Small/Mid Cap Equity

3Q 2021 Commentary

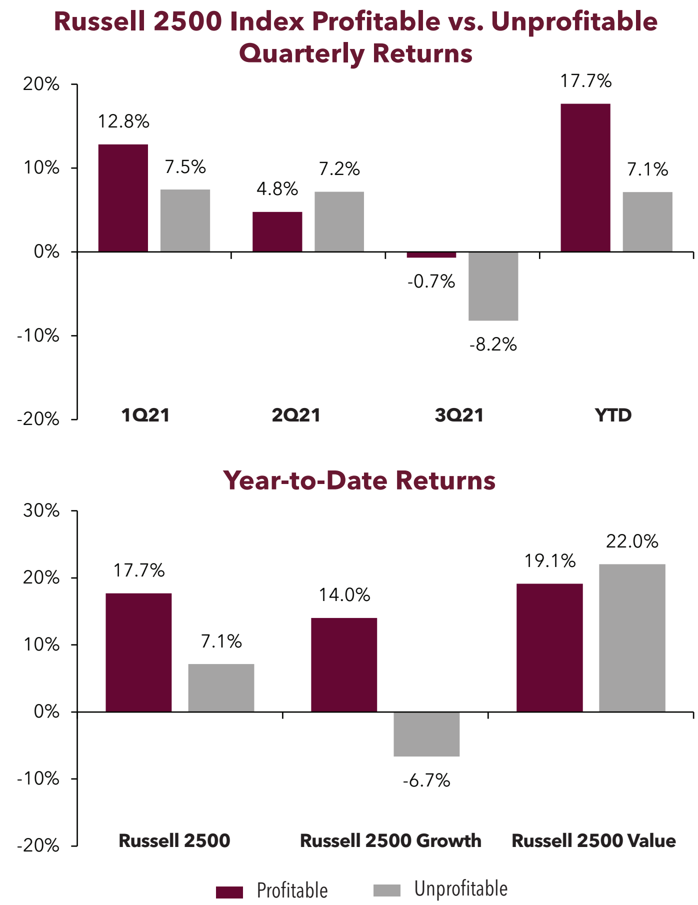
Small/mid caps pull back amid uncertain economic backdrop

Small/mid cap equities searched for direction in the third quarter as supply chain disruptions, inflationary pressures and an intra-quarter spike in COVID-cases led to a choppy three-month period for risk assets. Market performance generally ranged from flat to moderately negative across the globe, with small/mid cap companies performing near the lower end of that range. On a total return basis, the Russell 2500 Index ended a streak of five consecutive quarters of positive performance with a decline of -2.68%. Despite the recent negative returns and heightened volatility into quarter-end, the small/mid cap market remains firmly in positive territory on a year-to-date basis, having generated a total return of 13.83% through the first nine months of the year.

On the economic front, data reported during the quarter pointed to moderating growth in the U.S., suggesting the economy may be losing some momentum from the robust 6.7% annualized real Gross Domestic Product (GDP) growth rate posted in the second quarter. Corporate commentary during the quarter was flooded with mentions of inflationary pressures, labor shortages and the resulting supply chain constraints, which have negatively impacted the ability of companies to meet demand in the current environment. Of equal interest to investors continues to be the Federal Reserve's (Fed) views on the future path of interest rates. In late September, the Fed updated its 'dot plot', which signaled a first rate hike could come as early as next year. The Committee also stated that a reduction in asset purchases would "soon be warranted." Against this uncertain backdrop, treasury yields remained volatile, with the 10-year yield dropping to a 2021 low of 1.15% in early August before rising meaningfully to end the quarter at 1.47%. Coinciding with the late-quarter rise in interest rates was an increase in commodity prices. These outsized moves provided a favorable backdrop for the Energy and Financials sectors, which led the way with returns of 3.52%* and 2.29%*, respectively. Sector laggards included Communication Services and Consumer Staples, which both ended the period with declines of -11.34%* and -7.67%*, respectively.

Profits matter, value closes the gap on growth, quality in focus

In previous iterations of this quarterly letter, we have highlighted the significant outperformance of money-losing companies relative to profitable businesses. While this dynamic has been frustrating for many active managers, the current period has provided some optimism that a reversal in this trend may be taking hold. As illustrated in the next chart, profitable companies outperformed loss-makers by 751 basis points in the third quarter after underperforming in the second quarter. Moreover, since the end of last year through September 30, profitable companies within the index are up 17.7% and outperforming loss-makers by over 1050 basis points. This style reversal, however, has not been a linear shift, as bouts of outperformance this year from unprofitable businesses (e.g. Meme stock rallies) have attempted to derail this factor reversal. Nevertheless, we are certainly pleased that more reasonably valued stocks began catching up to the most expensively traded companies, and we are hopeful that this pattern will continue.



Source: FactSet
Information is based on trailing twelve-month price-to-earnings data. Past performance is not indicative of future results. Please see important disclosures at the end of this document.

