# Executive Summary

As the COVID-19 crisis emerged domestically in March 2020, the US stock market began to sell off sharply as most of the economy went into shelter-in-place mandates to minimize the spread of the virus. Strong year-end returns created a challenging forward return environment for 2020, well before the COVID-19 crisis disrupted the US economy.

## Overview

During 2Q20 ("2Q"), small cap equities experienced a historic snapback with the Russell 2000 Index rallying 25.4% and recovering a significant portion of losses from the prior quarter. In many ways, 2Q was a mirror image of 1Q20 as the sectors hit hardest by the pandemic also led the way (Energy, Consumer Discretionary). The safe havens that held up best during the downturn in turn lagged during the 2Q rebound (Utilities, Consumer Staples). After exploding higher to a peak of 1,139 bp on March 23rd, the spread to worst on the JP Morgan US High Yield ("HY") Index declined to a trough of 625 bp on June 8th and ended the quarter at 722 bp. Still elevated vs. pre-COVID-19 levels but significantly improved, nonetheless.

Critically, we witnessed a wave of successful new debt issuance as companies worked to shore up balance sheets and extend their liquidity runway. While bankruptcy filings have increased, this was largely confined to companies already in distressed sectors such as Retail and Energy. Despite the classic risk-on rally, the 10-year US treasury yield declined slightly during 2Q; a divergence that bears monitoring. Economic activity ground to a near halt in late March as retailers temporarily closed their doors and consumers mostly stayed home focusing on immediate needs rather than wants.

In April, green shoots began to emerge and consumer spending in many areas improved sequentially for the remainder of 2Q. New home sales were quick to recover amid low mortgage rates, limited re-sale inventory, and renewed interest in suburban living. Low mortgage rates spurred a refinancing boom with consumers reinvesting monthly savings in home improvement projects and new furniture. Restaurants with proven off-premise models took market share (e.g. pizza delivery, fast food drive-through) while dine-in centric concepts pivoted to carry-out to lessen sales declines and cash burn. E-commerce, already a secular market share gainer vs. brick and mortar stores, notched higher as consumers were almost exclusively shopping online. While traditional travel and leisure spending remains severely depressed (e.g. cruises, hotels, airlines), boat and RV sales grew as socially distant alternatives and many casinos are now re-opening due to strong demand.

## Micro Cap Equity

Our Micro Cap Equity strategy underperformed its benchmark, the Russell Microcap Index, during 2Q as the equity market rose sharply due to unprecedented monetary and fiscal stimulus. The most impacted sectors – Healthcare and Consumer Discretionary – rallied for different reasons. Healthcare was led by biotechs, in particular by an exuberant amount of companies scrambling for the first coronavirus vaccine. Consumer Discretionary rebounded after being one of the most heavily impacted sectors from the previous quarter. The Material sector outperformed as new positions initiated in higher-margin higher-quality specialty chemical companies recovered considerably during 2Q. The Information Technology ("IT") sector also gained as a new position in a highly specialized laser company rebounded as their China-related business recovered quickly along with continued aerospace and defense wins in the US.

The underweight to Healthcare, especially in biotech, was the largest detriment to performance. Many of these companies are speculative and entered the race for the initial coronavirus vaccine. The market did not discriminate as biotechs experienced one of their most impressive quarters in history. Our strategy tends to avoid biotechs given their high cash burn rates and overall speculative characteristics.

The strategy is focused on companies with strong balance sheets and liquidity profiles that can weather the current challenging environment. The strategy is overweight companies with strong free cash generating capabilities, that have the ability to show highly improved metrics into a global economic recovery.

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## Micro Cap Equity (cont.)

We have identified companies that possess strong recovery capabilities in their cash flow characteristics as the economy slowly improves, prioritizing business activities that will rebound more quickly in a coronavirus world. Credit market indicators will provide useful signals regarding the timeframe and strength of the recovery.

