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Executive Summary

Risk assets rallied in 4Q 2019 (“4Q”) as near-term recession fears receded in the wake of a “Phase One” US-China trade deal, a strong holiday shopping season, continued low unemployment / positive wage growth, and a steepening of the yield curve.

Overview

After briefly rising at the onset of October, US high yield (“HY”) credit spreads plunged in December closing near year-end lows. The HY rally in December was led by CCC-rated bonds, reversing stark underperformance vs. BB-rated bonds year-to-date (“YTD”) through November 2019. The US 10-year treasury yield increased from 1.65% to 1.92% during 4Q and the yield curve (10-year vs. 3-month) dis-inverted on October 11th.

Small cap growth stocks outperformed small cap value stocks led by Healthcare and Information Technology (“IT”) sectors while classically defensive and interest rate sensitive groups lagged (Utilities, Consumer Staples, and Real Estate). After trailing large caps significantly YTD through 3Q19, small caps turned the tables in 4Q19 as the Russell 2000 Index outpaced the S&P 500 Index.

Micro Cap Equity

Our Micro Cap Equity strategy underperformed its benchmark, the Russell Microcap Index, during 4Q as top detractors were led by the Healthcare, Communication Services, and Consumer Staples sectors. In Healthcare, our lack of exposure to the highly speculative biotech sector, which was the strongest sub-sector of 4Q, contributed negatively to our relative performance. In Communication Services, a publishing and digital company suffered a business unit impairment which negatively impacted the stock’s valuation. In Consumer Staples, an agricultural business suffered as corn and ethanol prices remained depressed during the Chinese and US trade negotiations.

Top contributors in 4Q included the Materials, IT, and Consumer Discretionary sectors. In Materials, two gold mining positions significantly added to performance as their activities were boosted in order to increase production. In IT, one of our communications companies entered a joint venture with a significant competitor which drove the stock higher. In Consumer Discretionary, a nursing education company significantly expanded their student base by adding more programs and witnessing strong results from their digital advertising initiatives. During 4Q, the strategy increased its weighting to the Materials and IT sectors while decreasing its weighting to the Industrials and Financials sectors.

Small to Micro Cap Equity

During 4Q, our Small to Micro Cap Equity strategy outperformed its benchmark, an even blend consisting of the Russell Microcap and Russell 2000 Indices. Top contributors were the Consumer Discretionary, IT, and Financial sectors. Within Consumer Discretionary, a casino company’s shares rallied after announcing lucrative sports betting agreements with three partners. Within IT, a semiconductor company beat street expectations for 4Q19 and raised guidance benefitting from stabilized NAND prices / favorable demand elasticity, market share gains in notebooks and smartphones, and an expected recovery in SSD solutions. In Financials, a provider of transaction-driven marketing solutions outperformed as bank customers increased usage of the company’s banking rewards platform.

Top detractors included the Healthcare, Energy, and Materials sectors. Within Healthcare, a diagnostics company underperformed amid investor concerns about a deteriorating reimbursement outlook and increased competition from larger players that could threaten market share. In the Energy sector, a services provider reduced its guidance due to a sharper-than-expected slowdown in US land activity and a slower offshore project pipeline. Within Materials, a concrete company reported a difficult quarter on the back of slowing projects in Manhattan and West California, higher cement prices in Texas, and deferred shipments of aggregates.

Small Cap Equity

Our Small Cap Equity strategy outperformed its benchmark, the Russell 2000 Index, during 4Q as top contributors included the Consumer Discretionary, IT, and Financials sectors. In the Consumer Discretionary sector, a gaming industry supplier reported impressive 3Q19 results marked by revenue acceleration in its gaming equipment and cash access businesses. The company capitalized on strong stock price performance with an equity raise that will fund balance sheet de-leveraging. Within IT, a semiconductor company beat street expectations for 4Q19 and raised guidance benefitting from stabilized NAND prices / favorable demand elasticity, market share gains in notebooks and smartphones, and an expected recovery in SSD solutions. In the Financial sector, a regional bank successfully offset net interest margin compression with stronger than expected loan growth and effective management of credit risk.

Top detractors included the Healthcare, Consumer Staples, and Materials sectors. Within Healthcare, a provider of clinical software and other solutions underperformed as the market remains skeptical of their ability to drive a sustainable acceleration in revenue growth. In the Consumer Staples sector, an operator of warehouse club retail stores missed street expectations for same store sales due to softer traffic early in 3Q19 amid poor weather and an unfavorable comparison vs. a successful promotion in the prior year. A distributor of roofing materials reported disappointing F4Q19 results and declined to offer forward guidance as a rebound in residential roofing volumes was not enough to offset competitive pricing pressure.

