Small Cap Value Equity
Q2 2019 Commentary

Market Review:

US equities had a volatile second quarter, but the Russell 2000 returned 2.1% and the S&P 500 finished up 4.3%. The S&P 500 also posted its best first half in 22 years (1997), up 18.5%. The quarter saw an extension of the major themes that sparked volatility over the past three quarters, namely the US-China trade dispute and the Federal Reserve's shifting interest rate policy. Stocks were up significantly in April, extending the rally that began at the end of December when the Fed began shifting to a more accommodative stance on interest rates. However, the market retreated sharply in the month of May when trade negotiations deteriorated and concerns grew over a lengthened dispute. Stocks recovered quickly with the best month of June for the S&P 500 since 1955, largely on hopes of interest rate cuts by the Fed.

Returns for the Russell 2000 in the quarter were mixed, with five of the eleven sectors finishing in positive territory. Industrials (+8.2%) was the best-performing sector, driven by optimism for a global cyclical recovery in the latter half of the year. Financials (+5.2%) and Utilities (+5.2%) were the next best-performing sectors, as each soared on increasing Fed rate cut expectations. Information Technology was up +3.1%, with software and IT services companies outperforming. Energy was the worst-performing sector (-8.9%), as the WTI oil benchmark declined on concerns of reduced demand from slowing global growth. Communication Services (-5.9%) was also a laggard, impacted by increasing uncertainty over telecom spending and advertising budgets.

Concerns grew on US-China trade when Treasury Secretary Steven Mnuchin announced that talks had gone "substantially backward," and the Trump Administration soon levied a new 25% of tariffs on $200B of Chinese imports while threatening additional measures. China President Xi Jinping retaliated with tariffs on $60B of US imports; furthermore, the Xi administration appeared to take a much harder long-term stance on trade, indicating through several statements and other actions, that the country is prepared to negotiate for an extended period if necessary. Concurrently, President Trump threatened to levy tariffs on Mexico unless the Mexican government took action to deter the flow of Central American migrants passing through its borders. Ultimately, the Trump administration reached an agreement with Mexico, and on the final day of the quarter, Trump and Xi reached some concessions and an agreement to restart talks.

Yields on US government bonds continued to decline, reflecting concerns over slowing global growth and increased demand for safe haven assets. Although the US economy surprised with 3.1% GDP growth for the first quarter, the IMF lowered its projection for global growth to 3.3% in 2019, down from 3.6% in 2018. The 10-year US Treasury yield dipped below 2% and has fallen by more than a full percentage point over the past three quarters. Notably, the 10-year yield also dipped below the yield on short-term Treasurys, resulting in an inverted yield curve; however, most economists dismissed the likelihood of an impending recession.

Performance Analysis:

The Small Cap Value Equity strategy composite returned 2.9% (gross) and 2.8% (net) for the second quarter of 2019. The strategy outperformed the Russell 2000 and Russell 2500 Value for the quarter.