## Small to Micro Cap Equity

During 2Q, our Small to Micro Cap Equity strategy outperformed its benchmark, an even blend consisting of the Russell Microcap and Russell 2000 Indices. Top contributors to performance were the IT, Communications Services, and Financials sectors. Within IT, a semiconductor device company drove strong revenue and cash flow growth as the company's technological advances expanded their total addressable market. In the Communications Services sector, a telecom services provider benefitted from telecommuting trends in the wake of the coronavirus. Within Financials, banks rebounded due to attractive valuations and improving economic activity though we remain watchful of credit quality.

Top detractors to performance were the Real Estate, Energy, and Healthcare sectors. In the Real Estate sector, a REIT focused on commercial property leased to US government agencies underperformed amid a market rotation away from defensive businesses. Within Energy, an oil services company focused on the relatively less cyclical production phase of a well lagged risk-on rally that favored energy companies with higher commodity sensitivity and operating leverage. Within Healthcare, a specialty pharmaceutical company reduced guidance due to headwinds related to COVID-19 as well as stronger than expected competition for a key product.

## Small Cap Equity

Our Small Cap Equity strategy outperformed its benchmark, the Russell 2000 Index, during 2Q. Top contributors to performance were the Financials, Communications Services, and Consumer Discretionary sectors. Within Financials, banks rebounded due to attractive valuations and improving economic activity though we remain watchful of credit quality. In the Communications Services sector, a television broadcaster provided forward guidance for positive free cash flow each quarter this year despite disruption in advertising spending tied to the pandemic. Within Consumer Discretionary, an on-line education platform continued to experience strong subscriber and revenue growth, particularly as students transitioned to remote learning.

The top detractors to performance were the Energy, Industrials, and Real Estate sectors. Underperformance in the Energy sector stemmed from an allocation effect as the strategy was modestly underweight the sector as it outperformed within the benchmark. Within Industrials, a maker of computer-based testing and simulation systems underperformed due to investor concerns that a weak macro backdrop will pressure auto and other industrial capital expenditures. In Real Estate, a REIT focused on commercial property leased to US government agencies underperformed amid a market rotation away from defensive businesses.

## Small Cap Value Equity

Our Small Cap Value strategy outperformed its benchmark, the Russell 2000 Value Index, during 2Q as the equity market rose sharply due to unprecedented monetary and fiscal stimulus. The most detrimentally impacted sectors of the last quarter – Energy and Consumer Discretionary – rallied as investors anticipated a V-shaped recovery. Although the strategy lacked exposure to energy and maintains lower consumer exposure, we significantly outperformed in 2Q. The Material sector outperformed as new positions initiated in higher-margin higher-quality specialty chemical companies recovered considerably during 2Q. The IT sector also gained as a new position in a highly specialized laser company rebounded as their China-related business recovered quickly along with continued aerospace and defense wins in the US.

The underweight to Consumer Discretionary and Energy sectors was the biggest detractor to performance. Although these two sectors were significantly impacted by the pandemic, they were able to recover. Our cash flow analysis caused us to remain cautious as balance sheets in these sectors continued to deteriorate as many businesses exhausted cash during 2Q and took on new debt.

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## Small Cap Value Equity (cont.)

The strategy is focused on companies with strong balance sheets and liquidity profiles that can weather the current challenging environment. The strategy is overweight companies with strong free cash generating capabilities, that have the ability to show highly improved metrics into a global economic recovery. We have identified companies with strong recovery capabilities in their cash flow characteristics as the economy slowly improves, prioritizing business activities that should rebound more quickly in a coronavirus world. Credit market indicators will provide useful signals regarding the timeframe and strength of the recovery.

## Small to Mid Cap Equity

Our Small to Mid Cap Equity strategy underperformed its benchmark, the Russell 2500 Index, during 2Q as the equity market rose sharply due to unprecedented monetary and fiscal stimulus. The most impacted sectors – Energy and Consumer Discretionary – rallied as investors anticipated a V-shaped recovery as pandemic restrictions were eased across the country. The Financial Services sector outperformed due to underweighting the bank industry and selectively overweighting insurance companies. Banks provided customers short term relief but will see rising credit losses over time. Insurance companies benefitted from improving credit and equity markets supporting their profitability. The Consumer Discretionary sector underperformed due to underweighting the consumer services and retailing industries that strongly rebounded during 2Q despite experiencing closures or limited services.

