Executive Summary

The Russell 2000 Index, a proxy for small cap equities, declined 4.36% in 3Q21 (“3Q”); though remained within the bounds of a multi-month consolidation. Despite volatility related to the COVID-19 Delta variant, consumers remained resilient with strong demand for goods and improving demand for services driving revenue trends for most companies.

Overview

Margin headwinds intensified due to stressed global supply chains and rising costs for commodities, freight, and labor. The Financials, Energy, and Real Estate sectors outperformed while Healthcare, Consumer Staples, and Consumer Discretionary lagged.

Small cap value stocks outperformed small cap growth stocks, which were impacted by significant weakness in Biotechnology companies. The S&P 500 Index, a proxy for large cap stocks, returned 0.58% and outperformed small cap stocks in 3Q. The 10-year US Treasury yield rose slightly during the quarter from 1.48% to 1.52%, falling to a low of 1.19% in early August before finishing in September with a sharp rise. The US High Yield (“HY”) market remained firm with the spread-to-worst on the JP Morgan US HY Index finishing the quarter at 385bp, up marginally from 370bp at the end of 2Q21 (“2Q”). The new issue calendar remains busy as companies take advantage of favorable conditions to refinance debt at lower interest rates and extend maturities.

Micro Cap Equity

Our Micro Cap Equity strategy underperformed its benchmark, the Bloomberg Micro Cap Index, during 3Q as the Delta variant caused a resurgence in cases and hospitalizations in the US. As US Treasury rates fell due to increased fears of economic slowing from another wave of COVID-19 infections, companies that benefitted from a continued reopening of the US economy were most negatively impacted. At the end of the quarter, the collapse of Evergrande (a large real estate developer in China) also spurred concerns of a global growth slowdown which further negatively impacted cyclicals. As we exited the quarter and the Federal Reserve (“Fed”) guided the market toward a tapering event, rates rose dramatically in the final two weeks of the quarter. As these events played out, volatility between value and growth factors became rather pronounced. The quarter also concluded with an energy crisis in the European market, as natural gas prices shot up to dramatic levels and drove fuel shortages across European markets.

Although the Consumer Discretionary sector was hard hit during the quarter with the emergence of the Delta variant, performance in the sector was the strongest contributor. Performance was led by a top position in the sector which received a strategic investment from a large private investor. As a result, the strategic investment announcement was followed by significant returns in the stock price of the company. The IT sector was also a strong contributor to performance. A semiconductor holding performed extremely well after announcing quarterly earnings and incremental design wins for their microchips in various handset providers. Semiconductor companies were generally very strong in the quarter as shortages continued to persist while demand trends continued to be strong. The Real Estate sector was also a strong contributor as many of our hotel holdings performed favorable as occupancy rates continued to improve from rather depressed levels since the outset of the pandemic.

The Materials sector was an area of underperformance during 3Q as many cyclicals suffered from the COVID-19 resurgence during the late summer. A gold mining company was the largest detractor as gold prices suffered with decreased inflation expectations from the Fed’s transitory commentary throughout the quarter. The Financials sector underperformed due to negative impacts on two of our insurance holdings as Hurricane Ida contributed to heavy losses across the East Coast. Healthcare was a large contributor to underperformance as a COVID-19 resurgence once again limited surgical procedures as patients began to overwhelm hospitals throughout southern parts of the US.

Small to Micro Cap Equity

Our Small to Micro Cap Equity strategy outperformed its benchmark, a mix of the Bloomberg 2000 and Bloomberg Micro Cap Indices, in 3Q. Top contributors in the quarter were the Consumer Discretionary, Information Technology ("IT"), and Financials sectors. Within Consumer Discretionary, a casino operator beat street expectations for 2Q revenue, EBITDA, and free-cash-flow ("FCF"); further driving balance sheet de-leveraging. Management continued to express confidence in the sustainability of margins. In the IT sector, a provider of enterprise storage solutions reported stronger than expected 2Q results as revenue growth accelerated and margins improved despite cost headwinds. Within Financials, a regional bank reported above-consensus earnings-per-share ("EPS") as accelerating loan growth and better-than expected net interest margins were partially offset by lower mortgage banking revenue.