Similar observations can be drawn from the recent divergence between growth and value. After a three-year stretch of growth leadership within small/mid cap markets, we observed growth's market dominance begin to fade in October 2020. Following a strong rebound in performance for the Russell 2500 Value Index relative to the Russell 2500 Growth Index, its one-year return differential now sits at +22.40% in favor of the Value index. Unsurprisingly much of this outperformance in the current year has been driven by loss-makers within the Value index (see chart above) as 'meme' stocks like AMC and GameStop helped fuel this lower quality rally earlier in the year and boosted returns for the Russell 2500 Value Index. AMC was down 32.85% in the third quarter, however, while GameStop fell 18.06%. Despite this recent charge from the value segment, growth continues to outpace value over multi-year horizons. We would note that the valuations for both the Russell 2500 Index and Russell 2500 Value Index continue to remain historically attractive (on a forward P/E basis) relative to the Russell

*Percentage represents Russell 2500 Index sector return for the quarter.

2500 Growth Index, suggesting further normalization may occur to the benefit of value-oriented investors.

Looking deeper under the surface at factors instead of standard style indexes, we observed leadership arise for more quality-oriented investments during the quarter. Whether looking at metrics of earners versus non-earners as outlined above, or traditional quality metrics based on return-on-equity, 'quality' was a consistent leadership factor during the quarter after lagging in recent periods. Looking ahead, following the unprecedented underperformance of quality factors in 2020 and the additional dislocation created by the two meme stock rallies in 2021, we believe higher quality companies will continue to benefit on a relative basis as earnings growth becomes a stronger driver of future returns and the valuation multiple expansion that began a few years ago plateaus, or even begins to recede, against a continued rise in interest rates.

Performance Review

For the third quarter of 2021, the Aristotle Small/Mid Cap Equity Composite generated a total return of -2.08% gross of fees (-2.20% net of fees), outperforming the -2.68% total return of the Russell 2500 Index. Sector allocation contributed positively to relative performance, while security selection modestly detracted. Security selection within the Health Care, Materials and Industrials sectors added the most value on a relative basis, while selection within Information Technology, Consumer Staples and Consumer Discretionary detracted. From an allocation perspective, the portfolio benefited from an overweight in Financials and an underweight in Consumer Discretionary; however, this was partially offset by an underweight in Real Estate and an overweight in Industrials.

Relative Contributors	Relative Detractors
Catalent	Itron
Gartner	Advanced Energy Industries
Charles River Laboratories	Nu Skin Enterprises
ASGN	Herbalife Nutrition
Kraton	Harsco

CONTRIBUTORS

Security selection added the most value within the Health Care, Materials and Industrials sectors. Additionally, an overweight in Financials and an underweight in Consumer Discretionary contributed positively to relative performance. Additionally, the portfolio's orientation toward companies with reasonable valuations and avoidance of money-losing companies also contributed. At the company level, **Catalent** and **Gartner** were two of the largest contributors during the quarter.

- **Catalent (CTLT)**, a pharmaceutical contract development and manufacturing organization that provides delivery technologies, development, and manufacturing solutions to the global pharmaceuticals industry, benefited from strong organic revenue growth and an announced acquisition to bolster its Softgel and Oral Technologies (SOT) segment. We maintain a position, as we believe the company's recently enhanced competitive position in the biologics market, along with the stability of its legacy business, has the potential to create value for shareholders over the course of the next several years.
- **Gartner (IT)**, a leading provider of research and advisory services for the information technology industry, benefited from strong demand for technology consulting services and company-specific margin improvements. We maintain a position, as we believe a combination of continued operating improvements, strong free cash flow and an increase in shareholder-friendly deployment of excess capital via buybacks should benefit shareholders going forward.

DETRACTORS

Security selection detracted within the Information Technology, Consumer Staples and Consumer Discretionary sectors. Additionally, an underweight in Real Estate and an overweight in Industrials detracted from relative performance. At the company level, **Itron** and **Advanced Energy Industries** were two of the largest detractors during the quarter.

- **Itron (ITRI)**, a global manufacturer and distributor of electric, water and gas meters and advanced meter systems, declined due to supply chain constraints resulting in delays of product deliveries. We maintain a position, as we view these challenges as temporary and believe the company remains well-positioned to benefit from power grid modernization, which should continue to drive demand for the company's smart metering and grid monitoring solutions.
- **Advanced Energy Industries (AEIS)**, a global power supply manufacturer, declined amidst near-term supply chain disruptions and COVID-related demand uncertainties. We maintain a position, as we believe advancements in semiconductor manufacturing, driven by innovations related to 5G, 3D NAND and industrial IoT products, will increase demand for the company's power conversion solutions.

Recent Portfolio Activity

Buys/Acquisitions	Sells/Liquidations
J & J Snack Foods	Proofpoint
	QTS Realty Trust

BUYS/ACQUISITIONS

- **J & J Snack Foods (JJSF)**, a manufacturer, marketer and distributor of branded niche snack foods and frozen beverages, was added to the portfolio. We believe the company's diverse product mix, strong financial position and company-specific operating efficiency initiatives have the potential to drive further upside and create value for shareholders. Furthermore, we believe the company will benefit from a cyclical recovery of key away-from-home venues, including restaurants, amusement parks and sports arenas.

