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Executive Summary

Global trade issues, especially the US-China relationship and other geopolitical issues like Brexit, were considered headwinds to global growth and export driven industries during 3Q19 ("3Q"). A strong US job market and solid consumer data were key drivers of optimism that US domestic growth would continue.

Overview

By most accounts, the domestic consumer economy remains quite healthy, supported by low unemployment, improving wages, and elevated confidence. Housing activity continued to rebound driven by favorable demographics and declining mortgage rates. Despite these positives, business confidence has notably diverged lower amid erupting trade tensions, weakness in manufacturing, slowing global growth, an inverted yield curve, and continued political turmoil in the US and abroad. The Federal Reserve ("Fed") reduced rates by 25 basis points in September, although there appears to be a lack of consensus among voting members on the overall economic outlook.

The US 10-year treasury yield declined from 2.03% to 1.68% during 3Q19 ("3Q"), reaching its lowest levels since 2016. US high yield ("HY") credit spreads were essentially flat during the quarter and the new issuance calendar was busy as companies took advantage of low rates/spreads and strong investor demand to refinance debt and extend maturities. After underperforming for most of the year, value-oriented small cap stocks outperformed growth-oriented small cap stocks in 3Q with much of this reversal occurring in September.

Micro Cap Equity

Our Micro Cap Equity strategy outperformed its benchmark, the Russell Microcap Index, during 3Q as top contributors included the Industrials, Healthcare, and Financials sectors. In Industrials, an injection molding machinery company positively contributed due to an acquisition from a public competitor for a premium. Our largest healthcare position benefitted from sale rumors during the quarter which significantly added value within the worst performing sector of the index. In Financials, a timely purchase of a failed takeover in the insurance sector aided performance as the company pursued a significant buyback with cash derived from breakup fees as a result of the failed transaction.

Top detractors in 3Q were led by the Materials, Information Technology ("IT"), and Consumer Discretionary sectors. In Materials, a chemicals producer was negatively impacted by the oversupply and declining profitability of its product during the quarter. In IT, a software company revised their annual guidance as the resignation of its CEO impacted performance. Within Consumer Discretionary, a furniture brand was negatively impacted by new Chinese tariffs which ultimately impacted their bottom line. During 3Q, the strategy increased its weighting to the Materials and Financials sectors while decreasing its weighting to the Industrials and Utilities sectors.

Small to Micro Cap Equity

During 3Q, our Small to Micro Cap Equity strategy outperformed its benchmark, an even blend consisting of the Russell Microcap and Russell 2000 Indices. The top sector contributions included IT, Healthcare, and Communication Services. Within IT, an infrastructure software firm rallied due to its expanding addressable market and potential for accelerating revenue, margins, and free cash flow. Within Healthcare, a biotechnology company outperformed following positive reimbursement decisions and growing enthusiasm for its platform. Within Communications Services, a provider of in-flight internet connectivity systems and services rallied after reporting stronger than expected 2Q19 earnings and raised full year guidance.

Top sector detractors in 3Q included Consumer Discretionary, Financials, and Energy. Within Consumer Discretionary, a gaming equipment maker was pressured as the slot machine replacement cycle underperformed near-term expectations amid casino operator consolidation. In Financials, underperformance was driven by an allocation effect, as the strategy was significantly underweight the sector. Within Energy, an oil services provider reported disappointing 2Q19 EBITDA due to challenging market conditions sparking an expanded audit committee review.

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Small Cap Equity

Our Small Cap Equity strategy underperformed its benchmark, the Russell 2000 Index, during 3Q as top detractors included the Consumer Discretionary, Healthcare, and IT sectors. Within Consumer Discretionary, a gaming equipment maker was pressured as the slot machine replacement cycle underperformed near-term expectations amid casino operator consolidation. In the Healthcare sector, a medical device maker lost market share in its intravenous therapy solutions business as larger competitors lead with price. Within IT, a data protection service provider announced the resignation of its CEO and reduced forward guidance due to unexpected new product performance issues, below-plan pipeline conversion, and fewer large deal sales.

Top contributors included the Communications Services, Industrials, and Materials sectors. In Communications Services, a provider of in-flight internet connectivity systems and services rallied after reporting stronger than expected 2Q19 earnings and raised full year guidance. Within Industrials, a specialty contractor for utility and communications infrastructure outperformed due to 5G build-out anticipation as well as solid results within their broadband and energy pipeline divisions. Additionally, a provider of water treatment equipment and services benefitted as the company delivered against earnings expectations as investors recognized the company's defensive/recurring benefits regarding a significant portion of their product offerings.

