Small Cap Value Equity
Q4 2018 Commentary

Market Review:

Through the first three quarters of 2018, it appeared as though the US equity market was headed for another big year, as the Russell 2000 was up over 11% to that point. However, the fourth quarter quickly erased those gains, with the Russell 2000 finishing down 20.2% for the quarter and the Russell 2500 Value down 17.1%. It was one of the worst quarterly declines since the inception of the Russell 2000 Index. The percentage of companies in the Russell 2000 that are not making a profit rose above 35%. These non-earners declined 25.6% in the quarter versus -19.1% for those companies which had positive earnings. On a sector basis for the Russell 2000, Energy was the worst performer, down 41.3%. The WTI oil benchmark, which began the quarter at a nearly four-year high of $75 per barrel, declined 38% to $45 on concerns of excess inventories in the midst of slowing global growth. Materials (-26.5%) was the next worst performer as commodity prices declined over fears of slowing global growth. Utilities (-2.0%) was the best performer, as it and other defensive sectors, including Consumer Staples (-13.3%) and Real Estate (-14.1%) outperformed.

The fourth quarter was a reminder of how abruptly sentiment can shift, not only on stocks, but also on the US economy. In early October Fed Chairman Jerome Powell telegraphed interest rates were “a long way from neutral,” noting that extremely accommodative monetary policy was no longer necessary. This statement alone appeared to spark investor anxiety. By November, Powell shifted course, stating rates were “just below” neutral, and by the December rate hike of 0.25% the Fed dot plot implied there would only be two raises in 2019. While few indicators point to an imminent recession in the US, tempered outlooks from prominent technology and industrial firms indicate increasing pockets of weakness. The market sell-off was also driven by fears of a potential trade war with China. With $250B of Chinese goods already subject to tariffs, the Trump administration said it was prepared to impose tariffs on all remaining Chinese imports, before both sides agreed to delay any further tariff actions for 90 days.

Heading into 2019, we believe political unrest will likely continue to weigh on global markets. In the US, this includes a partial Federal government shutdown over funding for a border wall, President Trump’s surprise announcement on a US troop withdrawal from Syria, and a newly Democratic-led House of Representatives sure to apply pressure on Trump. Internationally, we believe markets will continue to contend with significant uncertainty surrounding Brexit, conflict between President Emmanuel Macron and protesters in France, and a new President in Brazil, among a host of other issues.

Performance Analysis:

The Russell 2000 returned -20.2% for the fourth quarter and -11.0% for the full year 2018 while the Russell 2500 Value returned -17.1% for the fourth quarter and -12.4% for the full year 2018.

The Small Cap Value Equity strategy composite returned -14.3% (gross) and -14.5% (net) for the fourth quarter and -9.5% (gross) and -10.2% (net) for the full year 2018, outperforming both the Russell 2000 and Russell 2500 Value for the quarter and year.

