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Executive Summary

Amid the COVID-19 outbreak, global markets experienced sharp losses during 1Q20 ("1Q") as pandemic concerns materialized and the economy swiftly began to price in the potential long-term and negative impacts. During the quarter, the broad-based S&P 500 Index fell -19.60% while the small-cap oriented Russell 2000 Index declined -30.61%.

Overview

Within the Russell 2000 Index, Energy was by far the worst performing sector after enduring a one-two punch from both supply shock (Russia-Saudi price war) and demand shock as more Americans worked from home and eschewed non-essential travel. The Consumer Discretionary sector underperformed as the US economy began to feel the effects of social distancing measures intended to flatten the curve of the virus with acute impacts felt across the travel, leisure, retail, and restaurant industries. The defensive-oriented Utilities and Healthcare sectors declined the least, although still posting double digit losses. Information Technology ("IT") and Consumer Staples also declined, but less than the overall small-cap index, as select companies were viewed as near-term beneficiaries of changes in consumer behavior (remote work, virtual calls/meetings, data consumption, food-at-home, pantry-loading).

The JP Morgan US High Yield ("HY") Index declined -14.30% in 1Q as spreads vaulted +525 bp during the quarter to finish at 949 bp. Underpinning the flight to safety, the 10-year US treasury yield plummeted from 1.92% to 0.67% during the quarter, although the 2-year vs. 10-year US treasury yield curve steepened modestly as the Federal Reserve ("Fed") aggressively cut rates.

Micro Cap Equity

Our Micro Cap Equity strategy underperformed its benchmark, the Russell Microcap Index, during 1Q as top detractors were led by the Healthcare, IT, and Consumer Discretionary sectors. In Healthcare, our lack of exposure to the highly speculative biotech sector, which was the strongest sub-sector in the quarter, contributed negatively to performance. As the world slowed from the COVID-19 pandemic, companies with little global economic risk performed the best including speculative biotech's that searched for the next vaccine to combat the coronavirus. In IT, an emerging fiber laser company was negatively impacted by the slowdown in China as it relates to semiconductor equipment and industrial CapEx. In Consumer Discretionary, our restaurant and casino holdings were essentially shut down as pandemic concerns forced most state governments to close all non-essential businesses. The Consumer Discretionary sector was one of the most impacted sectors during the quarter.

Top contributors included the Industrials, Real Estate, and Consumer Staples sectors. In Industrials, we harvested early 1Q profits from several companies that posted strong results as 2019 concluded on an upswing. A water industrial company closed significant new business wins after experiencing delays in the previous quarters. In Real Estate, a REIT focused on rental properties for the US government realized meaningful rent improvements as some development buildings were brought online late in the previous year. In Consumer Staples, our overweight to a strong defensive sector in the quarter aided performance in what was a very difficult period for equities overall.

Small to Micro Cap Equity

During 1Q, our Small to Micro Cap Equity strategy underperformed its benchmark, an even blend consisting of the Russell Microcap and Russell 2000 Indices. Top detractors to performance included the Healthcare, Consumer Discretionary, and Communications Services sectors. Within Healthcare, a pharmaceutical company underperformed following a surprise adverse legal decision regarding their patents for a key heart drug. In the Consumer Discretionary sector, gaming operators and suppliers were negatively impacted by casino closures due to COVID-19. While we remain optimistic that traffic will ultimately rebound, the temporary loss of revenue and associated cash burn will drive deteriorating credit metrics for leveraged companies. Within Communications Services, a television broadcaster lagged due to investor concerns about weakness in advertising (50% of revenue) due to COVID-19. We expect the remainder of the business (retransmission fees and political advertising) to continue to grow.

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Small to Micro Cap Equity (cont.)

