Overview

The Bloomberg 2000 Index, a proxy for small cap equities, decreased 5.4% in 3Q23 (“3Q”). Equities started strong in July as market participants priced in an increased probability of a soft landing given the steady job market, resilient consumer and a line of sight to the conclusion of Federal Reserve (“Fed”) rate hikes. However, stocks came under pressure in the final two months of the quarter as rising oil prices, a breakout in long term US Treasury yields and high-profile labor disputes reanimated inflation fears and undercut the bullish narrative. The 10-year US Treasury yield increased from 3.86% to 4.59% during 3Q, the highest level since 2007. Only two of the 11 sectors in the Bloomberg 2000 Index delivered positive returns in 3Q. Energy rallied nearly 10% while Financials were slightly positive. The worst performing sectors in the Bloomberg 2000 Index were Healthcare, Utilities and Information Technology (“IT”). Large caps were modestly better than small caps as the S&P 500 Index declined 3.7% whereas small cap value stocks outperformed small cap growths stocks in the quarter. Belying the negative volatility in equities, the spread-to-worst on the JPM US High Yield Index declined from 434 bps to 427 bps.

Micro Cap Equity

Our Micro Cap Equity strategy underperformed its benchmark, the Bloomberg Micro Cap Index, during 3Q as top contributors included the Healthcare, Industrials and Consumer Staples sectors. Within Healthcare, our underweighted position, and focus on value, led to significant outperformance as the sector suffered and was the worst detractor to the index during the quarter. Many healthcare companies that burned cash as they focused on drug development will be challenged to fund their activities with incremental equity capital raises going forward. Within Industrials, our exposure to companies that benefitted from infrastructure spending helped to drive stronger performance during the quarter. As many areas of the market slow down in a higher interest rate environment, those areas with exposure to government funded projects continue to do very well. Within Consumer Staples, our exposure to companies within the fruit space performed relative to other areas as pricing continued to improve in the space while shipping costs continued to drop as supply chains eased during the quarter. We expect this sector to contribute to performance going forward as higher energy prices will likely force consumers to watch their budgets more closely in the future.

Top detractors in the quarter included the IT, Financials and Consumer Discretionary sectors. Within IT, a semiconductor company was negatively impacted by declining sales as inventory levels in the space became bloated as consumer demand for its respective technology products waned during the quarter. Many areas of the IT sector are dealing with excess inventories after a very robust Covid period caused production levels to dramatically increase after supply chains began to normalize. Within Financials, a financial service provider saw its subscriber base fall during the quarter which negatively impacted its profitability outlook for the remainder of the year. Within Consumer Discretionary, an auto service retailer suffered as replacement tire demand waned and consumers traded down to lower cost service alternatives which impacted the company’s sales and margin outlooks for the remainder of the year. We believe auto maintenance will ultimately return as consumers that defer these activities will only see the increased need for these activities as they will tend to hold onto their vehicles for a longer duration in a tougher economic climate.

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 3Q. Top contributors included the Energy, Healthcare and Industrials sectors. Within Energy, a provider of oilfield services benefitted from accelerating international demand while improved margins and free cash flow have driven significant balance sheet de-leveraging and a narrowing of the valuation discount relative to peers. In the Healthcare sector, a pharmaceutical company focused on therapies for cholestatic liver disease made an accretive acquisition while a competitor reported disappointing data. Within Industrials, a construction services firm benefitted from elevated government spending on roads, bridges and other infrastructure projects which drove improved revenue and margins for the foreseeable future.

Small to Micro Cap Equity (cont.)

Top detractors to performance were the Communication Services, Consumer Discretionary and Financials sectors. Within Communication Services, a digitally focused advertising and marketing firm was negatively impacted by a slowdown in key verticals (Technology, Financials Services, Media and Entertainment). In Consumer Discretionary, a provider of premium expedition cruises and land-based adventure travel did not increase FY23 guidance despite a significant 2Q beat, disappointing investors who have become increasingly cautious on the broader economy. In the Financial sector, a provider of prepaid debit cards continued to struggle with headwinds created by sunsetting legacy contracts and technology investments that have yet to improve profitability.

Small Cap Equity

The Small Cap Equity strategy underperformed its benchmark, the Bloomberg 2000 Index, during 3Q. Top detractors in the quarter were the Communication Services, Consumer Discretionary and IT sectors. Within Communication Services, a television broadcaster underperformed due to soft core advertising trends and elevated balance sheet leverage. In the Consumer Discretionary sector, a franchisor of high value/low-price gyms reported healthy membership growth, but franchisees have slowed the pace of unit development due to rising interest rates, higher construction costs, constrained real estate availability and macro jitters. Within IT, a power semiconductor company underperformed as fears of a lower recovery in China overwhelmed strong financial results.

Top contributors included the Energy, Healthcare and Industrials sectors. In the Energy sector, a provider of oilfield services benefitted from accelerating international demand while improved margins and free cash flow have driven significant balance sheet de-leveraging and a narrowing of the valuation discount relative to peers. Within Healthcare, a pharmaceutical company focused on therapies for cholestatic liver disease made an accretive acquisition while a competitor reported disappointing data. In the Industrials sector, a logistics services provider reported better than expected shipment volumes partly owing to share gains due to the bankruptcy of a long-time competitor.

Small Cap Value Equity

The Small Cap Value Equity strategy underperformed its benchmark, the Bloomberg 2000 Value Index, during 3Q. The top contributor was the IT sector. A company's bias towards highly undervalued companies within the IT sector aided performance relative to higher growth higher valuation peers which suffered more dramatically during the quarter. The significant move higher in interest rates during the quarter was a result of strong economic data emanating from a strong consumer spend. The summer months created the most negative drag in higher growth sectors including those sectors that were most interest rate sensitive.

