Executive Summary

During 2Q21 ("2Q"), the Russell 2000 Index delivered a 4.3% gain, nearing the upper bound of what was a somewhat narrowly defined trading range for most of the quarter. 1Q21 ("1Q") earnings were mostly favorable as revenue accelerated amid prior year comparisons, vaccine optimism, and the re-opening of the economy.

Overview

Despite global supply chain bottlenecks and increased inflation, margins benefitted from lean cost structures (given defensive measures taken during the pandemic), efficient working capital management, and pricing power. Performance was mixed in 2Q as the Energy, Consumer Discretionary, Real Estate, Telecom, and Information Technology ("IT") sectors outperformed while Utilities, Financials, Consumer Staples, Industrials, Materials, and Healthcare sectors lagged.

Value-oriented stocks narrowly outperformed growth-oriented stocks, although 2Q was a tale of two periods. In April and May, cyclical stocks led on the back of strong earnings, while growth and defensive stocks led the charge in June as the rally in US Treasuries gained steam. After spiking in 1Q, the 10-year US Treasury yield declined from 1.74% to 1.45% during 2Q. The speculative "meme stock" frenzy continued as a handful of companies with questionable business models contributed to the returns of the Russell 2000 Index (a frustrating headwind for active portfolio managers). Despite shifting sands in terms of equity factor performance, the high yield ("HY") market continued its steady march higher as the spread-to-worst on the JP Morgan US HY Index declined from 406 bp to 370 bp. Deal flow remains substantial with corporations coming to market to lower their cost of debt, extend maturities, and de-risk their balance sheets. Investor appetite for new issues remains robust.

Micro Cap Equity

Our Micro Cap Equity strategy outperformed its benchmark, the Russell Microcap Index, during 2Q as the equity market continued to perform well as vaccination rates approached 70% in the US and the economy began to fully reopen. Elevated inflation expectations during 1Q saw a significant pullback in the latter half of 2Q as the Federal Reserve ("Fed") signaled inflation would be transitory as the economy normalized. Healthcare was a significant outperformer during 2Q as companies that experienced a slowdown during the winter COVID-19 period began a resurgence as patients returned to the office. Higher-cost medical equipment providers experienced an easing regarding hospital capital budgeting which led to significant order increases. Energy was the second largest contributor as higher oil prices led to increased cash flow and more drilling activity which benefitted our holdings within the sector. Industrials was a significant outperformer, as acquisition activity in 2Q led to significant outperformance as a large holding in the office furniture space was acquired by a competitor.

After strong performance in 1Q, the Materials sector experienced a pull back as inflation expectations abated in 2Q as the Fed repeatedly issued transitory statements regarding inflationary pressures. Our Consumer Discretionary exposure was a relative laggard as many of the "meme stocks" led performance in the sector. Retail investors pushed valuations in a theater stock to extremes, and as a significant constituent of our benchmark, our lack of exposure was a significant detractor. The Real Estate sector was also a relative laggard as several hotel holdings pulled back from recent highs during 2Q.

As the economy accelerated and inflation persisted in 2Q, the Fed calmed markets with its transitory inflation commentary. After significant stimulus over the past year, the economy has accelerated with its reopening. Many supply chains were impacted and prices rose across many industries as companies struggled to meet demand from the recovery. Despite these impacts, we feel supply chain issues will abate and inflationary pressure will subside. As 2021 progresses and stimulus fades, we expect more volatility in the markets. However, we also expect the economy to remain strong as consumers and businesses remain flush with cash as it begins to stand on its own without government stimulus. Demand should continue into the end of the year and supply chains will likely normalize in the first half of 2022.

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 including the Consumer Discretionary, Energy, and Healthcare sectors. Within Consumer Discretionary, a casino operator reported stronger than expected 1Q EBITDA due to continued momentum in Nevada locals properties, sequential occupancy improvement on the Las Vegas Strip, and cost efficiencies that should drive future margin expectations well above historical averages. In the Energy sector, an oil and gas exploration and production company focused on the Rocky Mountain regions outperformed due to rising commodity prices along with an initiation of a dividend that exceeded market expectations. Within Healthcare, a hospital operator demonstrated continued improvement in operating fundamentals as same-store patient volumes recovered and profitability benefitted from cost controls and divestitures of underperforming locations. Successful debt refinancing has vastly improved the company's credit profile by extending maturities, reducing interest expense, and boosting free cash flow.

