Small Cap Value Equity
Q3 2018 Commentary

Market Review:

US equities surged in the 3rd quarter of 2018, with the Russell 2000 advancing 3.6% and the Russell 2500 Value up 2.7%. Within the small-cap stock universe (Russell 2000) this quarter Telecom was the best performing sector, up 12.6%. Healthcare (+7.6%) rallied on news that the Trump administration is considering drug pricing policies that would not significantly alter the current drug supply chain or pharmaceutical industry profits. Information Technology (+5.7%) continued to outperform and the Industrials sector rebounded (+4.4%) after being the worst-performing sector in the 2nd quarter; several leading transportation and capital goods firms posted strong earnings and the Purchasing Managers' Index rose in August to its highest level in 14 years. Energy (-2.8%) and Consumer Staples (-1.7%) were the laggards in the quarter. Energy stocks declined in July and August on concerns of rising supply and slowing global economic growth, and Consumer Staples stocks struggled partly on concerns over declining margins.

The percentage of companies in the Russell 2000 that are not making a profit reached 35%. This level has historically coinced with recessions or recession-like levels. However, in 2017 and early 2018, stocks advanced partly on evidence of synchronized global growth. Now a full decade from the financial crisis of 2008, the bull market that began in March 2009 is the longest-running bull market in history. Stocks' ongoing advance has been supported by a host of positive economic data, including GDP growth for the 2nd quarter at 4.2%, unemployment at 3.9%, and consumer confidence at its highest level in 18 years. Moreover, year-over-year EPS growth for the S&P 500 is expected to be over 20% for 2018, the highest level of growth since 2010. However, the bull market will have to contend with a number of increasing headwinds going into 2019. The Federal Reserve, which increased interest rates another quarter percentage point in September, is expected to raise rates again in December and continue its tightening policy for the foreseeable future. Furthermore, while the US, Mexico and Canada reached a last minute compromise to revamp NAFTA, the Trump administration remains in conflict with China over trade disputes. After imposing 10% tariffs on an additional $200B of Chinese imports, bringing the total to $250B, China retaliated with tariffs on an additional $60B of US imports on top of $50B instituted earlier in the year. The trade war has raised concerns from business leaders about the potential disruption of supply chains and increases in materials costs.

Performance Analysis:

In the third quarter of 2018, the Small Cap Value Equity strategy increased 0.5% (gross) and 0.4% (net of fees). The Russell 2000 returned 3.6% and the Russell 2500 Value was up 2.7% in the quarter.