Figure 1: Small Cap Value Equity Returns vs. Benchmark

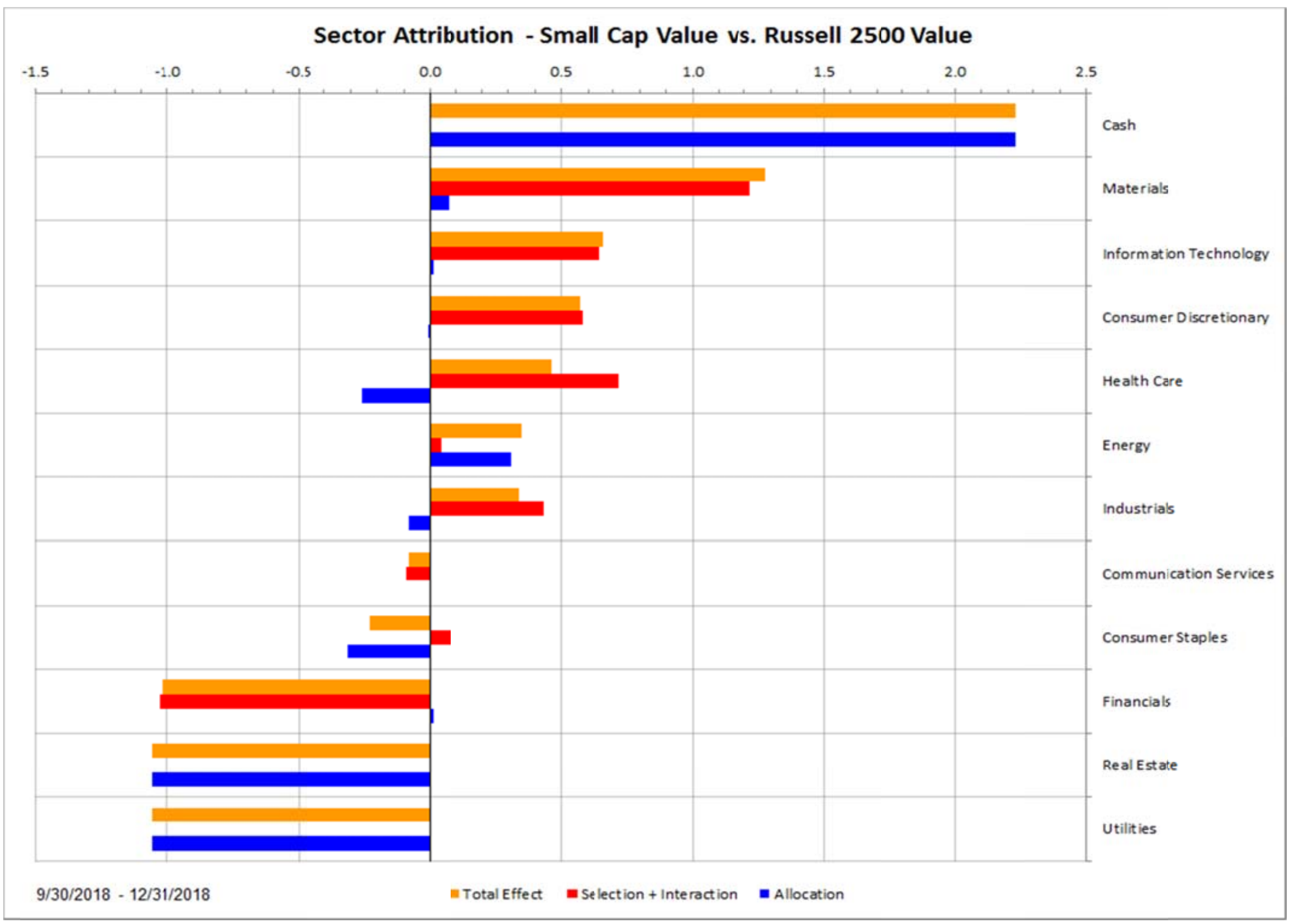
	Q4	YTD	1 Yr	3 Yr	5 Yr	10 Yr	Since Incept*
Small Cap Value (gross)	-14.3	-9.5	-9.5	3.1	-2.2	8.8	11.1
Small Cap Value (net)	-14.5	-10.2	-10.2	2.3	-2.9	8.1	10.2
Russell 2500 Value Index	-17.1	-12.4	-12.4	6.6	4.2	11.6	10.6
Russell 2000 Index	-20.2	-11.0	-11.0	7.4	4.4	12.0	9.0

**December 31, 1993. Performance for periods greater than 1 year is annualized.*

The fourth quarter's heightened volatility and dramatic sell-off were led by deep Cyclicals and Healthcare stocks. While macroeconomic factors, namely slowing global growth, escalating China trade tariffs and normalizing monetary policy negatively impacted equity markets, the unwinding of algorithmic/high frequency trading positions also contributed to the steep slide. High quality (measured by balance sheet rating and profitability) and low beta stocks outperformed in Q4 amid the rising volatility; the flight to safety resulted in the US 10-year yield falling 36bps in the quarter to 2.69% at quarter end. While Growth outperformed Value in 2018 by 488 basis points (Russell 2500 Growth – Russell 2500 Value returns), Value outperformed Growth by 295 basis points in Q4.

Portfolio Attribution:

Attribution Effects – Small Cap Value vs. Russell 2500 Value 9/30/2018 – 12/31/2018



Source: SCCM/Bloomberg, 12/31/2018.

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

Our strong stock selection combined with an underweight allocation made the ***Materials*** sector the largest contributor to relative performance for the quarter. Outperformance here was led by Loma Negra (+25.9%). The portfolio also benefitted from our strong stock selection in ***Information Technology***, as Mitel (+1.2%) was acquired, and Orbotech (-4.9%) made progress on clearing regulatory hurdles to be acquired by a large cap company. Our underweight allocation to the ***Utilities*** and ***Real Estate*** sectors detracted from relative performance. Additionally, our weak stock selection in ***Financials*** detracted from relative performance as Bank Ozk (-39.5%) reported weaker than expected earnings and Brighthouse (-31.1%) underperformed.

Portfolio Changes:

Purchases

Brunswick Corporation (BC) – Brunswick, headquartered in Mettawa, IL, is a leading manufacturer of recreation products including marine engines, boats, and fitness equipment. Its highly profitable marine engine business essentially operates in a duopoly market structure and is gaining share internationally. In addition to capitalizing from strong demand for outboard engines, Brunswick is increasing its scale in its parts & accessories division. The company has successfully restructured its boat business and we believe it will benefit from a historical low level of channel inventory for both new and used boats. Moreover, the company is looking to spin off its Fitness division, which could serve as a positive catalyst for Brunswick's shares. We purchased shares at 10 times forward earnings.