Top detractors included the Financials, Materials, and Consumer Staples sectors. Within Financials, despite a regional bank delivering EPS upside on improving credit trends, the company ultimately underperformed as declining interest rates weighed on group sentiment. In the Materials sector, a specialty metals producer reported 1Q revenues below expectations and continued to face choppy demand from aerospace customers with an uncertain timeline to full recovery. Within Consumer Staples, a food distributor that primarily serves independent and chain restaurants continued to report improving sales and EBITDA though lagged due to a lukewarm investor reaction to its planned acquisition of a distributor to the convenience store channel.

Small Cap Equity

Our Small Cap Equity strategy outperformed its benchmark, the Russell 2000 Index, during 2Q with top contributors including the Consumer Discretionary, Healthcare, and Industrials sectors. Within Consumer Discretionary, a casino operator reported stronger than expected 1Q EBITDA due to continued momentum in Nevada locals properties, sequential occupancy improvement on the Las Vegas Strip, and cost efficiencies that should drive future margin expectations well above historical averages. In the Healthcare sector, a hospital operator demonstrated continued improvement in operating fundamentals as same-store patient volumes recovered and profitability benefitted from cost controls and divestitures of underperforming locations. Successful debt refinancing has vastly improved the company's credit profile by extending maturities, reducing interest expense, and boosting free cash flow. Within Industrials, a manufacturer of power transmission equipment for a wide swath of industrial end markets delivered a 1Q beat-and-raise on accelerating global demand, market share gains, and solid incremental margins despite headwinds in material and freight costs.

The top detractors in 2Q included the Consumer Staples, Financials, and Real Estate sectors. Within Consumer Staples, a food distributor that primarily serves independent and chain restaurants continued to report improving sales and EBITDA though lagged due to a lukewarm investor reaction to its planned acquisition of a distributor to the convenience store channel. In the Financial sector, a regional bank delivered EPS upside on improving credit trends though underperformed as the decline in interest rates weighed on group sentiment. Within Real Estate, slight underperformance was driven by allocation effect as favorable stock selection was offset by an underweight to the group which outperformed the index modestly during 2Q.

Small Cap Value Equity

During 2Q, our Small Cap Value Equity strategy significantly outperformed its benchmark, the Russell 2000 Value Index, as equity markets continued to perform well as vaccination rates approached 70% in the US and the economy began to fully reopen. Elevated inflation expectations during 1Q saw a significant pullback in the latter half of 2Q as the Fed signaled inflation would be transitory as the economy normalized. The Financials sector significantly outperformed in 2Q as acquisition activity accelerated as the strategy was the beneficiary of a significant premium offered to one of its holdings from a large bank.

Small Cap Value Equity (cont.)

The Industrials sector was a significant outperformer, as acquisition activity in the quarter led to outperformance as a large holding in the office furniture space was acquired by a larger competitor. Healthcare was a significant outperformer during 2Q as companies that experienced a slowdown during the winter COVID-19 period began a resurgence as patients returned to the office.

Our Consumer Discretionary exposure was a relative laggard in 2Q as many of the "meme stocks" led performance in the sector. Retail investors pushed valuations in a theater stock to extremes, and as a significant constituent of our benchmark, our lack of exposure was a significant detractor.

Small to Mid Cap Equity

Vaccine approvals provided visibility for a strong US recovery in 2021 and will positively impact sectors like Consumer Discretionary. We believe a global economic recovery will follow the US providing opportunity for globally exposed companies in the Materials, Energy, and Industrial sectors. Government stimulus efforts have supported companies through the COVID-19 pandemic as two large stimulus bills were passed in the past four months as the mass vaccination project was underway. Aggressive fiscal policy is raising inflation expectations benefitting the Financials sector at the expense of interest rate sensitive areas such as the Utilities sector.

