Equity Strategies

Executive Summary

Interest rates and inflation expectations rose in 2Q 2018 (2Q) as the labor market continued to tighten and the Federal Reserve ("Fed") indicated rates will rise throughout 2018. Tax cuts for businesses and most individuals seem likely to boost economic growth, spur capital investment, and place upward pressure on inflation.

Overview

From March 2016 through the end of 2Q, the 10-Year US Treasury rate has increased from 1.77% to 2.86%. As these rates have risen, US high yield credit spreads tightened by approximately 375 basis points ("bp") over the 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. The Energy sector significantly outperformed the broader market during 2Q as oil prices rose and OPEC modestly increased their production goal. As commodity prices increased, the Industrials and Materials sectors lagged as higher input prices could impact margins.

Micro Cap Equity

Our Micro Cap Equity strategy underperformed its benchmark, the Russell Microcap Index during 2Q as top sector contributors included the Materials, Healthcare, and Utilities sectors. Materials benefitted as the implementation of steel tariffs provided significant outperformance for one of the strategy's holdings as profit margins expanded and steel prices remained elevated for this US steel producer. A top healthcare holding performed strongly as problems from a previous acquisition were rectified and expectations for increased revenues and margins improved for the balance of 2018. A utility company experienced improved performance as the company signed new water projects for the remainder of 2018. The top detractors to performance were the Energy, Financials, and Consumer Staples sectors. As oil prices accelerated from global supply disruptions, many energy companies with offshore exposure experienced the highest returns. The strategy invests in onshore land energy companies with stronger balance sheets and better growth dynamics which underperformed those companies during 2Q. The financial sector experienced weaker returns relative to their REIT counterparts as interest rates backed off their highs in May due to trade war fears that permeated the markets. Ultimately, we expect improved earnings and M&A to drive the sector as valuations are attractive and tangible catalysts outside of quantitative interest rate factors remain, further driving intra-quarter trading swings. Consumer staples underperformed driven by a holding impacted by negative swings in soft commodities affected by US agricultural tariffs placed on China.

Smaller Companies Growth Equity

Our Smaller Companies Growth Equity strategy outperformed its benchmark, the Russell 2000 Growth Index during 2Q as top sector contributors consisted of Consumer Discretionary, Industrials, and Healthcare. In Consumer Discretionary, the strategy benefitted from a casino operator acquisition resulting in a sizeable premium. In Healthcare, a services holding company benefited from strength in its pharmaceutical services segment and the announcement of a strategic partnership with a large contract research organization

(CRO), creating a significant revenue opportunity. In the Industrials space, a supplier of defense electronics experienced a weak 2Q, but recovered due to strong forward fundamentals and a robust free cash flow, despite the weaker quarterly report. The top detractors to performance were Information Technology and Consumer Staples sectors. In the Information Technology sector, a provider of inflight entertainment was negatively impacted by a shift in management as well as the ongoing trade wars involving a large Chinese supplier. In Consumer Staples, a coffee foodservice company experienced slower volume growth driven by declines stemming from two large customers.

Small Cap Equity

Our Small Cap Equity strategy outperformed its benchmark, the Russell 2000 Index in 2Q as top sector contributors were Consumer Discretionary, Healthcare, and Energy. In Consumer Discretionary, a theme park operator posted a solid quarterly earnings report as their organizational restructuring and prior capital investments both generated positive earnings. In Healthcare, a managed care company continued to build membership and control cost trends in the Medicare and Medicaid markets. In Energy, an offshore rig operator began to witness steady advances in demand due to improvements in the price of oil globally. The top detractors to performance were Materials, Real Estate, and Information Technology. In the Materials sector, a maker of silicon-based products was impacted by Chinese overproduction and lower demand from polysilicon producers. In Real Estate, our sizeable underweight to the sector was negatively impacted, as this segment of the small cap market was the second best performing sector in the Index. In addition, our lone Real Estate holding slightly underperformed. In the Information Technology sector, a provider of inflight entertainment was negatively impacted by a strategy shift enacted by management as well as the ongoing trade conflict involving a large Chinese supplier.

Small Cap Value Equity

Our Small Cap Value Equity strategy outperformed its benchmark, the Russell 2000 Value Index during 2Q, led by contributions from the Financials, Technology, and Industrials sectors. Financials outperformed as M&A activity accelerated in the regional banking sector, which is a trend we expect to continue as banks merge to gain scale and drive earnings growth. Smaller regional banks have more attractive growth prospects and better opportunity for consolidation relative to their larger peers. Technology was driven by the outperformance from a single holding that signed a contract with a large money center bank. Industrials benefitted as the transportation industry continued to drive higher rates with increased demand from a supply constrained industry. The top detractors to performance were the Energy, Real Estate, and Materials sectors. As oil prices accelerated from global supply disruptions, the most leveraged energy companies drove most of the performance in 2Q. The strategy invests in higher quality energy companies with more conservative balance sheets which led to the underperformance in the sector. The Real Estate sector experienced a strong rebound during 2Q, as trade wars influenced rates to back up significantly from their mid-quarter highs. However, our underweight to the sector, given valuations and lack of catalysts outside of the interest rate curve movements, caused underperformance during 2Q. Materials were underperformers during 2Q as fears of global trade wars impacted the outlook for Chinese growth which negatively impacted this sector. Ultimately, many of our Material sector holdings are aided by tariffs as they are US companies that have more domestic market exposure.

