Equity Strategies

Executive Summary

The equity and high yield markets rebounded sharply in 1Q 2019 (“1Q”), reflecting incrementally more dovish Federal Reserve (“Fed”) commentary and optimism regarding US-China trade discussions. The Fed signaled an end to the tightening cycle with no anticipated 2019 interest rate increases and an end of asset sales in September 2019.

Overview

US high yield credit spreads narrowed by approximately 130 basis points during 1Q recovering over half of the 4Q 2018 (“4Q”) widening that occurred during the recent equity selloff. The US 10-year Treasury yield decreased from 2.68% to 2.41% during the quarter in sympathy with the change in Fed posture. The non-cyclical growth sectors of Technology and Healthcare outperformed in 1Q as defensive sectors of Consumer Staples and Utilities lagged.

Micro Cap Equity

Our Micro Cap Equity strategy outperformed its benchmark, the Russell Microcap Index, during 1Q as top contributors included our Industrials, Materials, and Energy sectors. In Industrials, many of our machinery companies outperformed as recessionary fears of 4Q proved to be premature after earnings were reported. Within Materials, several companies benefitted from increased outlooks on infrastructure spending at the state level. In Energy, an ethanol company benefitted from the implied demand that was anticipated from a potential China trade deal.

Top detractors to performance in the quarter were the Healthcare, Financials, and Real Estate sectors. Within Healthcare, a sudden CEO change and delays in an expected pipeline opportunity negatively impacted one of our medical device holdings. The Financials holdings were negatively impacted by the inversion of the yield curve as concerns over net margin compression threated the banking industry. In the Real Estate sector, lower yields provided a significant boost to valuations causing underperformance as a result of our underweighted position. During the quarter, the strategy increased its weighting to the Healthcare sector while decreasing its weighting to the Financials sector.

Small to Micro Cap Equity

Our Small to Micro Cap Equity strategy outperformed its benchmark in 1Q, an even blend consisting of the Russell Microcap and Russell 2000 Indices. Top contributors included the Communications Services, Industrials, and Consumer Discretionary sectors. Within Communications Services, a television broadcaster outperformed due to improving core advertising trends, optimism regarding the outlook for 2020 political advertising, and benefitting from a successful synergy realization from recent M&A activity. Within Industrials, a manufacturer of digital inkjet printers used by the textile industry to print directly onto cloth is experiencing accelerating top line growth driven by new products. In Consumer Discretionary, a specialty retailer of hard surface flooring managed solid same store sales growth despite challenging hurricane rebuild comparisons in addition to Chinese tariffs being imposed on popular products.

Top detractors to performance in the quarter were the Healthcare and Real Estate sectors. Within Healthcare, a neuromodulation medical device company reported a strong quarter, yet underperformed due to an unexpected CEO change and delays in a significant pipeline opportunity. The strategy underperformed in the Real Estate sector due to our underweight position versus the index as the sector rallied amid lower interest rates and a dovish pivot by the Fed.

Small Cap Equity

Our Small Cap Equity strategy outperformed its benchmark, the Russell 2000 Index, during 1Q led by top contributors within the Communications Services, Consumer Discretionary, and Information Technology sectors. Within Communications Services, television broadcasters broadly outperformed due to improving core advertising trends, optimism regarding the outlook for 2020 political advertising, and increased M&A activity. In Consumer Discretionary, an apparel company guided 2019 EPS above consensus, driven by rising sales and profits in its acquired DKNY business and continued strong performance of its licensed “power brands” consisting of Tommy Hilfiger and Calvin Klein. The company is rapidly de-leveraging its balance sheet through EBITDA growth and improving FCF. Within Information Technology, a leading provider of gaming equipment and cash access services to the casino industry reported better than expected revenue in 4Q driven by strong slot unit shipments and significantly improved FCF which should help drive de-leveraging going forward. Top detractors in the quarter were focused on the Healthcare, Real Estate, and Energy sectors. Within Healthcare, a specialty pharmaceutical company underperformed despite reporting a solid quarter and guiding above street consensus as investors focused on a potential competitive approval. The strategy underperformed in the Real Estate sector due to our underweight position versus the index as the sector rallied amid lower interest rates and a dovish pivot by the Fed.