Figure 1: Small Cap Value Equity Returns vs. Benchmark

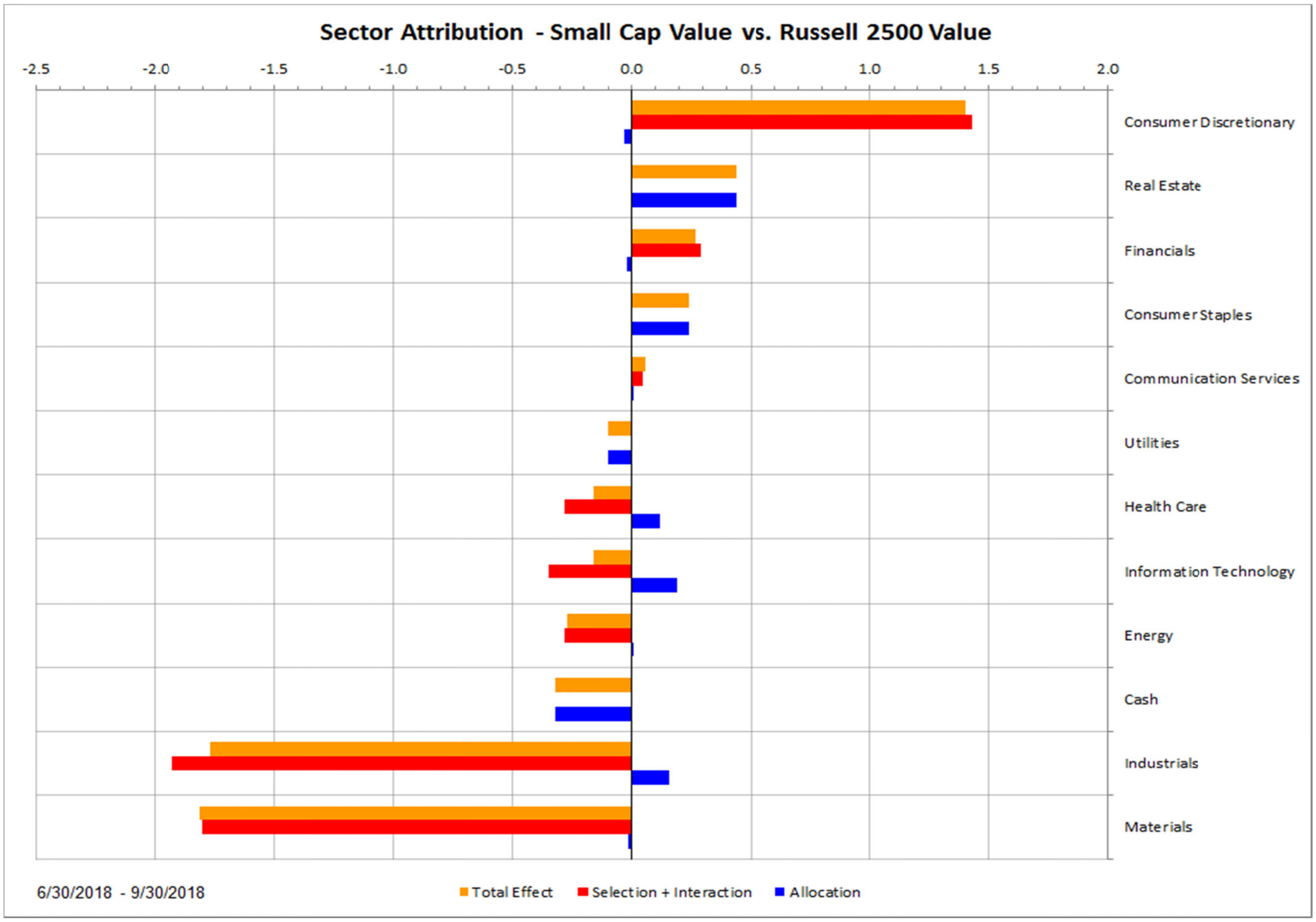
	Q3	YTD	1 Yr	3 Yr	5 Yr	10 Yr	Since Incept*
Small Cap Value (gross)	0.5	5.6	7.0	8.7	2.2	7.7	11.8
Small Cap Value (net)	0.4	5.0	6.2	8.0	1.5	7.0	10.9
Russell 2500 Value Index	2.7	5.8	10.2	14.5	10.0	10.5	11.5
Russell 2000 Index	3.6	11.5	15.2	17.1	11.1	11.1	10.0

**June 1992. Performance for periods greater than 1 year is annualized..*

In the quarter, Growth further outperformed Value with the Russell 2500 Growth Index +7.2% and the Russell 2500 Value Index +2.7%, a 500 basis point spread. Year-to-date, the Growth over Value spread has widened to 1,000 basis points driven by the dominance of Technology and Consumer Staples. International stocks, despite compelling valuations, lagged on concerns of slowing growth, escalating US trade tensions and the stronger US dollar.

Portfolio Attribution:

Attribution Effects – Small Cap Value vs. Russell 2500 Value 6/30/2018 – 9/30/2018



Source: SCCM/Bloomberg, 9/30/2018.

The following attribution analysis of the Small Cap Value Equity portfolio utilizes the Russell 2500 Value as the benchmark of comparison for the third quarter of 2018.

