# Small Cap Equity

1Q 2021 Commentary

## Small Cap Rally Continues, Leading to Near-Record 12-Month Return

Small cap equities continued to generate robust positive returns in the first quarter of 2021, as the Russell 2000 Index returned 12.70% for the period. While short squeezes had an outsized effect on small cap returns earlier in the quarter (to the dismay of many active managers), the dominant factors that boosted equity prices throughout the period included optimism surrounding the COVID-19 vaccine and a hefty fiscal stimulus package adopted by Congress. Treasury yields rose meaningfully during the quarter (a continuation from the fourth quarter of 2020), with the 10-year yield rising from 0.93% at year-end to 1.74% on March 31, on expectations that increased fiscal stimulus could lead to faster economic growth and higher inflation. Rising rates and a steeper yield curve benefited cyclical, value-oriented segments of the market in the first quarter, as these areas are generally expected to do well in a reflationary environment.

Overall, the pace of the rally over the last year has been nothing short of astounding, with the Russell 2000 Index generating a cumulative total return of 126.87% since the small cap market bottomed on March 18, 2020, compared to "just" 74.49% for the large cap Russell 1000 Index. For the one-year period ending March 31, 2021, the Russell 2000 Index returned 94.85%, the second-highest output for the small cap market in a one-year period (using month- or quarter-end data) since the benchmark's inception. Despite the near-record performance for small caps over this time, history would suggest that forward returns can remain positive going forward. In fact, the Russell 2000 Index has generally produced a strong return in the three-year period following similarly strong rallies, as shown in the table below listing the ten best one-year periods since the benchmark's inception (excluding the first quarter) and their subsequent returns. While history does not always repeat itself, we believe the small cap market continues to provide attractive upside potential, especially for companies with strong fundamentals and reasonable valuations.

| Small Cap Market | | |
|---|---|---|
| 1-Year Ending | Russell 2000 Index Return | Subsequent 3-Year Annualized Return |
| June 1983 | 97.50 | 9.95 |
| March 1981 | 72.13 | 12.35 |
| September 1983 | 69.92 | 7.04 |
| March 2004 | 63.83 | 12.00 |
| March 2010 | 62.76 | 13.45 |
| March 1983 | 61.83 | 15.10 |
| June 1981 | 48.52 | 9.87 |
| December 2003 | 47.25 | 13.56 |
| December 1991 | 46.05 | 11.40 |
| September 1991 | 45.08 | 14.20 |

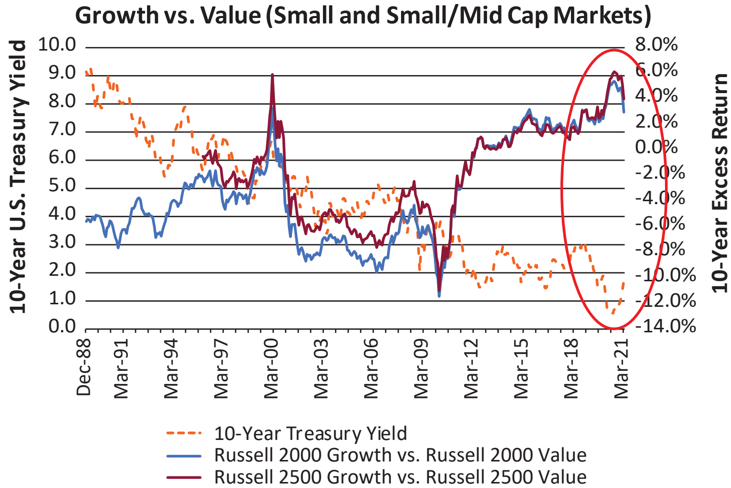
*Source: eVestment*

## Cyclical, Value-Led Rally in the First Quarter

Every sector in the Russell 2000 Index advanced during the quarter. As previously mentioned, we believe the rising rate environment provided a favorable backdrop for more cyclical, value-oriented securities, with Energy (41.86%*), Consumer Discretionary (26.57%*), Materials (19.95%*) and Financials (18.23%*) leading the way during the period. The Industrials (15.75%*) and Consumer Staples (15.39%*) sectors also contributed positively, outperforming the broader small cap market. Health Care (0.36%*), Utilities (3.36%*), and Information Technology (5.27%*) were the weakest sectors in the first quarter, while Communication Services (9.78%*) and Real Estate (10.04%*) also underperformed despite generating strong absolute returns.