SELLS/LIQUIDATIONS

- **Proofpoint (PFPT)**, a next-generation security and compliance company that provides cloud-based solutions, was removed from the portfolio after being acquired by the private equity firm Thomas Bravo.

- **QTS Realty Trust (QTS)**, a real estate investment trust that owns and operates data centers, was removed from the portfolio after being acquired by Blackstone, Inc.

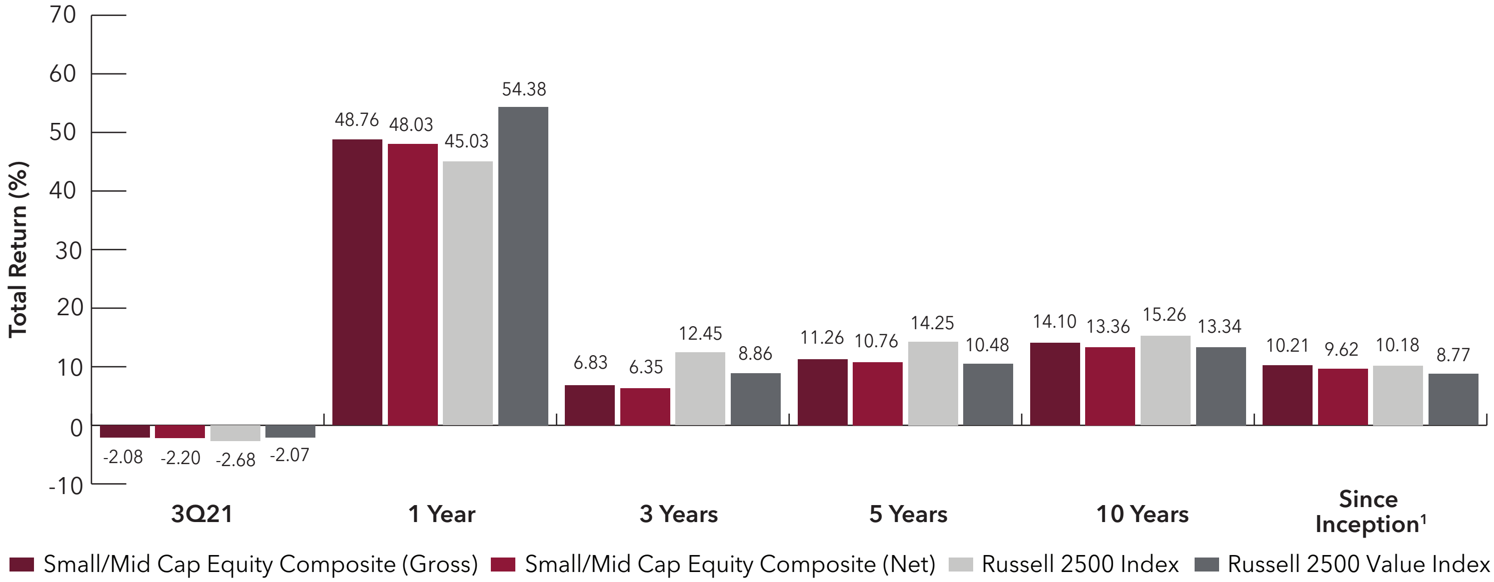
Outlook and Positioning

Our long-term outlook for the small/mid 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. Thus far in 2021, including the third quarter, we have seen short-term periods where more reasonably valued companies have recovered on a relative basis, but this has not been a linear shift in the market. Additionally, short-term dislocations driven by the meme stock rallies have periodically allowed the low-quality rally to continue, but we believe higher quality businesses have the potential to recover meaningfully going forward. Overall, 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 continue to improve 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, Information Technology and Financials 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 Real Estate as a result of valuations and structural challenges for various end markets within the sector. 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/Mid Cap Equity Composite Performance

All Periods Ended September 30, 2021



Year	Small/Mid Cap Equity Composite (Gross, %)	Small/Mid Cap Equity Composite (Net, %)	Russell 2500 Index (%)	Russell 2500 Value Index (%)
2021 YTD	12.59	12.18	13.83	20.14
2020	10.23	9.71	19.99	4.88
2019	23.73	23.25	27.77	23.56
2018	-10.22	-10.55	-10.00	-12.36
2017	13.98	13.24	16.81	10.36
2016	22.73	21.89	17.59	25.20
2015	3.77	3.17	-2.90	-5.49
2014	2.91	1.78	7.06	7.11
2013	38.34	37.41	36.82	33.32
2012	16.49	15.27	17.88	19.21
2011	0.00	-1.11	-2.51	-3.36
2010	28.17	28.07	26.70	24.82
2009	28.88	28.88	34.38	27.68
2008	-30.53	-30.53	-36.78	-31.99

Sources: SS&C Advent, Russell Investments

Composite returns for periods ended September 30, 2021 are preliminary pending final account reconciliation.

[1]The Aristotle Small/Mid Cap Equity Composite has an inception date of January 1, 2008 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.

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.