PENN CAPITAL

Executive Summary

The Russell 2000 Index, a proxy for small cap equities, declined -7.53% in 1Q22 ("1Q") as investor concerns around tightening US monetary policy and Russia's unprovoked and deadly invasion of Ukraine overwhelmed the strong job market and re-opening optimism. In response to broadening inflationary pressures, the Federal Reserve ("Fed") ended their asset purchase program, raised interest rates and signaled plans to begin shrinking its balance sheet which stoked fears of a policy mistake and started an eventual US recession. Russia's attack on Ukraine has quickly become a human tragedy on a massive scale and threatens to exacerbate inflation (particularly gasoline and food) and further weigh on global economic growth.

Overview

The impact of the pandemic appears to be dissipating as people are beginning to more definitively return to socializing, travel and in-person work. The 10-year US Treasury yield rose from 1.52% at the end of December to 2.32% by the end of March. Discounting stepped-up macro risks, the US Treasury yield curve (2's vs. 10's) flattened throughout the quarter and briefly inverted on April 1st. Rising rates applied pressure on longer duration small cap growth stocks, which underperformed small cap value stocks by over 10% in the quarter. Large cap stocks outperformed small caps as the S&P 500 Index declined 4.6% in 1Q.

Amid already tight supply-demand conditions, crude oil prices marched steadily higher in January and early February then proceeded to spike following the Russian invasion. Energy, Utilities and Basic Materials sectors outperformed while Healthcare, Information Technology ("IT") and Consumer Discretionary lagged. High yield ("HY") spreads were remarkably well-behaved in the face of macro uncertainty as the spread-to-worst on the JP Morgan US HY Index increased only modestly from 375 bps to 399 bps during 1Q. BB-rated bonds underperformed single-B and CCC rated bonds due to higher interest rate sensitivity. HY conditions remain largely favorable and the new issue market is active.

Micro Cap Equity

Our Micro Cap Equity strategy outperformed its benchmark, the Bloomberg Micro Cap Index, during 1Q with top contributors including the Materials, Healthcare and IT sectors. Within Materials, our gold exploration companies performed extremely well as demand for the commodity increased with the escalation of geopolitical tensions. In Healthcare, our exposure to surgical device companies outperformed as surgical procedures accelerated while Covid hospitalizations decreased. In IT, a payments technology company significantly improved its outlook for growth which strongly contributed to performance.

The strategy experienced underperformance in the Energy, Communication Services and Consumer Staples sectors. Within Energy, our underweight position was a significant allocation detractor as oil prices rallied significantly after Russia's attack on Ukraine. Within Communication Services, our exposure to online travel companies underperformed as lingering impacts of Covid negatively impacted booking trends. In the Consumer Staples sector, many holdings continued to struggle from supply chain challenges and inflationary pressures which negatively impacted their earnings trajectory.

Small to Micro Cap Equity

The Small to Micro Cap Equity strategy outperformed its benchmark, a mix of the Bloomberg 2000 and Bloomberg Micro Cap Indices, during 1Q. Top contributors included the Healthcare, Energy and IT sectors. Within Healthcare, a maker of diagnostic medical imaging products guided for FY22 revenues well in excess of Street expectations driven by surging demand for its new imaging agent for detection of prostate cancer. In the Energy sector, a provider of oilfield services rallied amid rising commodity prices and optimism that tight pressure-pumping supply/demand dynamics would fuel favorable pricing. Within IT, a maker of high-resolution 3D lidar sensors guided FY22 revenue ahead of consensus driven by broad-based demand across its auto, robotics, industrial and smart infrastructure end markets.

Small to Micro Cap Equity (cont.)

Top detractors to performance included the Consumer Discretionary, Utilities and Real Estate sectors. Within Consumer Discretionary, an online gaming company reported lower than expected 4Q21 sales and EBITDA amid heightened competition and higher investment spending tied to new market launches. In the Utilities sector, underperformance stemmed from an allocation effect as the strategy was underweight the sector which outperformed. Within Real Estate, a commercial real estate advisory firm delivered solid 4Q21 results, although underperformed as initial FY22 guidance calls for slowing growth against more difficult prior year comparisons.

Small Cap Equity

The Small Cap Equity strategy significantly outperformed its benchmark, the Bloomberg 2000 Index, during 1Q. Top contributors to performance included Healthcare, IT and Communications Services sectors. Within Healthcare, a maker of diagnostic medical imaging products guided for FY22 revenues well in excess of Street expectations driven by surging demand for its new imaging agent for detection of prostate cancer. In the IT sector, a provider of technology solutions to the global travel and tourism industry rallied amid accelerating momentum in corporate and leisure travel demand post-Omicron. In Communications Services, a television broadcasting company outperformed due to expectations for robust political ad spending, improving auto advertising, growing net retransmission fee revenue and strong free cash flow.