From a style perspective, the Russell 2000 Value Index outperformed the Russell 2000 Growth Index for a second consecutive quarter, with a respective total return of 21.17% versus 4.88% in the first quarter. Much of this outperformance was driven by the sector leadership discussed in the previous paragraph, as these sectors generally have a higher representation in the small cap value benchmark. We have discussed the strong relative performance of longer-duration equities in previous iterations of this commentary. These securities, which are typically described as "growth stocks" given much of their perceived value is derived from future cash flows that may not be realized for a number of years, have outperformed meaningfully since Treasury yields began declining in 2018. While longer-duration assets may promise higher growth in the future, they are also generally more sensitive to movements in interest rates. As expected, longer-duration assets such as those found in the biotechnology and software sectors underperformed in the first quarter given the upward pressure on rates, which has a direct impact on a company's discount rate.

**Rolling 10-Year Excess Return**
**Growth vs. Value (Small and Small/Mid Cap Markets)**




*Source: FactSet*
*Past performance is not indicative of future results. Please see important disclosures at the end of this document.*

*Percentage represents index sector return for the quarter.

Despite value's recent outperformance, the trailing 10-year relative performance between growth and value (depicted in the chart on the previous page), which eclipsed the extremes of the dot-com bubble in 2020, suggests further normalization will likely occur to the benefit of value-oriented investors. As such, we believe the current environment and the market's reflationary expectations may continue to pressure these longer-duration businesses, which could provide a more favorable backdrop for companies with strong free cash flow characteristics and lower valuations going forward.

## Mixed Bag for Quality Factors

While value recaptured a portion of its multi-year underperformance in the first quarter, it was more of a mixed bag for quality. In a welcome change from 2020, companies with positive earnings generally outperformed loss-makers during the period. However, companies with low returns on equity, greater earnings variability, higher leverage and higher betas also outperformed. We believe this is an important factor going forward, especially on the heels of the strong one-year period for the small cap market. While valuation expansion typically drives stock market returns in the early stages of a recovery (as was the case in the last nine months of 2020), later gains are typically driven by earnings growth. We believe this should benefit companies with stronger earnings profiles and less earnings variability going forward.

## Performance Review

For the first quarter of 2021, the Aristotle Small Cap Equity Composite generated a total return of 12.02% gross of fees (11.88% net of fees) compared to the 12.70% total return of the Russell 2000 Index. Security selection contributed positively to performance, while sector allocation detracted. Security selection within the Financials, Health Care and Utilities sectors added the most value on a relative basis, while the Consumer Staples, Real Estate and Industrials sectors were the largest detractors. From an allocation perspective, the portfolio benefited from an underweight in Health Care and an overweight in Industrials; however, this was offset by an underweight in Consumer Discretionary and an overweight in Information Technology.

The entirety of the Small Cap Equity Composite's underperformance came in the first half of the quarter, as the portfolio's underexposure to the most heavily shorted companies in the benchmark detracted during the small cap short-squeeze rally to begin the year. As this noise cleared and the market shifted toward rewarding companies with more attractive valuations, we were pleased to see the portfolio outperform the Russell 2000 Index from the middle of February to the end of the quarter.

| Relative Contributors | Relative Detractors |
|---|---|
| Sonos | Quidel |
| U.S. Xpress Enterprises | Mercury Systems |
| Customers Bancorp | Bottomline Technologies |
| CAI International | Chemed |
| Designer Brands | Itron |

### CONTRIBUTORS

Security selection added the most value within the Financials, Health Care and Utilities sectors. Additionally, an underweight in Health Care and overweight in Industrials contributed positively to relative performance. At the company level, **Sonos** and **U.S. Xpress Enterprises** were two of the largest contributors during the quarter.

- **Sonos, Inc. (SONO)**, a leading manufacturer of wireless home audio systems, benefited from strong demand for recently launched products driven by continued at-home consumer spending, as well as optimism surrounding the company's first foray into the portable speaker market. We maintain our position as we believe the company's innovative hardware and software offerings have the potential to create shareholder value as demand for smart home products continues to grow.

- **U.S. Xpress Enterprises, Inc. (USX)**, a leading asset-based truckload carrier in the United States, benefited from improvements in the trucking market and continued progress in rolling out its unique fleet digitization platform. We maintain a position, as we believe the company is well-positioned to benefit from strong industry supply and demand dynamics, and that recent company-specific operational efficiency initiatives, such as fleet digitization, can create value for shareholders.

### DETRACTORS

Security selection detracted within the Consumer Staples, Real Estate and Industrials sectors. Additionally, the portfolio's underweight in Consumer Discretionary and overweight in Information Technology detracted from relative performance. At the company level, **Quidel** and **Mercury Systems** were two of the largest detractors during the quarter.

