Equity Strategies

Executive Summary

Interest rates and inflation expectations rose in 3Q 2018 ("3Q") as the labor market tightened and the Federal Reserve ("Fed") continued to raise interest rates. We believe tax cuts for businesses and most individuals will boost economic growth, spur capital investing, and place upward pressure on inflation.

Overview

From March 2016 through the end of 3Q, the 10-Year US Treasury rate increased from 1.77% to 3.06%. 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 secular growth sectors of Information Technology and Healthcare outperformed in 3Q while the Energy and Materials sectors lagged the general market during this time period after experiencing gains in the previous quarter.

Micro Cap Equity

Our Micro Cap Equity strategy slightly underperformed its benchmark, the Russell Microcap Index, during 3Q led by Industrials, Financials, and Materials sectors. Industrials struggled during 3Q as tariffs threatened the margins of companies that import machined components from China. Financials detracted as rising deposit costs stoked fears of net interest margin compression in bank's profits going forward. The Materials sector was weak as trade wars with China ignited concerns of significantly slowing demand for many commodity materials.

Top contributors in 3Q included Consumer Discretionary, Healthcare, and Information Technology sectors. In the Consumer Discretionary sector, retail and restaurants performed strongly as consumer spending showed signs of considerable improvement during the period. In Healthcare, an orthopedics company was acquired at a premium as merger activity ramped up in 3Q. Performance in the Information Technology sector was driven by a payments processing company that reported strong quarterly results.

Smaller Companies Growth Equity

Our Smaller Companies Growth Equity strategy underperformed its benchmark, the Russell 2000 Growth Index, during 3Q principally due to stock selection within the Consumer Discretionary sector. Within the Energy sector, underperformance mainly stemmed from the strategy's overweight position. The Financial sector detracted primarily due to underperformance driven by stock selection versus sector allocations.

Notable outperformers include a specialty pharmaceutical concern focused on opioid-reducing strategies whose collaborative sales partnership with a major pharmaceutical peer is beginning to pay dividends with sales momentum fully underway. We experienced sizable outperformance in a pharmaceutical concern with exposure to the burgeoning cannabis industry. Another standout performer was a telecom carrier which provides a cloud-based communications platform for large enterprises in the US. Year-to-date this company has continued to execute and valuations have remained attractive on a price-to-sales basis. The strategy experienced significant outperformance in a leading provider of gaming equipment and cash services. We continue to favor their business due to the highly discounted nature of the FinTech segment as well as their continued ability to de-leverage, further improving their long-term valuation potential.

Conversely on the downside, a gaming concern led detractors during 3Q due to overall weakness in the gaming space

as well as the recent malaise occurring in companies with levered capital structures in general over the majority of 3Q. A gaming company was amongst the detractors for the quarter, impacted by weakness in the sector as well as execution issues that plagued its growth properties that has cast doubt on the optimism toward these projects. In Energy, we exited an exploration & production company after multiple quarterly disappointments culminating in a guidance reduction which called into doubt the company's prior growth outlook and the quality of its most recent acquisition. We had concerns with their ability to deliver its deleveraging program and created an inferior risk/reward scenario, in our opinion. Within the Materials sector, a specialty chemical producer was weaker on the heels of a disappointing business update relating to the closure of one of the company's titanium dioxide facilities, due to cost escalations and an extended timeline which was largely unanticipated. In the Home Improvement Retail space, a retailer underperformed due to concerns about tariffs on Chinese flooring products and unfavorable hurricane comparisons.

Small Cap Equity

Our Small Cap Equity strategy underperformed the Russell 2000 Index in 3Q as Consumer Discretionary was a sizeable laggard, due principally to stock selection, as was Financials and Industrials, both experiencing underperformance driven by stock selection versus sector allocations. Healthcare was the best performing sector for 3Q, followed by Technology and Communication Services.

Notable outperformers included a specialty pharmaceutical concern focused on opioid-reducing strategies whose collaborative sales partnership with a major pharmaceutical peer is beginning to pay dividends with sales momentum fully underway. Another standout performer was a theme park operator which has seen material increases in attendance and season passes, as well as continued de-leveraging and stellar capital allocation strategies to unlock further equity value. Outside of the Healthcare space, the strategy experienced outperformance in a movie theater chain that continues to see record box office numbers. Conversely on the downside, a gaming concern led detractors during 3Q due to overall weakness in the gaming space as well as the recent malaise occurring in companies with levered capital structures in general over the majority of 3Q. Within Materials sector, a specialty chemical producer was weaker on the heels of a disappointing business update relating to the closure of one of the company's titanium dioxide facilities, due to cost escalations and an extended timeline which was largely unanticipated. In the Homebuilding space, a provider of insulation installation services was impacted, softening housing data related to slowing new home sales in the face of rising interest rates and potentially deteriorating home affordability.

Small Cap Value Equity

Our Small Cap Value Equity strategy underperformed its benchmark, the Russell 2000 Value Index, during 3Q, led by Industrials, Financials, and Materials sectors. Industrials struggled during 3Q as tariffs threatened margins of companies that import machined components from China. Financials detracted as rising deposit costs stoked fears of net interest margin compression in bank's profits going forward. The Materials sector was weak as trade wars with China ignited concerns of significantly slowing demand for many commodity materials. Top contributors to performance in 3Q included Healthcare, Consumer Discretionary, and Information Technology sectors. In Healthcare, an orthopedics company was acquired at a premium as merger activity ramped up during the quarter. In the Consumer Discretionary sector, retail and restaurants performed strongly as consumer spending showed signs of considerable improvement. Performance in the Information Technology sector was driven by a payments processing company that reported strong quarterly results.

Small to Mid Cap Equity

Our Small to Mid Cap Equity strategy outperformed its benchmark, the Russell 2500 Index, in 3Q with contributions from the Information Technology, Industrials, and

Consumer Staples sectors. In the Information Technology sector, high growth consumer software companies reported strong subscription growth as well as usage. In the Industrials sector, a defense contractor reported solid backlog and sales growth in the quarter following a weak 2Q 2018 that challenged the stock. The strategy was underweight the Consumer Staples sector due to rising input costs and limited pricing power. The top detractors in 3Q were the Materials, Consumer Discretionary, and Energy sectors. In the Materials sector, a cement products company missed volume targets due to challenging weather conditions for construction in their markets. Within the Consumer Discretionary sector, a flooring retailer experienced margin compression due to an adverse shift toward lower margin products. Our Energy exposure detracted stemming from a Permian Basin based producer experiencing high transportation costs due to limited infrastructure which undermined their ability to ship resources to their market.

Mid Cap Equity

The Mid Cap Equity strategy underperformed its benchmark, the Russell Midcap Index, during 3Q as the top detractors included the Consumer Discretionary, Industrials, and Energy sectors. In the Consumer Discretionary sector, casino operators and equipment suppliers underperformed due to softening revenue trends on the Las Vegas strip and in Macau, as well as concerns that higher wages could shrink margins. Within Industrials, despite solid demand and tight capacity, a trucking company underperformed amid investor worries that the cycle is peaking which could pressure rates in 2019 and beyond. Within Energy, an exploration and production company was negatively impacted by lower natural gas prices for most of the quarter. Top contributors for the quarter were the Information Technology, Real Estate, and Consumer Staples sectors. In the Information Technology sector, an on-line dating company continues to outperform expectations as it finds new ways to monetize its brands by converting network participants into paying users. The strategy also benefitted being significantly underweight in both the Real Estate and Consumer Staples sectors, compared to the benchmark, which were pressured by rising interest rates.

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 for the remainder of 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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