Top detractors to performance were the Consumer Discretionary, Utilities and Real Estate sectors. Within Consumer Discretionary, an online gaming company reported lower than expected 4Q21 sales and EBITDA amid heightened competition and higher investment spending tied to new market launches. Within Utilities, underperformance stemmed from an allocation effect as the strategy was underweight the sector which outperformed. In the Real Estate sector, a commercial real estate advisory firm delivered solid 4Q21 results although underperformed as initial FY22 guidance calls for slowing growth against more difficult prior year comparisons.

The strategy remains overweight the Energy sector where fundamentals were favorable prior to the Russian invasion of Ukraine. Oil demand is steadily improving due Covid lockdowns ending and pent-up business/leisure travel demand. Supply is struggling to keep pace due to environmental concerns, increased regulation, capital starvation and a focus on shareholder returns over production growth for many exploration and production companies. The sector is under-owned by institutional investors and valuations are cheap relative to strong earnings and free cash flow. While rising oil prices are a headwind to spending and sentiment, inflation-adjusted oil prices are still low relative to history and we believe the consumer is strong enough to handle higher prices. The strategy continues to be overweighted the Consumer Discretionary sector, although we have tactically reduced our exposure to consumer goods in favor of service providers that we believe will benefit from re-opening and improving mobility post-pandemic. We are bullish on concepts that provide great value and are likely to gain market share in an inflationary environment.

Small Cap Value Equity

The Small Cap Value strategy outperformed its benchmark, the Bloomberg 2000 Value Index, during 1Q as top contributors included the Materials, Healthcare and Financials sectors. Within Materials, our gold exploration companies performed extremely well as demand for gold increased with the escalation of geopolitical tensions. In the Healthcare sector, our exposure to surgical device companies outperformed as surgical procedures accelerated while Covid hospitalizations decreased. In Financials, our significant underweight to banks led to a strong allocation effect.

Top detractors to performance included the Energy, Communication Services and Consumer Staples sectors. Within Energy, our underweight was a significant allocation detractor as oil prices rallied significantly after Russia's attack on Ukraine. Within Communication Services, our holdings with exposure to online travel underperformed as lingering impacts of Covid negatively impacted bookings trends. In the Consumer Staples sector, many holdings continued to struggle from supply chain challenges and inflationary pressures which negatively impacted their earnings trajectory.

Small Cap Value Equity (cont.)

As the Ukraine-Russian conflict continues, it has created broader inflationary pressures as prices for energy and grain commodities skyrocketed. Given the backdrop of recent inflationary pressure, this conflict has simply exacerbated the issue and forced the Fed to be more aggressively hawkish. Although we do not foresee a US recession next year, an aggressively hawkish stance will likely spook markets into pricing in such an event. As the labor market continues to remain tight through the summer and inflationary pressures likely not abating, it is hard to envision a change in the Fed's stance until we are deeper into this rate tightening cycle. It is likely that rates continue to push higher, but yield curves will likely remain on the brink of inversion as rates climb throughout the summer. The Fed is focused on higher real rates by raising rates and bringing the inflationary outlook lower as we progress through the year.

Real interest rates continue to be negative but have slowly started to climb. Rising real rates are a significant headwind for money-losing, speculative growth equities, but should favor profitable businesses that generate positive free cash flow and trade at reasonable valuations (consistent with our bottom-up fundamental approach). Our investment style has been most adept while managing through uncertain periods while attempting to capitalize on highly discounted valuations in volatile markets. We believe we are currently in this same type of environment where we have thrived the most in the past; with very low downside capture potential and significant outperformance potential when equities are most highly discounted.

Small to Mid Cap Equity

The Omicron variant appeared to be highly contagious and less virulent than previous Covid strains which may provide widespread resistance allowing for a further reopening of the economy over the coming months. The US has steadily added vaccine mandates, booster shots and therapies that will address the spread of the virus as it becomes an endemic. Inflation trends have endured beyond the "transitory" phase with supply chain disruptions and costs rising in many industries as companies need to demonstrate their ability to manage their supply chains.

Our Small to Mid Cap Equity strategy outperformed its benchmark, the Bloomberg 2500 Index, during 1Q aided by performance stemming from the Healthcare, Industrials and IT sectors. Within Healthcare, a medical imaging company experienced strong initial sales of a new contrast for the prostate market. Focusing on healthcare companies with strong cash flows also outperformed more speculative areas of the industry like biotechnology. In the Industrials market, a US product tanker experienced improving activity transporting commodities along the Gulf Coast. In IT, the strategy benefitted from a company that was acquired by a private equity firm at a significant premium to its prior closing price.

Energy and Consumer Discretionary were the leading laggards during the quarter. Although the Energy sector outperformed in 1Q as oil prices spiked with the Russian invasion of Ukraine, our strategy was moderately underweight the sector. An apparel company within Consumer Discretionary was exposed to the European consumer and sold off due to the Ukrainian conflict.

The Russian invasion of Ukraine has exasperated inflation concerns as Western countries have de-invested in Russia which is primarily an oil and gas export economy. Ukraine is a key supplier of agricultural products which could provide additional stress especially in emerging markets. Companies are challenged to raise prices to maintain margins in this cost environment. The Fed has indicated short term interest rates will ramp up as they reduce securities through 2022 which will tighten lending standards. Companies which maintain ready access to capital can weather these headwinds.