- **Quidel Corporation (QDEL)**, a developer and manufacturer of medical diagnostic tests, experienced negative near-term sentiment as a result of a mixed earnings report. We maintain a position, as we believe the company will continue to benefit from a market-leading position in influenza testing, strong product innovation and expanded opportunities associated with COVID-19, which are likely to be plentiful despite the development of a vaccine.

- **Mercury Systems, Inc. (MRCY)**, a provider of secure sensor and safety-critical processing subsystems for the aerospace and defense markets, declined despite posting strong operating results and closing on what we view to be an accretive acquisition. We maintain a position, as we believe the company is well-positioned to capitalize on continued outsourcing of subsystem development, strong M&A opportunities and continued technological innovation.

## Recent Portfolio Activity

| Buys/Acquisitions | Sells/Liquidations |
|---|---|
| Box | RPC |
| eHealth | |
| Flushing Financial | |

### BUYS/ACQUISITIONS

- **Box, Inc. (BOX)**, a technology company focused on cloud content management and file-sharing services for businesses, was added to the portfolio. We believe Box's leading cloud content management platform provides significant opportunity for the business to take share as more companies shift content management to the cloud and away from on-premises vendors.

- **eHealth, Inc. (EHTH)**, an online broker of Medicare, individual/family, small business and ancillary insurance products, was added to the portfolio. We believe the company is well-positioned to benefit from expanding Medicare enrollment trends and its leading position as an omnichannel broker should allow the company to increase its market share as online enrollment and services continue to expand.

- **Flushing Financial Corporation (FFIC)**, a New York-based bank holding company that provides products and services to consumers, businesses and governmental units, was added to the portfolio. We believe the company's shares are attractively valued and that a recent acquisition, which provides scale benefits and extends the company's geographical footprint and customer base, along with improving fundamentals should create value for shareholders going forward.

### SELLS/LIQUIDATIONS

- **RPC, Inc. (RES)**, an oilfield services company primarily focused on the completion phase of well development in the United States, was removed from the portfolio due to concerns that the company's earnings power could be hampered by increasing competitive pressure in the industry.