The top contributors to performance were the Real Estate, Industrials, and IT sectors. In Real Estate, given near term pressure on casino traffic, the portfolio sold out of gaming operators and suppliers and acquired two gaming REITs that own hard assets and have more defensive income streams. In the Industrials sector, a construction services company reported solid fiscal 1Q results, reiterated full year guidance, and is benefitting from investor optimism regarding a potential Federal infrastructure spending program. Within IT, a semiconductor company successfully sold its foundry business providing for excess cash to pay down debt and fund growth investments.

Small Cap Equity

Our Small Cap Equity strategy underperformed its benchmark, the Russell 2000 Index, during 1Q. Top detractors to performance included the Healthcare, Consumer Discretionary, and Communications Services sectors. Within Healthcare, a pharmaceutical company underperformed following a surprise adverse legal decision regarding their patents for a key heart drug. In the Consumer Discretionary sector, gaming operators and suppliers were negatively impacted by casino closures due to COVID-19. While we remain optimistic that traffic will ultimately rebound, the temporary loss of revenue and associated cash burn will drive deteriorating credit metrics for leveraged companies. Within Communications Services, a television broadcaster lagged due to investor concerns about weakness in advertising (50% of revenue) due to COVID-19. We expect the remainder of the business (retransmission fees and political advertising) to continue to grow.

Top contributors to performance were the Real Estate, Consumer Staples, and IT sectors. Given near term pressure on casino traffic, the portfolio sold out of gaming operators and suppliers and acquired two gaming REITs that own hard assets and have more defensive income streams. In Consumer Staples, a warehouse club retailer reported better than feared 4Q19 same store sales while recent sales trends have accelerated significantly as consumers stock up on consumables (84% of the sales mix). Within IT, a leading provider of cloud software for contact centers rose on expectations benefitting from "work from home" demand and a ramp up of hotlines across different verticals.

Small Cap Value Equity

During 1Q, our Small Cap Value Equity strategy outperformed its benchmark, the Russell 2000 Value Index, as top contributors included the Real Estate, Materials, and Energy sectors. In Real Estate, the strategy capitalized on strong performing REITs including a healthcare services REIT and a REIT focused on developing building headquarters for various US government agencies. In Materials, we monetized strong performance in our gold mining companies that experienced benefits from both improved exploration activity and increasing gold prices. In Energy, our timely exit from the sector, prior to Saudi Arabia's declaration of massive production growth, aided the strategy by mostly avoiding exposure to the volatile oil industry.

Top detractors in 1Q were led by the IT, Healthcare, and Utilities sectors. In IT, a healthcare technology company suffered as revenue loss accelerated and new bookings slowed due to increased competition. In Healthcare, a lab testing company was negatively impacted as they focused on testing and treatment relating to COVID-19 while their other procedures were abandoned. In Utilities, one of our holdings failed to attain a rate case increase which negatively impacted their future earnings outlook.

Small to Mid Cap Equity

The COVID-19 quarantine is a unique demand shock to the US economy that we believe will create liquidity pressure on all US companies. Companies must have strong balance sheets and ready access to capital to weather this uncertain period. Every equity manager must become a credit manager in the short term which is our long-term approach to investing.

Lower oil prices, weak current demand and distressed industry credit spreads make the Energy sector practically uninvestable in the current market. We believe the Energy sector will need to go through a default cycle to reduce debt loads, shut in current resources, and reset contracts which will in the intermediate to long term lead to higher energy prices.

Small to Mid Cap Equity (cont.)

During 1Q, our Small to Mid Cap Equity strategy modestly outperformed its benchmark, the Russell 2500 Index, as the equity market sold off sharply in the last five weeks of the quarter. Market liquidation provided very high return correlations across small to mid cap stocks. The portfolio's defensive positioning was not fully rewarded due to the broad selloff.

The IT sector outperformed as a semiconductor's acquisition during the quarter cleared a key regulatory hurdle. In the Real Estate sector, a datacenter REIT experienced limited business disruption from the COVID-19 crisis. The Healthcare sector underperformed as a biopharma company received a negative judicial ruling on their heart drug patents. In the Financial Services sector, real estate insurance companies sold off due to fears of rising mortgage foreclosures.

