Equity Strategies

Executive Summary

Trade clashes between the US and Chinese governments coupled with concerns regarding a tightening monetary policy sharply spiked risk aversion during 4Q 2018 ("4Q"). Global supply chains were reexamined as the potential tariff regime requires companies to contemplate moving product sourcing, raising prices, or absorbing higher costs that typically reduce profit margins.

Overview

In 2018, the Federal Reserve raised interest rates four times and allowed up to $50b of securities to mature monthly. US high yield credit spreads widened by approximately 200 basis points during 4Q which is the weakest quarter since 3Q 2011. The 10-year US Treasury yield decreased from 3.09% to 2.69% during 4Q as economic concerns mounted. Historically, our equity strategies have performed well when either credit spreads tighten or interest rates rise, which we believe is a clearly favorable environment. Overall, defensive sectors consisting of Utilities, Consumer Staples, and Real Estate, outperformed in 4Q due to rising uncertainty. The Energy sector significantly lagged broader markets as oil prices fell amid rising US production.

Micro Cap Equity

Our Micro Cap Equity strategy performed in line with its benchmark, the Russell Microcap Index during 4Q. Top contributors included Healthcare, Consumer Discretionary, and Energy sectors. In Healthcare, our concentration on cash flow generative companies versus our underexposure to biotech related companies generated a significant amount of outperformance in 4Q. In Consumer Discretionary, a direct-to-consumer meal alternative company was acquired for a significant premium. Within Energy, our underweight to the oil service sector resulted in strong relative performance versus the index. Top detractors were the Materials, Industrials, and Financials sectors. In Materials, a phosphate company experienced factory outage issues resulting in increased volatility. In the Industrials sector, several trucking companies were impacted by higher operating costs as driver wages and higher insurance costs impacted business. The financials of these trucking companies were generally impacted by rising deposit costs which caused margin compression, although credit remained generally healthy. In 4Q, our strategy increased its weighting to the Industrials, Healthcare, and Technology sectors while decreasing the weighting to the Consumer Discretionary, Financials, and Materials sectors.

Smaller Companies Growth Equity

Our Smaller Companies Growth Equity strategy underperformed its benchmark in 4Q, the Russell 2000 Growth Index, with top detractors stemming from the Communication Services, Financials, and Energy sectors. In Communication Services, a provider of transaction-driven marketing solutions saw a sizable revenue miss due to lack of participation by advertisers. Lower rate expectations dampened the Financials sector in 4Q with one regional bank experiencing significant margin compression in the quarter. In Energy, an offshore rig provider was negatively impacted by declining oil prices in 4Q as the potential for a slowdown raised concerns on tendering new rigs. Contributors in the quarter were concentrated to the Healthcare, Industrials, and Real Estate sectors and were primarily driven by strong stock selection. In Healthcare, a biopharmaceutical company rose on better than expected results from their kidney cancer treatment drug, resulting in higher prescriptions in 4Q. In Industrials, a provider of air cargo services announced a large contract with Amazon which benefitted the stock. Lastly, a triple-net-lease REIT company experienced higher than anticipated same-store cash net operating income and lower expenses, while occupancy rates hovered at 100%.

Small Cap Equity

Our Small Cap Equity strategy underperformed the Russell 2000 Index in 4Q. The top detractors to performance were Information Technology, Financials, and Energy. In the Information Technology sector, a software company posted modest earnings, however, the company disclosed weak order figures which negatively impacted the stock. Lower rate expectations dampened the Financials sector in 4Q with one regional bank experiencing significant margin compression. In Energy, an offshore rig provider was negatively impacted by declining oil prices in 4Q as the potential for a slowdown raised concerns on tendering new rigs. Top contributors were focused within the Healthcare, Communications Services, and Industrials sectors. In Healthcare, a biopharmaceutical company rose on better than expected results from their kidney cancer treatment drug, resulting in higher prescriptions in 4Q. In Communications Services, an application software company made a sizable acquisition that will assist to accelerate the company's shift to live services and focus on higher quality and more complex video games. In Industrials, an intermodal container company experienced better than expected utilization and leasing returns that drove a stellar earnings report in the quarter.