Top detractors included the Healthcare, Industrials, and Materials sectors. Within Healthcare, a maker of advanced cardiology instrument control systems disappointed the market with a reduced outlook for systems revenue. In the Industrials sector, a manufacturer of office furniture lagged as the Delta variant delayed office re-opening plans and higher commodity costs/supply chain disruptions suppressed margins. Within Materials, a producer of specialty alcohols and essential ingredients for the food, beverage, and health markets missed 2Q expectations as margins were pressured by a run-up in commodity costs.

Small Cap Equity

The Small Cap Equity strategy outperformed its benchmark, the Bloomberg 2000 Index, in 3Q. Top contributors in the quarter were the IT, Consumer Discretionary, and Communications Services sectors. Within IT, a provider of enterprise storage solutions reported stronger than expected 2Q results as revenue growth accelerated and margins improved despite cost headwinds. In the Consumer Discretionary sector, a casino operator beat street expectations for 2Q revenue, EBITDA, and FCF; further driving balance sheet de-leveraging. Management continued to express confidence in the sustainability of margins. In Communications Services, a provider of in-flight internet connectivity systems raised its long-term revenue growth, EBITDA margin, and FCF guidance amid record equipment sales that ultimately drove high margins via recurring services revenue.

The top detractors in the quarter were centered around the Industrials, Energy, and Real Estate sectors. Within Industrials, a manufacturer of office furniture lagged as the Delta variant delayed office re-opening plans and higher commodity costs/supply chain disruptions suppressed margins. In the Energy sector, a provider of oilfield services reported mixed results as an improving outlook for subsea (submerged ocean equipment) orders was offset by negative FCF. Within Real Estate, slight underperformance was driven by allocation effect as the strategy was underweight the sector which outperformed the benchmark.

Small Cap Value Equity

During 3Q, our Small Cap Value Equity strategy underperformed its benchmark, the Bloomberg 2000 Value Index. As the Delta variant spread throughout the US, companies poised to benefit from an economic reopening suffered. Although the Consumer Discretionary sector was impacted during the quarter as the Delta variant raged throughout the country, performance in the sector was the strongest contributor and was led by a position which received a strategic investment from a large private investor. As a result, the strategic investment announcement was followed by significant returns in the stock price of the company.

The IT sector contributed as one of our holdings integrated a "buy-now pay-later" company into its private label credit card business to drive a plan for increased growth.

Our overweight to Industrials was the largest contribution to underperformance in 3Q as holdings tied to recovery areas of the economy suffered the most due to elevated COVID-19 infections. Our holdings tied to the office furniture space and commercial aerospace market were negatively impacted during the quarter.

Small Cap Value Equity (cont.)

Healthcare was a large contributor to underperformance as the COVID-19 resurgence once again limited surgical procedures as patients began to overwhelm hospitals throughout southern parts of the US. The Materials sector was an area of underperformance as many cyclicals suffered during the quarter. Our gold mining holdings were the largest detractors as gold prices suffered with decreased inflation expectations from the Fed's transitory inflation commentary through the quarter.

As 2021 concludes, we expect volatility to continue as the world battles with elevated risks. As we exited the quarter, COVID-19 case growth peaked in the US and companies that had suffered the most during the quarter began to benefit as hopes for a continued reopening of the US economy began to once again emerge. On the flip side, the markets need to prepare for the end of the Fed stimulus era as the tapering signal was extinguished by the Fed at its most recent meeting.

The US is still contending with inflationary headwinds that were caused by supply chain bottlenecks, increasing the price of goods and services related to transportation. These bottlenecks will likely persist into 2022 but should be alleviated over the next year in our opinion. Employment rates should continue to climb as unemployment benefits sunset. With job openings well above the unemployment rate, wage inflation and labor shortages in many industries were detrimental for many businesses. We anticipate late quarter volatility to persist but expect markets to calm as the US economy continues to improve and the unemployment rate continues to decline as we exit 2021.

Small to Mid Cap Equity

The COVID-19 Delta variant extended the pandemic farther into 2021 than previously expected. The US has steadily added vaccine mandates, booster shots, and therapies to address the pandemic. The US reopening phase will differentiate between service companies that will witness a return in demand and businesses that will not experience a recovery due to enduring changes in consumer buying trends.

Inflation trends have endured beyond the "transitory" phase with supply chain disruptions and costs rising in many industries. Companies need to demonstrate their ability to manage supply chains and raise prices to maintain profit margins. Companies have access to capital while credit spreads confirm that corporate balance sheets can weather the current challenges.