Iberiabank Corporation (IBKC) – Iberiabank, headquartered in Lafayette, LA, is a commercial bank with 267 branches in Louisiana and five other southern states. The company has $13.4 billion in assets, and commercial real estate and business loans make up nearly three-quarters of its loan portfolio. Iberiabank is well-positioned to benefit from rising interest rates. Potential stock catalysts include organic growth and credit improvement. Through its recent acquisitions, the company has an opportunity to improve profitability given the high level of cost savings. We believe Iberiabank could also be an attractive target for a large cap buyer. We purchased shares at 10 times forward earnings.

Magellan Health (MGLN) – Magellan Health, headquartered in Avon, CT, is a leading healthcare management business focused on delivering innovative specialty solutions for the most complex areas of health, including special populations. The company provides services to health plans and other managed care organizations, employers, labor unions, and government agencies. Magellan has restructured its business and is well-positioned to improve its net margin over the next two to three-years by improving its profitability in Virginia and continuing to scale its pharmacy business segment. We think new contract wins will also cause shares to rerate. We purchased shares at 12.5 times forward earnings.

Progress Software (PRGS) – Progress Software, headquartered in Bedford, MA, offers databases, application, messaging servers, and development tools. The company serves about 140,000 organizations in more than 180 countries, and allows developers to be more productive. Its software offers users the ability to detect patterns from sensor data, with the goal of predicting machine failure. As more companies invest in Industrial Internet of Things (IIoT), Progress Software will increase its recurring revenue from new customer wins. The company's new focus to provide Cognitive Applications, which allow applications to learn as they gather more information, should cause earnings growth to accelerate. We purchased shares at 14 times forward earnings.

REV Group (REVG) – REV Group, headquartered in Milwaukee, WI, is a leading manufacturer of specialty vehicles including fire & emergency vehicles, RVs, and buses. The company is in the process of streamlining its purchasing practices, optimizing manufacturing processes, and standardizing product platforms. After facing significant supply chain challenges in 2018, the company is well-positioned to consolidate the fragmented global specialty vehicle market. Over 70% of its business is government related, and REV Group should see revenue and earnings growth meaningfully accelerate as new programs ramp up. We purchased shares at 9.5 times forward earnings.

Sykes Enterprises (SYKE) – Sykes Enterprises, headquartered in Tampa, FL, offers customer relationship management solutions to Fortune 1000 clients. The company has a global base of 55k workstations and provides customer care solutions via phone, email, web, and chat support. Over 50% of its revenue is derived from supporting technology and telecom-related companies. The company is well-positioned to benefit from the trend toward contact center outsourcing. Sykes is a leader in contact center outsourcing and its scale advantages should help it to improve its profitability. We purchased shares at 12 times forward earnings.

Taylor Morrison (TMHC) – Taylor Morrison, headquartered in Scottsdale, AZ, operates as a homebuilder. The company builds single-family homes, and develops land, which includes lifestyle and master-planned communities. Taylor Morrison focuses on the East and West regions of the United States. The company is well-positioned to improve its market share and margins. The entry-level channel is about one-third of its mix, and shares should rerate as order growth accelerates in this segment as well as in its "move-up" communities. Taylor Morrison owns attractively priced land parcels and we believe it should expect its share price to appreciate once market participants see a stabilization in margins and order growth. We purchased shares at 7 times forward earnings.

Village Super Market (VLGEA) – Village Super Market, headquartered in Springfield, NJ, operates supermarkets throughout New Jersey, New York, Connecticut, Pennsylvania, Delaware, and Maryland. The company generates 75% of its sales from groceries, dairy and frozen, produce, and meat products. The rest of its sales come from non-foods, pharmacy, etc. The company benefits from being a member of Wakefern Food, the largest retailer-owned food cooperative in the US and owner of the ShopRite brand name. Key catalysts for the stock include promoting its online channels, store pick-up, and delivery. Village Super Market is also remodeling several of its stores and improving customer service to build market share. We purchased shares at 13 times forward earnings.