Our strategy is invested in companies that can potentially generate strong 2022 cash flows in an inflationary environment. While looking for opportunity, strong balance sheets and improving cash flow generation are key indicators for inclusion. We will continue to utilize credit spreads to guide overall portfolio positioning, sector exposures and security inclusion through a volatile market environment. This is a critical indicator that differentiates between stock market sell offs and an adverse turn in the business cycle.

Mid Cap Equity

The Mid Cap Equity strategy performed in-line with its benchmark, the Bloomberg Midcap Index, during 1Q. Top contributors to performance included the Materials, Financials and Industrials sectors. A US fertilizer company experienced a significant cost advantage to global peers due to access to domestic natural gas. Within Financials, banks and insurance companies are expecting improved earnings due to higher interest rates. In the Industrials market, a US product tanker experienced improved activity transporting commodities along the Gulf Coast.

Top detractors included the Real Estate, Consumer Staples and Consumer Discretionary sectors. In Real Estate, a refrigerated cold storage company faced rising labor costs and low inventory levels. In Consumer Staples, a producer of frozen french fries encountered poor margins due to higher procurement costs. An apparel company within Consumer Discretionary was exposed to the European consumer and sold off due to the Ukrainian conflict.

Outlook

While mindful of the more uncertain geopolitical backdrop, our outlook for small cap equities remains constructive. We believe near term recession risk is low given the tight labor market, rising wages, elevated savings and under-levered consumer balance sheets. Real interest rates are negative and are likely to remain accommodative through multiple Fed rate hikes. Rising rates are a significant headwind for money-losing, speculative growth equities, but should favor profitable businesses that generate positive free cash flow and trade at reasonable valuations (consistent with our bottom-up fundamental approach).

While our portfolio's typically employ more financial leverage on average vs. their benchmarks, corporate credit fundamentals are robust. Many of our holdings have capitalized on favorable market conditions by refinancing debt at low interest rates and extending maturities. Consequently, we expect default rates to remain low for the foreseeable future even as overall growth slows. We are focused on businesses that can deliver improving earnings in 2022 and believe the sustainability of recent margin improvement and potential accretion from improved balance sheets (i.e., buybacks, dividends, M&A) is underappreciated by the market. Finally, small cap valuations remain attractive relative to large caps and tend to be more levered to the strong domestic economy and less exposed to international markets that could be pressured to a greater degree by the Russia-Ukraine war.

PENN CAPITAL

The views and opinions expressed are for informational and educational purposes only as of the date appearing in this material only and may change without notice at any time based on numerous factors, such as market or other conditions, legal and regulatory developments, additional risks and uncertainties and may not come to pass. These views are subject to change at any time and they do not guarantee future performance of the markets.

Indices are unmanaged and not available for direct investment. Index comparisons have limitations as volatility and other characteristics may differ from a particular investment.

All information has been obtained from sources believed to be reliable, but its accuracy is not guaranteed. There is no representation or warranty as to the current accuracy, reliability or completeness of, nor liability for, decisions based on such information and it should not be relied on as such.

This material is not intended to be relied upon as investment advice or recommendations, does not constitute a solicitation to buy or sell securities and should not be considered specific legal, investment or tax advice. It does not take into account the specific objectives, financial situation, or particular needs of any specific person. You should not assume that any discussion or information provided here serves as the receipt of, or as a substitute for, personalized investment advice. Investment decisions should be made based on an investor's objectives and circumstances and in consultation with his or her financial professionals. Investing in the stock market involves gains and losses and may not be suitable for all investors. Investors have the opportunity for losses as well as profits.

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 a boutique investment management firm based in Philadelphia, PA. We forge our own ideas, we respect hard work, and we are committed to our clients, our staff and our community.

Past performance is not 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. Portfolio holdings are subject change and may or may not be held by one or more Penn Capital portfolios from time to time. Please note that comparing the performance to a different index might have materially different results than those shown. The Bloomberg Micro Cap Index is a float market cap weighted benchmark of those securities in the Bloomberg Aggregate Equity Index with a market capitalization ranking of lower than 2,500. The Bloomberg US 2000 Index is a float market-cap-weighted benchmark of the lower 2000 in capitalization of the Bloomberg US 3000 Index. The Bloomberg US 2000 Value Index is screened from the Bloomberg US 2000 Index (B2000) and is constructed based on a linear combination of risk factors. The four factors are: 1) Earnings Yield, 2) Valuation, 3) Dividend Yield and 4) Growth. The factors are equally weighted when forming a composite signal where Growth is considered to be a negative indicator and thus flipped to be a negative. The Indices are market-capitalization-weighted. The current price is used to calculate the price-based ratios. The Bloomberg US 2500 Index is a float market-cap-weighted benchmark of the lower 2500 in capitalization of the Bloomberg US 3000 Index. The Bloomberg US Midcap Index is a float market-cap-weighted benchmark of those securities in the Bloomberg US 1000 Index ranked 201 to 1000 by market capitalization. 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-EQTYCOM_04112022