Figure 1: Small Cap Value Equity Returns vs. Benchmark

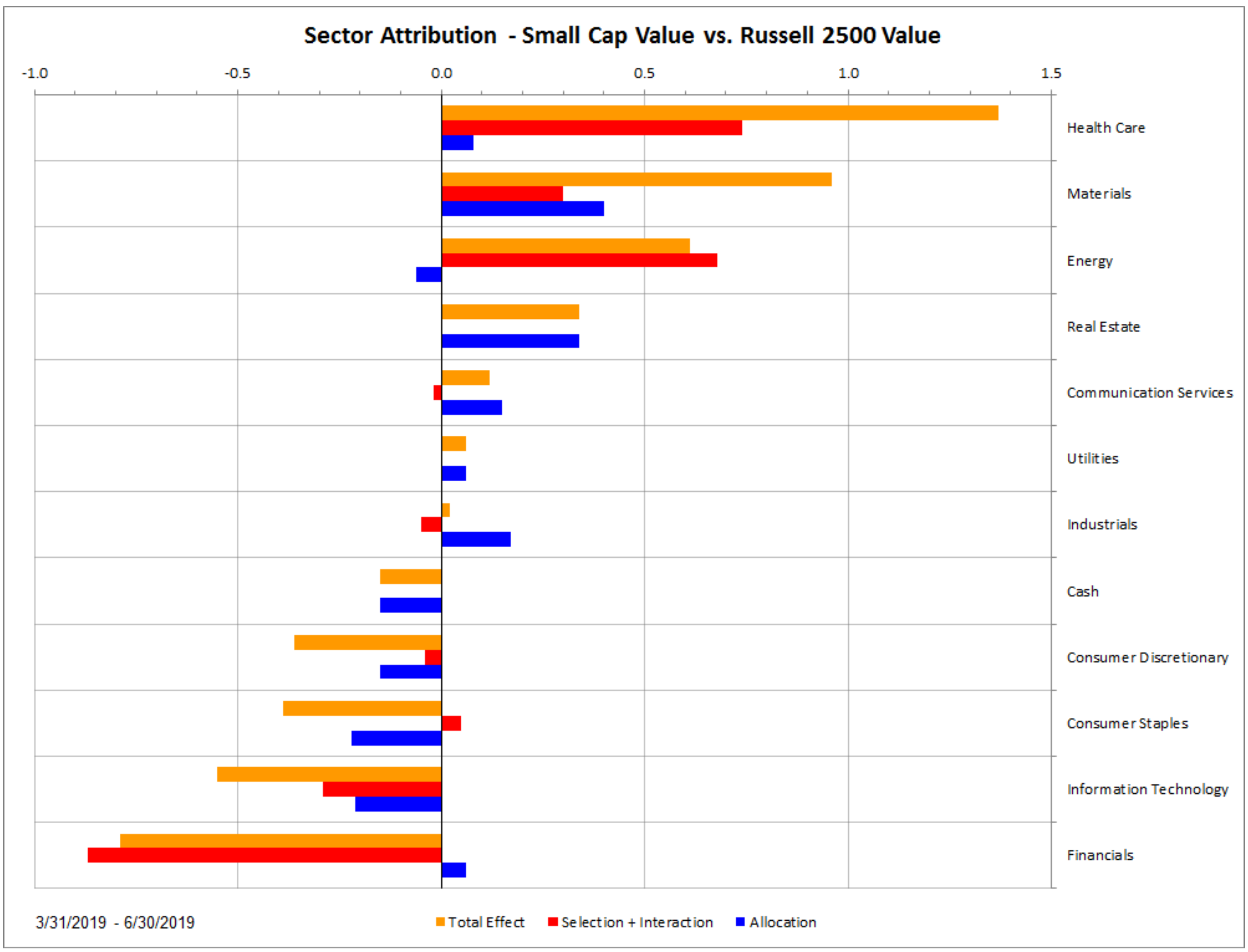
	Q2	1 Yr	3 Yr	5 Yr	10 Yr	Since Incept*
Small Cap Value Equity (gross)	2.9	-1.8	8.4	0.2	9.0	11.4
Small Cap Value Equity (net)	2.8	-2.5	7.7	-0.5	8.3	10.5
Russell 2500 Value Index	1.9	-1.9	9.0	5.6	13.3	10.9
Russell 2000 Index	2.1	-3.3	12.3	7.1	13.5	9.4

**12/31/ 1993. Performance for periods greater than 1 year is annualized. Past performance is no guarantee of future results.*

The quarter saw several narrative changes with an initial "risk-on" environment in April led by Growth and Cyclicals, followed by a "risk-off" rotation into Defensives in May, and finally a euphoric June back into high beta sectors. Growth continued its outperformance over Value by 226 basis points in the quarter (Russell 2500 Growth – Russell 2500 Value) and 935 basis points for the year.

Portfolio Attribution:

Attribution Effects – Small Cap Value vs. Russell 2500 Value 3/31/2019 – 6/30/2019



Source: SCCM/Bloomberg, 06/30/2019.

The following attribution analysis of the Small Cap Value Equity portfolio utilizes the Russell 2500 Value Index as the benchmark of comparison for the second quarter of 2019.

Our overweight allocation and strong stock selection made ***Healthcare*** the largest contributor to relative performance. Outperformance here was led by Capital Senior Living (+13.0%) and Magellan Health (+12.6%). Both companies have been targeted as potential acquisition candidates. Our overweight allocation and stock selection in ***Materials*** aided performance, as Neenah Inc. (+12.8%) and Cabot Corp. (+8.7%) outperformed. Stock selection within the ***Energy*** sector aided performance as Oceaneering (+29.3%) exceeded its profit expectations when it reported quarterly earnings.

Stock selection within the ***Financials*** sector detracted from relative performance. United Insurance (-9.9%) and Assured Guaranty (-4.9%) underperformed on concerns of lower interest rates and weaker underwriting results. Stock selection and our underweight allocation within the ***Technology*** sector detracted from relative performance as Verint Systems (-7.3%) and Sykes Enterprise (-2.9%) underperformed.