Sales

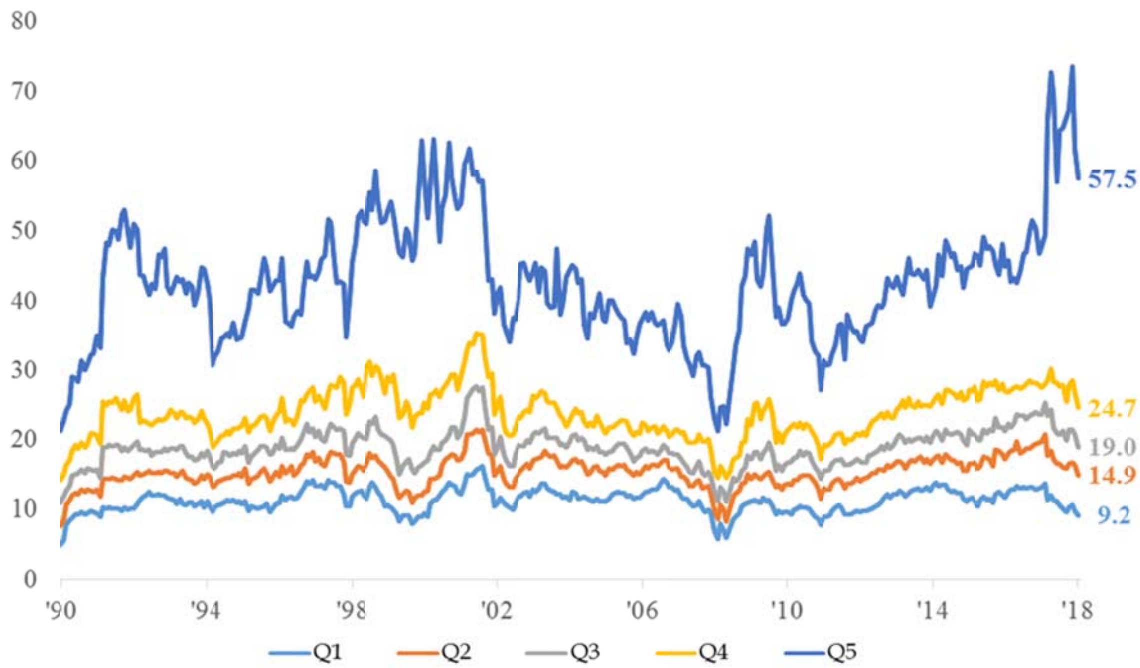
Mitel Networks (MITL) – We exited our position in Mitel after the company was acquired by a private equity firm.

Tahoe Resources (TAHO) – We exited our position in Tahoe after losing confidence in the company's ability to resolve the ongoing disputes it had with foreign government officials over its Escobal Mine in Guatemala.

Market Outlook:

Strong US economic data and robust corporate earnings growth in Q4 took a backseat to the market's increasing concerns on slowing global growth, the China trade war and normalizing monetary policy. The risk-off environment in 2018 resulted in 90% of major asset classes posting a negative return, versus the historical average of 29%, a pattern not experienced since 1921. While S&P 500 index earnings are expected to be up over 20% for 2018, with the index price decline, the Price/Earnings multiple fell 22%. Valuation multiples compressed the greatest for deep cyclicals (Energy, Financials, Industrials) and the least for stable sectors (Health Care, Utilities). We believe the rapid market sell-off and elevated volatility have presented an increasing number of attractive investment opportunities not seen for quite some time. However, the dispersion in valuation multiples remains high – a number of industries are trading at recession-like multiples while Growth stock valuations remain high. In past cycles, heightened volatility has historically led to multiple compression driven by the highest multiple stocks[1]. Even with the recent underperformance of Growth relative to Value stocks, the valuation of Growth stocks are at extreme levels relative to historical averages.

Figure 2: S&P 500 Median Trailing P/E By Quintile



Source: Strategas Research, 12/31/2018.

A headwind to global equities has been the tightening of monetary policy by world central banks. At year-end 2018, 56% of developed and emerging market central banks were tightening policy (30+ countries), the largest proportion in seven years. Historically, equities tend to deliver lower returns when more than half of the world's central banks are tightening policy[2]. In addition, the Federal Reserve's balance sheet run-off (quantitative tightening) continues to drain excess liquidity with the real global monetary base currently contracting 1% and projected to further contract by 4%+ by December 2019 if the Fed's current target of nearly $500B in assets roll off and the ECB and BOJ maintain assets at current levels. However, with global growth decelerating, central banks are already looking to adjust monetary policy, helping to stabilize global equities.

[1] Bernstein Research, "US Portfolio Strategy", December 2018.
[2] Ned Davis Research, "Global Monetary Tightening Hurting Equities", December 2018.

Fundamentally, in our view the prospect for US equities in 2019 appears positive, supported by a mid- to high-single digit year-over-year growth in S&P 500 earnings, relatively attractive valuation multiples and market sentiment coming off extreme levels. However, the current economic recovery's record length and the stark divergence between the economic recovery and financial recovery since 2009 should be considered. Nominal GDP growth in this cycle has been one of the weakest since the 1930's while equity market returns have been one of the strongest driven in part by unprecedented stimulus and aggressive monetary easing and a record level of share repurchases estimated at $4.5T in the US corporate sector. With less stimulative monetary policy and rising sovereign and corporate debt levels, the wide dispersion between asset price inflation and real economy inflation are at risk of convergence. In this environment, we believe risk-adjusted returns are likely to adjust to more normalized levels and strategies that have delivered superior risk-adjusted returns through market cycles become even more critical.

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.