The ***Consumer Discretionary*** sector was the largest contributor to relative performance for the quarter driven by strong stock performance combined with an overweight allocation in the portfolio. Outperformance here was led by a diverse group of attractively valued companies offering strong shareholder returns including Helen of Troy (+33.0%) and Motorcar Parts of America (+25.3%). Our overweight allocation and strong stock selection in ***Financials*** and our underweight allocation to ***Consumer Staples*** aided performance. Our underweight allocation and weak stock selection to ***Materials*** was the largest detractor to relative performance as Tahoe Resources (-43.3%) underperformed. Underperformance was also caused by our weak stock selection in ***Industrials*** as Babcock & Wilcox (-23.1%) and Copa Holdings (-14.7%) underperformed. We retain confidence in these allocation decisions based on valuations and the long-term outlook for our portfolio companies.

Portfolio Changes:

Purchases / Additions

There were no purchases in the portfolio during the quarter.

Sales / Reductions

VeriFone Systems – We exited our position in VeriFone Systems after the company was bought out by a consortium.

Babcock & Wilcox Enterprises – We exited our position in Babcock & Wilcox Enterprises after losing confidence in the new management team's ability to effectively restructure the company.

Quality Systems – We exited our position based on valuation grounds.

Market Outlook:

US equities have surged higher on strong corporate earnings growth, record levels of share buybacks and a resurgence of US economic growth in the context of slowing international growth. The stimulative effects of fiscal easing, namely US corporate tax reform and higher budget deficits, have lifted current year growth and served to counter the effects of monetary tightening. The divergent sentiment between US and international markets, further fueled by elevated trade tensions and tariffs, has led to a stronger dollar and significant flows into the US. It remains to be seen whether the extreme performance differential between US and global markets will persist, similar to the Growth versus Value disparity that is now approaching a record length.

The bull market leadership has been led by the Technology sector; at current levels, the market capitalization of the five largest S&P 500 stocks (all technology stocks: Amazon, Apple, Facebook, Google, and Microsoft) have a combined market capitalization larger than that of the smallest 281 members of the S&P 500. In 2018, six stocks (Amazon, Apple, Facebook, Google, Microsoft, and Netflix) have generated 50% of S&P 500 returns. Encouragingly, the recent broadening of the US equity market with leadership from the Health Care and Industrials sectors brings fresh support to an otherwise narrow market. The Technology sector has thrived, in part benefitting from relatively low levels of regulation and antitrust oversight; the Technology and E-commerce sector has ~27K regulations, among the least-regulated sectors, versus Manufacturing at ~215K and Finance at ~128K regulations[1]. However, Technology faces increasing risks from federal regulation as US regulatory agencies and legislative bodies, following in the steps of European Union, are now examining technology firms' anti-competitive behaviors, consumer privacy lapses, and allegations of bias behavior. While it is difficult to predict whether federal action will be taken, increased scrutiny is likely to rein in the overt competitive ambitions of these targeted companies.

Meanwhile, the growth of passive investments through ETFs, indexation, swaps and quantitative funds over the past decade have transformed the equity market structure and trading volumes. Through May 2018, total ETF assets under management (AUM) reached $5.0 trillion globally, up from $0.8 trillion in 2008. JPM Equity Strategy estimates that Indexed funds now account for up to 45% of equity AUM globally, while Quant Funds comprise an additional 15-20% of equity AUM. It is estimated that active single-name trading accounts for only ~10% of trading volume while 90% of trading volume comes from

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[1] BofA/ML Sector Focus Point, 10/1/2018.

Quant, Index, ETFs and Options[2]. The dominance of these products pose a risk as herd behavior and rules-based investing could potentially lead to liquidity disruptions and steep market declines.

Thank you for your continued support. Feel free to reach out to us if you have any questions.

Best Regards,
Schafer Cullen Capital Management, Inc.

[2] JPM Perspectives, 9/4/2018.