Small Cap Value Equity

During 4Q, our Small Cap Value Equity strategy slightly underperformed its benchmark, the Russell 2000 Value Index, as top detractors in 4Q were led by the Healthcare, IT, and Industrials sectors. In Healthcare, an IT company suffered as earnings failed to accelerate as previously anticipated. In IT, our underexposure to semiconductors, which was a strong subsector, negatively impacted compared to our relative performance. In Industrials, a defense supplier encountered integration issues with a recent acquisition and adjusted expectations. During 4Q, the strategy increased its weighting to the Consumer Discretionary and Real Estate sectors while decreasing its weighting to the Financials and Utilities sectors.

Top contributors included the Financials, Materials, and Real Estate sectors. In Financials, a large regional bank position was acquired by a larger bank at a premium. In Materials, select gold mining positions significantly added to performance as activity was ramped up in prospective new mines. In Real Estate, a government building REIT increased their dividends as development projects were completed and rents increased on new assets.

Small to Mid Cap Equity

Our Small to Mid Cap Equity strategy slightly underperformed its benchmark, the Russell 2500 Index, during 4Q as the equity market rallied into year-end reversing the weak market backdrop of the prior year-end. Small to mid cap stocks and credit spreads weakened sharply in August before rallying in September. Within the strategy's Healthcare sector, an electronic health record technology company underperformed due to reports of weaker operating margins stemming from IT investments. In the Real Estate sector, a network-neutral data center company remained independent after acquisition consideration.

The Communication Services sector outperformed during 4Q as a media company reported strong subscription figures from their satellite radio division and improved profitability within a popular streaming music service. In the IT sector, a semiconductor company announced growing backlog and content sales relating to their 5G network and handset customers.

Credit spreads, particularly in lower quality companies, tightened rapidly in December 2019 providing less room for significant improvement as we enter 2020. A sustained lower credit risk environment in 2020 would be beneficial for smaller cap stocks as compared to mid caps. The Federal Reserve ("Fed") would like to witness higher levels of inflation which should support a rising cost environment. This may benefit commodity suppliers and pressure margins for their industrial customers and for companies with tight labor pools. Trade uncertainties and slowing economic indicators are becoming apparent via corporate earnings.

Small to Mid Cap Equity (cont.)

We believe forward guidance regarding earnings prospects post trade policy adjustments will drive 2020 fundamentals.

The strategy is defensively positioned relative to its benchmark based on muted topline growth and low earnings visibility for companies in our investable universe. Incrementally investing in early cyclical and commodity companies could lead the stock market if inflation rises. We may witness a rotation away from high growth / high valuation areas of Technology and Healthcare if cyclical areas indicate improvement. The strategy has reduced exposure to interest rate sensitive areas, such as Utilities, based on the prospect of incrementally higher interest rates.

Mid Cap Equity

During 4Q, our Mid Cap Equity strategy outperformed the Russell Midcap Index as the best performing sectors included Consumer Discretionary and Communication Services sectors. Within Consumer Discretionary, an eyeglass retailer provided solid same store sales guidance and assuaged concerns regarding their joint venture with a big box retailer. Improving US-Chinese relations provided optimism regarding the Macau operations of a multinational casino company. Within Communication Services, a satellite radio company experienced strong subscriber group and improved the profitability of their recently acquired internet radio subsidiary. Top detractors included the Healthcare and Consumer Staples sectors. Within Healthcare, an IT firm reported weaker results due to incremental capital investments in their systems. In Consumer Staples, a warehouse club reported disappointing same store sales due to weak apparel sales.

Outlook

While we continue to monitor credit markets for budding weakness, the outlook remains generally favorable for our equity strategies given our focus on fundamental bottom-up stock selection and differentiated corporate credit research. HY spreads are approximating 15-month lows and credit issuers are easily able to access the market to refinance debt, fund internal growth initiatives, or finance acquisitions. Corporate credit fundamentals are solid with reasonable balance sheet leverage, strong interest coverage, and low default rates. Consumer spending (~70% of GDP) is healthy underpinned by a tight labor market. New home construction continues to improve driven by demographics, low interest rates, and a strong economy. Affordability remains a constraint as builders work to shift to more entry-level homes which extended the duration of the recovery. While business investments have lagged, we are hopeful that reduced trade uncertainty could loosen corporate purse strings in 2020.

Finally, the Fed appears more likely to cut interest rates in response to real or perceived economic weakness as opposed to raising rates in the case of faster growth or higher inflation. In our view, key risks to our expectation for continued modest positive GDP growth would be regression on trade talks, geopolitics, and the toxic domestic political environment. Despite posting strong absolute returns in 2019, small cap stocks remain historically cheap relative to large caps stocks. Further, we continue to believe value is inexpensive vs. growth and cyclicals are cheap compared to defensive-oriented equities.

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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. Investors cannot directly invest in an 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.

A copy of Penn Capital's current written disclosure statement discussing our advisory services and fees is available upon request. PC-EQTYCOM011420

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.

