly due to growing subscribers, higher rates, and expanding margins. Software companies benefitted from witnessing a mixed shift toward cloud subscriptions and away from traditional licensing sales, allowing for cash flow visibility with less reliance on securing service contracts. Our underweighting in the Real Estate and Consumer Staples sectors benefitted as rising rates and inflationary concerns weighed on these sectors. Top detractors to performance were the Consumer Discretionary, Financials, and Healthcare sectors. Tepid core advertising sales weighed on media companies including broadcast affiliates and over-the-top platforms. In Financials, an asset manager sold off due to concerns regarding risk parity strategies as market volatility accelerated during 1Q. Within Healthcare, a drug company underwent a disappointing FDA Advisory Committee review of a label expansion opportunity for one of their core products.

Mid Cap Equity

The Mid Cap Equity strategy slightly underperformed its benchmark, the Russell Midcap Index during 1Q. Top sector contributors to performance in the quarter were the Information Technology, Real Estate, and Utilities sectors. In the Information Technology sector, a social media company reported strong results driven by accelerating subscriber growth. The Mid Cap Equity strategy benefitted from its significant underweight to the Real Estate sector, which was pressured by a sharp increase in interest rates during the quarter. An electric utility company outperformed due to an improving pricing environment and optimism around synergy potential following a significant merger announcement. Top detractors to performance included the Energy, Industrials, and Consumer Discretionary sectors. Within Energy, an oil services provider experienced a disappointing forecast due to weather disruptions coupled with low visibility into the timing-of-day rate improvement for contract drilling. Within Industrials, a leading manufacturer of doors and windows reported softer than expected results amid higher freight and raw material costs and was further pressured by its CEO departure. Television broadcasters underperformed due to a lull in M&A activity and a sluggish near-term outlook for core advertising spend.

Outlook

In 2018, accelerating nominal Gross Domestic Product (GDP) growth should benefit cyclical sectors where our equity strategies tend to favor. Smaller, domestically-focused companies should benefit disproportionately from the new tax policy and should also outperform global large-cap companies, and in turn, could be negatively impacted by evolving trade policies. We expect spreads to decrease modestly in 2018 as the US economy absorbs future, measured Fed rate increases. We expect commodities to continue to rebound over the next year as supply and demand for oil and natural gas come into balance. Most of our equity strategies continue to underweight the defensive-oriented areas of the market that generally offer low earnings growth with high dividend payouts such as the Utilities, Consumer Staples, and Real Estate sectors. These sectors are more influenced by rising interest rates because of their increased cost of capital without the offset of growth in their earnings power. Rising rates will also make dividend yields less attractive as yields tend to rise on more traditional fixed income products.

Specialists in capital structure investing

At Penn Capital, we believe that understanding a company's entire capital structure is the best way to identify investment opportunities with the most value. In fact, we've found that managing bond portfolios makes us better equity managers, and vice versa. Employing a fully integrated credit and equity research process, we focus on non-investment grade companies in the micro to mid-capitalization range, where we can take advantage of inefficient security pricing. We are an independent, employee-owned boutique based in Philadelphia. We forge our own ideas, we respect hard work, and we are committed to our clients, our staff and our community.