Top detractors were the Utilities, Real Estate and Financials sectors. Within Utilities, our exposure to a utility company which suffered from severe wildfire damage during the quarter was highly detrimental to the portfolio as the market discounted bankruptcy risk as a result of potential liability issues arising from its culpability regarding the cause of the wildfires. Real estate was severely challenged as interest rates rose during the quarter. After a vibrant consumer spending summer, the market discounted a higher for longer interest rate outlook for the Fed which had a negative impact on one of the most interest rate sensitive areas of the market. Our underweight to financials contributed to negative performance when regional banks rallied as bank failure risk abated with less vigorous deposit outflows. Although regional banks gave up a majority of their rally during the last month of the quarter, the sector was still slightly positive to end the quarter after a significant rally to start the quarter. We still believe financials will be challenged as the market grapples with higher probabilities of loan losses as the credit cycle materializes in a higher for longer interest rate cycle.

Small to Mid Cap Equity

The Small to Mid Cap Equity strategy slightly underperformed its benchmark, the Bloomberg 2500 Index, during 3Q. Top detractors included the Consumer Discretionary, Materials and Communications Services sectors. In the Consumer Discretionary sector, a franchisor of high value/low-price gyms reported healthy membership growth, but franchisees have slowed the pace of unit development due to rising interest rates, higher construction costs, constrained real estate availability and overall macro jitters. Within Materials, a lithium mining company lagged as declines in spot lithium prices resulted from increased supply which in turn has given investors pause regarding the pace of future earnings growth. In the Communications Services sector, a digitally focused advertising and marketing firm was negatively impacted by a slowdown in key verticals (Technology, Financials Services, Media and Entertainment).

Top contributors to performance in the quarter included the Energy, Industrials and IT sectors. Within Energy, a provider of oilfield services is benefitting from accelerating international demand while improved margins and free cash flow have driven significant balance sheet de-leveraging and a narrowing of the valuation discount relative to peers. In the Industrials sector, a logistics services provider reported better than expected shipment volumes partly owing to share gains due to the bankruptcy of a long-time competitor. Within IT, a data storage manufacturer announced that they would complete their strategic alternatives assessment by year end. Additionally shares benefitted from expectations that memory markets have bottomed.

Mid Cap Equity

The Mid Cap Equity strategy performed in line with its benchmark, the Bloomberg Mid Cap Index, during 3Q. Top contributors in the quarter included the Energy, Industrials and Real Estate sectors. Within Energy, a provider of oilfield services benefitted from accelerating international demand while improved margins and free cash flow drove significant balance sheet de-leveraging and a narrowing of the valuation discount relative to peers. In the Industrial sector, a logistics services provider reported better than expected shipment volumes partly owing to share gains due to the bankruptcy of a long-time competitor. Within Real Estate, an industrial REIT is re-leasing tenants at attractive rent spreads in the mid to high teens and signing new leases in the 20% range offering upside for future net operating income growth and valuation multiple expansion.

Top detractors were the Consumer Discretionary, Materials and Communications Services sectors. In the Consumer Discretionary sector, a franchisor of high value/low-price gyms reported healthy membership growth, but franchisees have slowed the pace of unit development due to rising interest rates, higher construction costs, constrained real estate availability and macro jitters. Within Materials, a lithium mining company lagged as declines in spot lithium prices resulted from increased supply which in turn has given investors pause regarding the pace of future earnings growth. In the Communications Services sector, a provider of in-flight internet connectivity systems and services reduced their outlook as the company delayed the launch of its next-generation 5G network and is experiencing higher subscription suspensions due to routine maintenance and secondary market aircraft sales.

Outlook

Headline inflation peaked in mid-2022 and has steadily decelerated driven by lower prices for goods as supply chains normalize, a shift in consumer demand from goods to services and the resumption of widespread discounting at retail to clear excess inventories. The August Personal Consumption Expenditures (PCE) inflation report was below market expectations and should continue to moderate as the housing component decelerates in the months ahead. While labor inflation has proven stickier, our companies continue to report normalizing applicant flow, improved staffing levels, better efficiency as new hires ramp up and smaller year-over-year wage rate increases.

The September UAW strike has generated ample news coverage and provocative headlines, though the actual percentage of unionized labor in the US is small and we view these negotiations as a lagging labor market indicator, not a sign of accelerating wage inflation to come. It remains an open question whether the Fed can engineer a soft landing as inflation has not yet fully returned to their target range suggesting rates may need to stay higher for longer. The consumer still faces incremental headwinds from rising interest rates, oil prices and the resumption of student loan payments. However, many homeowners opportunistically refinanced at low fixed mortgage rates in recent years, thereby insulating themselves from the sharp rise in rates.

Outlook (cont.)

Additionally, "savers" are benefiting from increased interest income after years of little to no return on cash holdings. For businesses, higher interest rates reduce free cash flow and increase the hurdle rate to invest in new projects to drive growth. Nonetheless, corporate credit fundamentals remain healthy with low overall leverage, solid liquidity, low defaults and high interest coverage. The new issue market is open and functioning well, allowing companies to refinance maturities and fund acquisitions. Per Furey Research Partners, the price-to-earnings ratio for small cap equities is currently 25% below its historic median and the relative P/E discount versus the S&P 500 Index is at historic levels. This suggests significant upside potential once investors regain confidence in forward earnings power.

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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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