During 3Q, our Small to Mid Cap Equity strategy outperformed its benchmark, the Bloomberg 2500 Index, led by outperformance in the Healthcare, Consumer Discretionary, and Materials sectors. Within Healthcare, two biopharma processing companies continued to experience strong cash flows stemming from COVID-19 vaccine production. A flooring retailer in the Consumer Discretionary sector benefitted from expanding their sales to professional installers. In Materials, a lithium producer secured long term contracts to source high-end electric light vehicles.

The strategy experienced underperformance within the IT, Financials, and Consumer Staples during the quarter. In IT, semiconductor suppliers were impacted due to an underwhelming iPhone 13 introduction. A consumer financial lead-generation company experienced weak demand as credit card companies reduced their third-party marketing spend. In the Consumer Staples, a potato processor was impacted due to margin pressures as production and freight costs increased.

Despite concerns regarding the COVID-19 Delta variant, vaccinations provided visibility for a strong US recovery in the second half of 2021. The global economic recovery will follow the US, providing opportunity for globally exposed companies in the Materials, Energy, and Industrial sectors. Unprecedented government stimulus efforts have supported companies through the COVID-19 pandemic. Aggressive fiscal policy is raising nominal growth and the Fed will not change monetary conditions, in our opinion, to risk the US recovery over the coming months.

Small to Mid Cap Equity (cont.)

We believe the strategy is invested in companies that will benefit from a 2022 economic recovery. While looking for opportunities, 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 during a volatile market environment. Credit market indicators will provide useful signals regarding the timeframe and strength of recovery.

Mid Cap Equity

Our Mid Cap Equity strategy underperformed its benchmark, the Bloomberg Midcap Index, during 3Q as top detractors included the IT, Real Estate, and Consumer Staples sectors. In IT, semiconductor companies lagged due to supply chains concerns due to foundry order disruptions during the pandemic. A food storage REIT declined noting rising labor costs and low inventory levels with their food production customers. In Consumer Staples, the stock price of a potato processor was negatively impacted due to rising freight costs and production delays.

Top contributors were the Communication Services, Healthcare, and Materials sectors. In Communication Services, advertising-based media companies benefitted as ad rates increased. In the Materials sector, a nitrogen producer experienced strong demand and rising profitability for their fertilizer products. As we look forward into 2022, the strategy remains focused on companies with improving fundamentals while maintaining strong balance sheets.

Outlook

We maintain our positive outlook for small cap equities as well as our cyclical bias. This view is underpinned by the strong US consumer as we expect spending to be supported by hiring gains, rising wages, elevated consumer confidence, positive wealth effects from housing/stock prices, and under-levered consumer balance sheets. While demand should be robust, supply chain constraints will likely equate to more "out-of-stock" notices on shelves during the holiday season as consumers will be paying more for goods due to inflation driven price increases as well as reduced discounting amid lean inventories.

Current global supply chain headwinds are admittedly severe and unprecedented ranging from pandemic-driven plant shutdowns, labor shortages, raw material/component delays, shipping bottlenecks, container shortages, and inflation concerns. While we expect these issues to have a lasting impact well into 2022, we ultimately view them as transient and expect profit margins to recover as pricing actions take hold and costs inefficiencies ease. While we are mindful of the potential negative impact of higher oil prices on consumer spending, we believe it is manageable given the aforementioned positives. Energy companies are more disciplined today and we expect them to return capital rather than overproduce.

Delta variant concerns appear to be receding as re-openings continue to progress as children head back to in-classroom learning, social/entertainment events resume, leisure travel recovers, and football stadiums across the country are full. Return to the office and resumption of business travel seems to be the next significant milestone in terms of post-pandemic normalization. While employees have grown accustomed to telecommuting, CEOs are clearly anxious about productivity, culture, and effective on-boarding/training of new employees. Although the future nature of office work remains an open question, we continue to believe physical office space will play a crucial role as more companies implement hybrid models.

At the most recent FOMC meeting, the Fed announced expectations to begin tapering asset purchases in November/December though only half of the committee members expect an interest rate increase in 2022. HY credit market conditions remain favorable and default risk is low. We continue to believe small cap stocks are cheap relative to large caps (a differential that only widened further in 3Q) and small cap value is particularly attractive relative to small cap growth. M&A is accelerating amid low interest rates, low cost of debt, and improving visibility. Historically, our strategy's have been an outsized beneficiary of acquisitions given our focus on attractively valued companies with strong and consistent cash flows.

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