Small Cap Value Equity

Our Small Cap Value Equity strategy slightly underperformed its benchmark in 4Q, the Russell 2000 Value Index. Top contributors included Energy, Healthcare, Real Estate sectors. In the Energy sector, our underweight to oil exploration & production companies, as well as drilling companies, added significant outperformance during the quarter. In Healthcare, one of our diagnostic companies sold a small portion of its business for the equivalent of half their market capitalization. In the Real Estate sector, our exposure to healthcare-related real estate contributed to strong performance in 4Q. The top detractors to performance were the Financials, Utilities, and Consumer Discretionary sectors. In Financials, banks were impacted by rising funding costs which negatively impacted margins as credit remained very stable. In the Utilities sector, our underweighting during a declining rate period contributed to underperformance. In Consumer Discretionary, one retailer was impacted by poor merchandise stocking during the strong holiday period. During the quarter, the strategy increased its weighting to the Utilities, Real Estate, and Industrial sectors while decreasing its weighting to the Consumer Discretionary, Energy, and Materials sectors.

Small to Mid Cap Equity

Our Small to Mid Cap Equity strategy outperformed its benchmark, the Russell 2500 Index during 4Q. Top contributors included Energy, Healthcare, and Information Technology sectors. In the Energy sector, a natural gas exploration and production company benefitted from rising natural gas prices due to cold weather and low inventories. In the Healthcare sector, a biopharmaceutical company reported accelerating sales for its tyrosine kinase inhibitor which is prescribed to renal cancer patients. The Information Technology sector experienced a boost as a software company for customer service centers announced stronger sales and bookings as their market share grew versus legacy incumbent providers. The top detractors to performance were the Financials, Industrials, and Consumer Discretionary sectors. Within Financials, regional banks experienced net interest margin pressure due to increasing deposit competition. In the Industrials sector, a construction equipment company was negatively impacted over slower construction activity due to higher interest rates and trade uncertainties. The Consumer Discretionary sector weighed on gaming companies as economic uncertainties prevailed. During 4Q, the strategy increased its weighting to the Utilities, Real Estate, and Healthcare sectors while decreasing its weighting to the Industrials, Consumer Discretionary, and Communication Services sectors.

Mid Cap Equity

Our Mid Cap Equity strategy underperformed its benchmark, the Russell Midcap Index, during 4Q as top detractors included Energy, Consumer Discretionary, and Information Technology sectors. Energy producers and service providers were broadly impacted by the significant decline in crude oil prices during the quarter. In Consumer Discretionary, an apparel maker reported higher results in 3Q 2018 (3Q) and raised full year guidance driven by strength in its wholesale business, however, the retail segment stumbled and disappointed investors. Within Information Technology, a provider of electronic payment solutions missed consensus expectations for 3Q and reduced full year guidance, this was primarily driven by unfavorable foreign currency and divestitures as underlying business trends were in-line. Top contributors to performance were Industrials, Healthcare, and Materials sectors. Within Industrials, a logistics services company rebounded following a negative report from an activist investor that was widely criticized as inaccurate coupled with the company announcing a sizable share repurchase authorization. In the Healthcare sector, a medical equipment maker delivered sequential improvement in organic growth driven by new products and favorable deals in the breast health business. The outperformance in the Materials sector was driven by allocation effect as the strategy was underweight and underperformed modestly.

Outlook

Shortly after 4Q-end, the equity and high yield markets showed signs of a rebound, reflecting incrementally more dovish Fed commentary, optimism regarding US-China trade discussions, a very strong December 2018 employment report, and a recovery in oil prices following OPEC production cuts. We believe the domestic economy remains strong, supported by low unemployment, improving wage growth, elevated confidence, relatively low interest rates, and rising home values. Market volatility experienced in 4Q did little to dampen consumers' enthusiasm (ex. a popular credit card company reported a nearly 5% increase in holiday sales, their largest year-over-year increase since 2011). We expect the economy to remain healthy in 2019, but growth will decelerate as we lap benefits from the 2018 Tax Cuts & Jobs Act. A moderate pace of economic expansion sets the stage for a continuation of the current credit cycle. We believe high yield spreads will drift lower which is supportive of equity valuations. Key downside risks to this outlook include a re-escalation of trade tensions, a Fed policy mistake, further Washington dysfunction, and slowing economic conditions outside the US (China in particular).

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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