The Federal Reserve ("Fed") has basically backstopped investment grade companies via programs that purchase existing bonds and provide direct lending to these companies. Higher credit quality companies have a clear advantage compared to smaller competitors through this period. Regulator efforts have allowed most public companies to maintain liquidity in the short term. Companies are increasing debt levels while underlying cash generation has slowed due to the impact of the COVID-19 crisis. While this has provided short term relief, companies must prove their solvency over time by paying down their borrowings through cash generation. Government intervention is attempting to stave off a default cycle. Their actions will not eliminate the credit cycle but will buy time for companies. Some companies will utilize this liquidity opportunity to refocus and recover, however, weaker balance sheets will fail over the intermediate term in our opinion.

The strategy is focused on companies with strong balance sheets and liquidity profiles that can weather the current challenging environment. The strategy is overweight investment grade companies and businesses that have more cash than debt on their balance sheets. If these companies incrementally borrow, their balance sheets will continue to be strong. We will continue to utilize credit spreads to guide overall portfolio positioning, sector exposures, and security inclusion through a challenging market environment. Credit market indicators will provide useful signals regarding the timeframe and strength of recovery.

## Mid Cap Equity

During 2Q, our Mid Cap Equity strategy underperformed its benchmark, the Russell Midcap Index, as the equity market rallied sharply due to unprecedented monetary and fiscal stimulus. Top detractors to performance in 2Q included the IT, Real Estate, and Financial Services sectors. In IT, high valuation SaaS software companies outperformed sharply; a sector the strategy was moderately underweight. In Real Estate, a data center REIT underperformed the broader market due to its defensive characteristics. In Financial Services, life insurance companies lagged as lower long-term interest rates weighed on future investment income.

The top contributors to performance were the Communication Services, Industrials, and Consumer Staples sectors. In Communication Services, an internet marketplace company spun its largest investment to shareholders unlocking a conglomerate discount in the share valuation. In Industrials, a plumbing and paint company enjoyed strong sales as consumers focus on home improvement projects. In Consumer Staples, a club warehouse realized strong membership gains as their business model resonated with young families. Our strategy is focused on companies with strong balance sheets and resilient business models during this period of uncertainty.

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## Outlook

Overall, we have been encouraged and surprised by the pace of the economic rebound while fully acknowledging the mounting degree of difficulty given the recent rise in COVID-19 cases and hospitalizations. The spending surge in May and June may not be sustainable as it benefitted from pent-up demand, one-time stimulus checks, and temporarily increased unemployment benefits. Corporations will remain conservative in terms of re-hiring as they right-size cost structures for lower demand levels; capital spending will likewise be restrained for at least the balance of 2020. On the positive side, the swift rebound in HY market levels and strong demand for new debt issues (no doubt aided by the Fed's purchase of HY ETFs and individual bonds) has significantly lessened the probability of a corporate liquidity crunch and widespread bankruptcies which is clearly positive for small cap equity valuations.

We expect the Fed's interest rate policy to remain highly accommodative for the foreseeable future. Another round of US government stimulus is possible, though it is unlikely to be as large as the initial package. It goes without saying that any progress on a COVID-19 vaccine and/or therapeutics would be welcomed by the financial markets. While the recovery may prove to be a bit more uneven, we remain cautiously optimistic and believe corporate and consumer resilience will continue to surprise to the upside. Given our focus on bottom up fundamental research and differentiated corporate credit analysis, we believe this outlook provides a fertile environment for Penn Capital's strategies.

### 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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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.

A copy of Penn Capital's current written disclosure statement discussing our advisory services and fees is available upon request. PC-EQTYCOM071320