Small Cap Value Equity

Our Small Cap Value Equity strategy outperformed its benchmark, the Russell 2000 Value Index, during 1Q as top contributors included the Industrials, Consumer Discretionary, and Utilities sectors. In Industrials, many of our machinery companies outperformed as recessionary fears of 4Q proved to be premature after earnings were reported. In Consumer Discretionary, several automobile suppliers executed strongly during the quarter driving significant outperformance. In Utilities, lower treasury yields supported attractive returns to an overweight sector in the portfolio.

Top detractors to performance were Healthcare and Information Technology. In Healthcare, a specialty pharmacy company reduced earnings guidance as larger players became more aggressive on pricing. In the Information Technology sector, the semiconductor industry rallied on hopes of a trade deal, while the industry continued to have challenging revenue and inventory outlooks. Our underweight to a fundamentally challenged sector was an area of underperformance during 1Q. During the quarter, our strategy increased its Utilities and REIT weighting while decreasing its Financials weighting.

Small to Mid Cap Equity

Our Small to Mid Cap Equity strategy underperformed its benchmark, the Russell 2500 Index, during 1Q. Top sector detractors included the Healthcare, Information Technology, and Materials sectors. In the Healthcare sector, a drug company provided disappointing 2019 sales guidance due to concerns regarding emerging competition from a new entrant. In the Information Technology sector, a municipality software vendor reported weaker than expected bookings due to a lengthening sales cycle. In Materials, an automobile motor oil brand detracted due to rising price competition in the retail channel.

Our top contributors during the quarter were the Consumer Discretionary, Financials, and Communication Services sectors. Within Consumer Discretionary, a flooring retailer managed solid same store growth despite the application of Chinese tariffs on popular products. In Financials, a lower rate environment benefitted our insurance company positions over regional banks. Lastly, an OTT (over-the-top) vendor in our Communication Services sector booked strong advertising sales in 1Q. Overall, our strategy increased its weighting in the Information Technology sector while decreasing our exposure to the Healthcare sector.

Mid Cap Equity

Our Mid Cap Equity strategy outperformed its benchmark, the Russell Midcap Index, during 1Q with top contributors concentrated in the Communications Services, Energy, and Industrials sectors. Within Communications Services, television broadcasters broadly outperformed due to improving core advertising trends, optimism regarding the outlook for 2020 political advertising, and increased M&A activity. In Energy, a leading oilfield equipment and technology company delivered strong 4Q results and guided FY19 above street level expectations, underpinned by improving activity and market share gains. Within Industrials, a maker of equipment used in the production, storage, and distribution of liquified natural gas reported strong 4Q revenue growth, raised FY19 guidance, and offered a bullish outlook for large liquified natural gas projects.

Top detractors to performance in the quarter were the Healthcare, Consumer Discretionary, and Real Estate sectors. Within Healthcare, a developer and marketer of clinical software surprised the market with a mixed quarter and disappointing forward guidance following a more upbeat appearance at an investor conference. In Consumer Discretionary, a gaming equipment supplier reported 4Q EBITDA that was modestly below consensus expectations as a strong North American lottery market was offset by weaker international margins. Within Real Estate, a data center REIT provided initial 2019 guidance below street expectations due to a slowdown in leasing activity and stepped-up growth investments.

Outlook

The domestic economy remains stable, supported by low unemployment, improving wage growth, improving confidence, low interest rates, and rising home values. The Fed provided more accommodative policy due to slowing growth in 2019 primarily stemming from weakness in China and Europe. Global supply chains are being reexamined as rising tariff regimes require companies to contemplate moving product sourcing, raising prices, or absorbing higher costs that may reduce profit margins. These strategic decisions can cause short term disruptions for companies that will lead to operations that are marginally more insulated from future geopolitical events.

We expect the economy to remain healthy in 2019 but caution that earnings growth is decelerating 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 expect high yield spreads to drift lower which is supportive of equity valuations. At this point in the economic cycle, quality of corporate credit issuance needs to be monitored for possible deterioration which would signal a downturn in the credit cycle. 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).

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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. 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 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

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