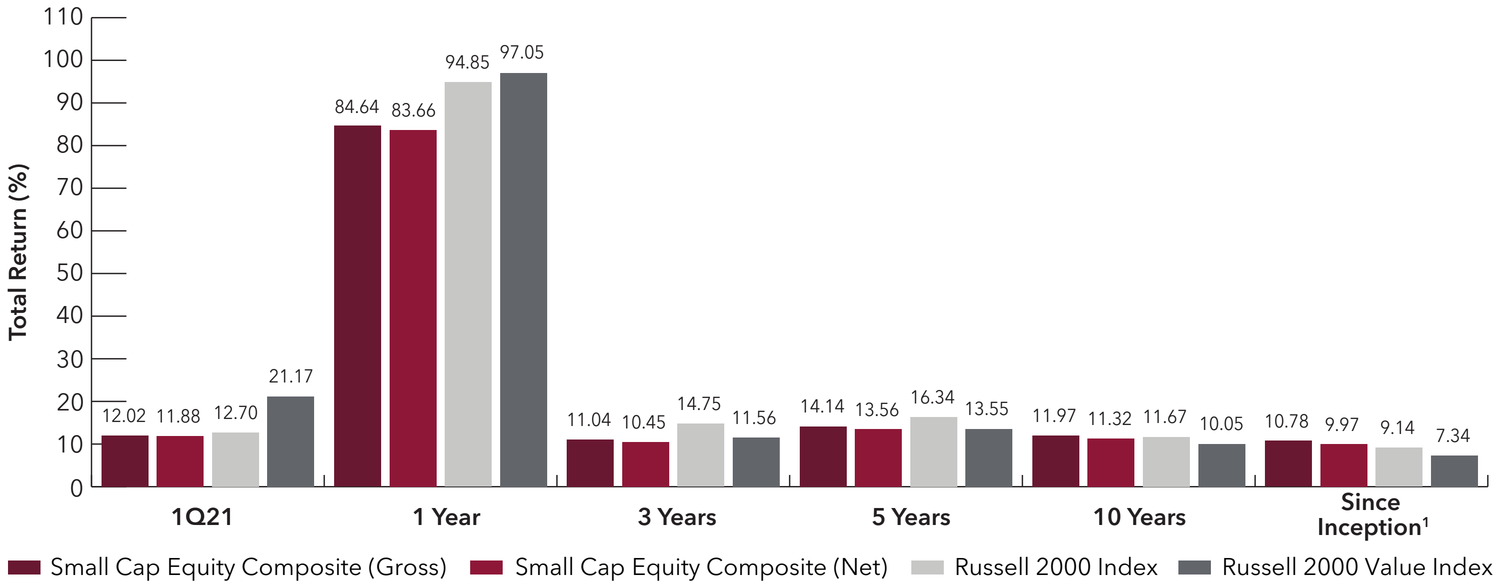
## Outlook and Positioning

Our long-term outlook for the small cap equity market remains positive, and we believe the current environment should provide a favorable backdrop for companies with strong fundamentals and attractive valuations over the next multi-year period. The pandemic environment that drove the markets last year created a headwind for many cyclical areas of the market, leading to a favorable environment for longer-duration growth companies and significant outperformance of money-losing companies relative to profitable businesses. We believe our focus on businesses with strong fundamentals and attractive valuations will be rewarded as these relative performance relationships continue to return to more normalized levels. Additionally, earnings growth is expected to improve substantially from last year and outpace that of large cap, which we believe provides further upside for the asset class. We believe active managers with a focus on quality should benefit as earnings growth becomes a more dominant driver of equity returns going forward.

Our current positioning is a function of our bottom-up security selection process and our ability to identify what we view as attractive investment candidates, regardless of economic sector definitions. Overweights in Industrials and Information Technology are broad-based with recent purchases across a variety of industries and end markets. Conversely, we continue to be underweight in Consumer Discretionary, as we have been unable to identify what we consider to be compelling opportunities that fit our discipline given the rising risk profiles as a result of structural headwinds for various brick and mortar businesses. We also continue to be underweight in Health Care due to our lack of exposure to early-stage biotechnology companies, which generally do not fit our discipline due to their elevated levels of binary risk. Given our focus on long-term business fundamentals, patient investment approach and low portfolio turnover, the strategy's sector positioning generally does not change significantly from quarter to quarter; however, we may take advantage of periods of volatility by adding selectively to certain companies when appropriate. As always, our focus remains on identifying what we view as attractive, long-term investment opportunities that can create value for shareholders over the next three to five years, which we believe gives us the best opportunity to generate alpha for our clients.

## Aristotle Small Cap Equity Composite Performance

*All Periods Ended March 31, 2021*




| Year | Small Cap Equity Composite (Gross, %) | Small Cap Equity Composite (Net, %) | Russell 2000 Index (%) | Russell 2000 Value Index (%) |
|---|---|---|---|---|
| 2021 YTD | 12.02 | 11.88 | 12.70 | 21.17 |
| 2020 | 10.08 | 9.47 | 19.96 | 4.63 |
| 2019 | 24.86 | 24.20 | 25.53 | 22.39 |
| 2018 | -11.59 | -12.03 | -11.01 | -12.86 |
| 2017 | 18.98 | 18.43 | 14.65 | 7.84 |
| 2016 | 19.53 | 18.92 | 21.31 | 31.74 |
| 2015 | 3.20 | 2.72 | -4.41 | -7.47 |
| 2014 | 3.32 | 2.45 | 4.89 | 4.22 |
| 2013 | 39.77 | 38.73 | 38.82 | 34.52 |
| 2012 | 17.39 | 16.58 | 16.35 | 18.05 |
| 2011 | -0.85 | -1.47 | -4.17 | -5.50 |
| 2010 | 24.92 | 24.03 | 26.85 | 24.50 |
| 2009 | 39.37 | 38.11 | 27.19 | 20.58 |
| 2008 | -34.27 | -35.01 | -33.80 | -28.92 |
| 2007 | 6.12 | 4.32 | -1.55 | -9.78 |
| 2006[2] | 7.31 | 7.31 | 2.97 | 3.75 |

Sources: SS&C Advent, Russell Investments
Composite returns for periods ended March 31, 2021 are preliminary pending final account reconciliation.
[1]The Aristotle Small Cap Equity Composite has an inception date of November 1, 2006 at a predecessor firm. During this time, Jack McPherson and Dave Adams had primary responsibility for managing the strategy. Performance starting January 1, 2015 was achieved at Aristotle Boston.
[2]For the period November 2006 through December 2006.
Past performance is not indicative of future results. Performance results for periods greater than one year have been annualized.
Returns are presented gross and net of investment advisory fees and include the reinvestment of all income. Gross returns will be reduced by fees and other expenses that may be incurred in the management of the account. Please see important disclosures enclosed within this document.