Small Cap Value Equity

During 3Q, our Small Cap Value Equity strategy slightly underperformed its benchmark, the Russell 2000 Value Index, as top contributors included the Industrials, Healthcare, and Financials sectors. In Industrials, an injection molding machinery company positively contributed due to an acquisition from a public competitor for a premium. Our largest healthcare position benefitted from sale rumors during the quarter which significantly added value within the worst performing sector of the index. A leading REIT company responsible for leasing to US government agencies performed extremely well aiding performance in the Financials sector.

Top detractors in 3Q were led by the Consumer Discretionary, IT, and Materials sectors. In Consumer Discretionary, a restaurant chain continued to struggle with traffic comparisons leading to its stock depreciating in 3Q. In Materials, a chemical producer was negatively impacted by their oversupply and declining profitability of its product. In IT, a software company revised their annual guidance as the resignation of its CEO impacted performance. During 3Q, the strategy increased its weighting to the Materials and Financials sectors while decreasing its weighting to the Industrials and Consumer Discretionary sectors.

Small to Mid Cap Equity

Our Small to Mid Cap Equity strategy outperformed its benchmark, the Russell 2500 Index, during 3Q posting a positive return whereas the benchmark lost value. The strategy also provided downside protection during July and August 2019 when risk aversion grew due to slowing economic data and trade fears. The IT sector outperformed as a software company announced strong backlog growth while a test equipment developer noted strong demand for 5G network chip test equipment. In Industrials, an aerospace and defense company benefited from rising US defense budgets to purchase computer hardware. Small to mid cap stocks and credit spreads weakened sharply in August before rallying in September. Value stocks significantly outperformed growth stocks during 3Q as healthcare stocks significantly lagged the broader market.

In Healthcare, a medical technology company underperformed stemming from price competition within their infusion consumables division while a medical device company struggled with salesforce turnover. In Consumer Staples, a beverage company did not complete expected aged inventory sales due to weaker market conditions.

We believe high growth, high valuation technology stocks are vulnerable to significant declines if the ongoing economic headwinds result in reduced enterprise spending. Credit spreads continue to fluctuate at an elevated level between the risks of slowing economic growth and monetary intervention to restore economic confidence.

Small to Mid Cap Equity (cont.)

Trade uncertainties and slowing economic indicators will begin to emerge via corporate earnings reports.

The strategy is defensively positioned relative to its benchmark based on slowing growth prospects in the short term due to weakening US growth. Credit spread movements will guide our positioning as we wade through a period of uncertainty.

Mid Cap Equity

During 3Q, our Mid Cap Equity strategy underperformed its benchmark, the Russell Midcap Index. Top detractors included the Consumer Discretionary and Industrials sectors. In Consumer Discretionary, a leading optical retailer underperformed as one of their largest customers embarked on a wellness program without utilizing their services. In the Industrials sector, low prices could challenge demand for a liquified natural gas equipment maker.

Top contributors to performance in the quarter were the IT and Materials sectors. The IT sector outperformed as a software company announced strong backlog growth while a test equipment developer noted strong demand for 5G network chip test equipment. In the Materials sector, a building materials company experienced strong public and non-residential construction jobs in the Southeastern portion of the US. During 3Q, the strategy increased its weighting to the Real Estate, Financials, and Utilities sectors while decreasing its weighting to the Consumer Discretionary, Communications Services, and Energy sectors.

Outlook

While recognizing that the current economic expansion is becoming long in the tooth, we still expect modest positive US GDP growth to set the stage for a continuation of the credit cycle. HY credit markets are functioning well, evidenced by September's activity. While we continue to monitor credit markets for signs of deterioration, corporate credit fundamentals remain solid with reasonable balance sheet leverage, strong interest coverage, and low default rates. The US consumer remains the lynchpin of our thesis as the tight labor market supports improving wage growth (and thereby spending) for lower- and middle-class workers. The near-term outlook for business investments is a bit murkier and likely hinges on the outcome of US-China trade talks, the pace of the Fed's accommodation, and to a lesser extent, the political climate. We believe the recent resurgence of value stocks relative to growth stocks is a trend that should continue which augurs well for our strategies given the focus on fundamental bottom-up stock selection and differentiated corporate credit research.

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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-EQTYCOM101419

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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 an independent, employee-owned boutique based in Philadelphia. We forge our own ideas, we respect hard work, and we are committed to our clients, our staff and our community.