The portfolio is focused on companies with strong balance sheets and liquidity profiles that can weather the current challenging environment and is overweight investment grade companies and businesses that have more cash than debt on their balance sheets.

The portfolio is increasing exposure to defensive sectors such as Utilities, Real Estate, and Consumer Staples that are less economically sensitive. The portfolio reduced exposure to Financial Services due to rising credit risk arising from the COVID-19 crisis as well as reducing our Consumer Discretionary sector weighting due to the widespread business shutdowns and employment uncertainty that will weigh on spending.

We will continue to utilize credit spreads to guide overall portfolio positioning, sector exposures, and security inclusion through a challenging market environment. We believe credit market indicators will provide useful signals regarding the timeframe and strength of recovery.

Mid Cap Equity

During 1Q, our Mid Cap Equity strategy underperformed the Russell Midcap Index as top detractors included the Consumer Discretionary, Financial Services, and Energy sectors. The Consumer Discretionary sector was heavily impacted when non-essential consumer businesses were shut down by public health officials. In the Financial Services sector, real estate insurers lagged due to slowing housing transactions and concerns that rising mortgage defaults could lead to higher claims activity. In Energy, oil prices sank due to pandemic demand shock coupled with an inability for OPEC+ producers to agree on reducing supplies. In response to the challenges in these three sectors, we reduced our exposure during the quarter.

Top contributors included the IT, Real Estate, and Consumer Staples sectors. In IT, a semiconductor company's acquisition cleared a key US regulatory hurdle allowing the transaction to close in early April 2020. In Real Estate, a refrigerated storage warehouse real estate investment trust benefitted as demand for fresh food deliveries continued while other areas of the economy were temporarily shut down. In the Consumer Staples sector, a club warehouse company benefitted as consumers began to consume more meals at home and reduced shopping trips due to pandemic concerns. The portfolio is focused on companies with strong balance sheets and resilient business models during this period of uncertainty.

Outlook

The COVID-19 pandemic is a global tragedy and the human toll, while already unthinkable, will undoubtedly get worse. Penn Capital's thoughts are with those who have been directly and indirectly affected by this crisis, as well as the nurses, doctors, and first responders battling on the front lines every day.

From an investment perspective, the performance of risk assets will likely hinge on the depth and duration of the outbreak which remains highly uncertain. At this time, we do not know how long certain businesses will be forced to remain closed, how long it will take consumers to resume old spending and behavior patterns once business reopens, how quickly businesses will re-hire furloughed workers, and the extent of damage to corporate and consumer balance sheets in the interim.

Despite this, there are reasons for guarded optimism. First and foremost, we have seen an unprecedented monetary and fiscal response to the pandemic.

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Outlook (cont.)

The Fed has essentially pledged to do whatever it takes to backstop market liquidity including buying investment grade corporate debt. Interest rates are likely to remain very low for quite some time. The federal government overcame bitter partisanship in order to pass a $2 trillion stimulus package, which while far from perfect, will help many hard-hit consumers and businesses weather the storm.

Despite a sharp sell-off in the HY debt market, a large cruise line company and two large restaurant companies were recently able to successfully issue new debt. Encouragingly, these offerings were significantly oversubscribed though came with higher interest costs and more protections for lenders than would have been necessary just two months ago.

In terms of positioning, we are leveraging our HY credit expertise to stress-test the balance sheets and liquidity of our portfolio companies. In certain cases, we have exited holdings that we deem to have an inadequate margin of safety and have top-graded the portfolio with ideas that have greater durability to withstand further near-term disruption while retaining upside leverage to an eventual recovery.

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.

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. 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. 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. The Russell Midcap Index measures the performance of the 800 smallest companies in the Russell 1000 Index, which represent approximately 25% of the total market capitalization of the Russell 1000 Index. The S&P 500 Index is a capitalization-weighted index of 500 stocks intended to be a representative sample of leading companies in leading industries within the U.S. economy. Investors cannot directly invest in an index.