During 2Q, our Small to Mid Cap Equity strategy underperformed the benchmark, the Russell 2500 Index. The Energy, Real Estate, and IT sectors enjoyed the strongest returns as secular growth areas of the market moderately outperformed after a strong cyclical return in Q1.

The more defensive sectors of Utilities and Consumer Staples lagged in 2Q as investors weigh the opportunity between cyclical and secular growth in 2021.

Within Materials, an electric arc furnace steel producer enjoyed strong demand and pricing in the Automotive segment. In Industrials, a credit rating agency is expecting strong consumer demand for their products in the second half of 2021. In the Communication Services sector, travel-related software companies weakened due to concerns regarding COVID-19 infections and restrictions on global travel. Within Healthcare, a biopharma company announced poor results in a drug trial that would expand its market in the oncology market.

Despite concerns regarding the COVID-19 Delta variant, vaccinations provide visibility for a strong US recovery in the second half of 2021. Unprecedented government stimulus efforts have supported companies through the COVID-19 pandemic. Aggressive fiscal policy is raising nominal growth while the Fed will not change monetary conditions to risk US recovery efforts over the coming months. Companies have access to capital and credit spreads confirm that corporate balance sheets can weather the pandemic. Over the next 2-3 years, companies must prove their solvency in the recovery by paying down their borrowings through cash generation.

The strategy is invested in companies that will benefit from a 2021 economic recovery. While looking for opportunity, strong balance sheets and improving cash flow generation are key indicators for inclusion. The strategy will continue to utilize credit spreads to guide overall portfolio positioning, sector exposures, and security inclusion through a volatile market environment. Credit market indicators will provide useful signals regarding the timeframe and strength of recovery.

Mid Cap Equity

The Mid Cap Equity strategy underperformed its benchmark, the Russell Midcap Index, during 2Q. Top detractors in the quarter included the Financials and Healthcare sectors. In Financials, regional banks lagged as interest rates fell and organic loan growth was soft. In Healthcare, an active pharmaceutical ingredient producer experienced weak sales in their cough and cold category due to a weak flu season. Top contributors in 2Q included the Materials, Utilities, and IT sectors. In Materials, an electrical arc furnace steel producer benefitted from growing demand in the automotive market. In Utilities, an independent power producer addressed their recovery plan from Winter Storm Uri. In IT, Apple semiconductor suppliers announced steady production guidance despite industry supply chain disruptions. Our strategy remains focused on companies with improving second half 2021 fundamentals while maintaining strong balance sheets.

Outlook

Our outlook for small cap equities remains constructive and we believe our strategies stand to benefit from improving economic activity. Year-over-year sales growth rates for many companies will decelerate in the near term as we lap prior year comparisons and tailwinds from government stimulus fade. Nonetheless, we expect consumer demand to remain very strong underpinned by an uptick in hiring, rising wages, elevated consumer confidence, and healthy consumer balance sheets with ample borrowing capacity to support spending. Emergence from the pandemic seems likely to drive some mean reversion in terms of spending trends with consumers shifting wallet share back towards travel, leisure, and experiences away from nesting, food-at-home, and discretionary spending.

While companies and consumers alike are feeling the pinch of inflation, freight and raw material pressures are likely somewhat transient and we expect cost increases to ease as supply chain conditions normalize and capacity catches up with demand. Wage inflation has more traction but increases in hourly pay and signing bonuses are critical to stimulating labor force participation and ultimately support consumption. The Fed remains mindful of inflation and recently signaled that the economy is making progress towards an eventual tapering of asset purchases, yet still remains focused on a full recovery from the pandemic in the labor market and expects to keep monetary policy accommodative for some time. HY credit market conditions remain favorable and default risk is low. We continue to believe small cap stocks are cheap relative to large caps and small cap value is particularly attractive relative to small cap growth. M&A is accelerating amid low interest rates, favorable debt market conditions, and improving visibility. Historically, our strategies have been an outsized beneficiary of acquisitions given our focus on attractively valued companies with strong and consistent cash flow.

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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.

A copy of Penn Capital's current written disclosure statement discussing our advisory services and fees is available upon request. PC-EQTYCOM071421

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