Small to Mid Cap Equity

Our Small to Mid Cap Equity strategy underperformed its benchmark, the Russell

2500 Index 2Q. Top sector contributors to performance were the Consumer Discretionary, Healthcare, and Real Estate sectors. In Consumer Discretionary, a ski resort company announced robust 2018/2019 season pass sales and a concert promotion and ticket processor firm enjoyed strong 2018 bookings. A streaming video player manufacturer performed well during 2Q as an increased number of users viewed more hours on their over-the-top platform. In Healthcare, a managed care company continues to build membership and control cost trends in the Medicare and Medicaid markets. In Real Estate, a corrections company saw increased demand from their facilities. The top detractors to performance were the Energy, Financials, and Materials sectors. In the Energy sector, a metallurgical coal company experienced production problems in a crucial mine which dragged performance. An asset manager saw net outflows during 2Q due to an institutional reallocation while a plastics company witnessed weakening volume trends as resin prices rose resulting in lower revenue.

Mid Cap Equity

TThe Mid Cap Equity strategy outperformed its benchmark, the Russell Midcap Index during 2Q, led by contributions from the Energy, Healthcare, and Consumer Discretionary sectors. Within the Energy sector, a leading offshore drilling contractor rallied amid rising crude oil prices and increased optimism around the long-term outlook for rig utilization and pricing. A provider of government-sponsored managed Healthcare services reported strong 1Q 2018 results and raised full year EPS (earnings-per-share) guidance driven by better-than-expected medical cost performance. In the Consumer Discretionary sector, a theme park operator reported double-digit attendance growth, exceeding market expectations, driven by enhanced marketing efforts and a strong reception to new rides and attractions. Top detractors to performance were the Information Technology, Industrials, and Real Estate sectors. Within Information Technology, a communications equipment supplier accepted a price concession from a large customer which effectively capped their revenue and gross margin potential for at least the next year. An Industrial equipment rental company lagged due to concerns that recently enacted tariffs could negatively impact business sentiment as well as uneasiness that the flattening yield curve suggests the commercial construction market may be at or near its peak. Our Real Estate allocation was detrimental as this segment of the market appreciated and was affected by our underweight positioning.

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 credit spreads to be range bound in 2018 as the US economy absorbs Fed rate increases. We continue to be overweight the US consumer as they stand to benefit from improving personal income, continued recovery in housing, and the "wealth effect" from a rising stock market. 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.

Please remember that past performance may not be indicative of future results. Different types of investments involve varying degrees of risk, and there can be no assurance that the future performance of any specific investment, investment strategy, or product (including the investments and/or investment strategies recommended or undertaken by Penn Capital), or any non-investment related content, made reference to directly or indirectly contained within this commentary be suitable for your portfolio or individual situation, or prove successful. Comparisons to indices are inherently unreliable indicators of future performance. The strategies used to generate the performance vary from those used to generate the returns depicted in the benchmarks. Penn Capital makes no representation as to the methodology used to generate the benchmark returns.

The Russell 2000® Index measures the performance of the small-cap segment of the U.S. equity universe. The Russell 2000 is a subset of the Russell 3000® Index representing approximately 10% of the total market capitalization of that index. It includes approximately 2000 of the smallest securities based on a combination of their market cap and current index membership. The Russell 2000 Index is constructed to provide a comprehensive and unbiased small-cap opportunity barometer and is completely reconstituted annually to ensure larger stocks do not distort the performance and characteristics of the true small-cap opportunity set. Investors cannot invest directly in an index.

The Russell 2500™ Index is composed of the bottom 500 stocks in the Russell 1000® Index and all the stocks in the Russell 2000® Index. The Russell 2500™ Index return reflect adjustments for income dividends and capital gains distributions reinvested as of the ex-dividend dates. Investors cannot directly invest in an index. The Russell 2000 Growth Index measures the performance of those Russell 2000 companies with higher price-to-book ratios and higher forecasted growth values. The Russell 2000 Value Index is comprised of the 2,000 smallest companies in the value sector of the Russell 3000 Index. The Russell Microcap Index includes the smallest 1,000 securities in the small-cap Russell 2000 Index plus the next 1,000 securities.

A copy of Penn Capital's current written disclosure statement discussing our advisory services and fees is available upon request.

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.

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