Portfolio Changes:

Purchases

Cabot Corp (CBT) — Cabot Corp, headquartered in Boston, MA, is a global leader in the production of Carbon Black, a fine carbon powder used to produce plastics, activated carbon for purification, and most notably reinforcements on tires. The company owns Carbon Black facilities around the world; the majority is produced in the US and China, with more than half of revenues coming from the Asia Pacific. Cabot Corp is well-positioned to capture greater market share, while keeping capital costs lower than its competitors. The company's investment toward its core business and divestment from weaker performing segments should lead to consistent growth. We purchased shares at 11.0 times forward earnings.

Huntsman (HUN) — Huntsman Corporation, headquartered in The Woodlands, TX, is a global chemical manufacturer. The company is a leader in the production of a variety of polyurethane and performance products, most notably MDIs. Polyurethanes, a growing part of the business, now makes up over 50% of revenues. The company benefits from generous cash returns and less cyclical chemical exposure. Huntsman is expected to see improved margins driven by higher MDI prices and elimination of lower margin products. We also expect to see higher profitability as Huntsman moves manufacturing from Europe to Asia. We purchased shares at 8 times forward earnings.

Lumentum (LITE) — Lumentum, headquartered in Milpitas, CA, manufactures a host of innovative optical and photonic products. Eighty-five percent of its business comes from optical communications products, including 3D-sensing technology and chip transceivers, where it is a market leader. Despite market disruptions caused by government restrictions placed on Huawei, one of Lumentum's customers, the company is poised to diversify its customer base and grow in the Datacom and 3D-sensing space. Lumentum should continue to be an innovative leader across its product line and improve margins as it consolidates recent acquisitions. We purchased shares at 10.9 times forward earnings.

MKS Instrumentals (MKSI) — MKS Instrumentals, headquartered in Andover, MA, develops and supplies components used to control gases for industrial manufacturing processes. The company has a global base of manufacturing plants in US, UK, Germany Italy, Korea, China, Israel, and Mexico. Over 50% of its sales come from semiconductor equipment manufacturers. The company is well-positioned to benefit from a recovery in the semiconductor space, and benefit from innovations in artificial intelligence, internet-of-things, and autonomous vehicles. MKS Instrumental's acquisitions of Newport Corporation and Electro Scientific Industries should also lead to synergies in business fundamentals, leading to higher profitability. We purchased shares at 14.5 times forward earnings.

Neenah Paper (NP) — Neenah Paper, headquartered in Alpharetta, GA, operates as a global paper manufacturer in the US and Germany. Through large distributors like Staples, Office Depot, and Walmart, the company sells technical products like filtration media and saturated and coated papers. Neenah is well-placed in an improving paper market with sales for their filtration products growing at twice the market rate. The company is also a leader in premium paper and packaging, which should help the company to maintain strong margins in a competitive climate. We purchased shares at 16.5 times forward earnings.

Stamps.com (STMP) — Stamps.com, headquartered in El Segundo, CA, provides a service for purchasing and printing postage over the Internet. The company is also the market leader in the subscription market serving SMBs and shippers with their software. The company earns high recurring free cash flow and margins. Additionally, it sees an opportunity to diversify its volume away from the USPS to other shippers such as FedEx and UPS and grow internationally. We purchased shares at 10.0 times forward earnings.

Weiss Markets (WMK) — Weiss Markets, headquarted in Sunbury, PA, operates supermarkets throughout Pennsylvania, and also has stores in Maryland, New Jersey, New York, Delaware, Virginia, and West Virginia. Key catalysts for the stock include expanding online ordering and drive-through services, as well as growing its store footprint in Virginia and Delaware. The company generates over 50% of its sales from center store and 30% from fresh food sales. The company is also expanding its centrally located distribution center to support its numerous store acquisitions. We purchased shares at 15.5 times forward earnings.

Sales

AGCO Corp (AGCO) – We exited our position in AGCO Corp based on concerns over weakening agricultural markets and rising competition in Brazil.

AMC Networks (AMCX) – We exited our position in AMC Networks because we see too many secular challenges facing the pay TV industry.

Brighthouse Financial (BHF) – We exited our position in Brighthouse Financial over concerns of how long it will take to increase its return on equity and free cash flow.

Capital Senior Living (CSU) – We exited our position in Capital Senior Living because of competitive pressures that will limit the company's ability to effectively manage its occupancy levels.

Carter's (CRI) – We exited our position in Carter's based on valuation grounds and concerns over its margins.

CVB Financial (CVBF) – We exited our position in CVB Financial based on our outlook for slower growth at the bank.

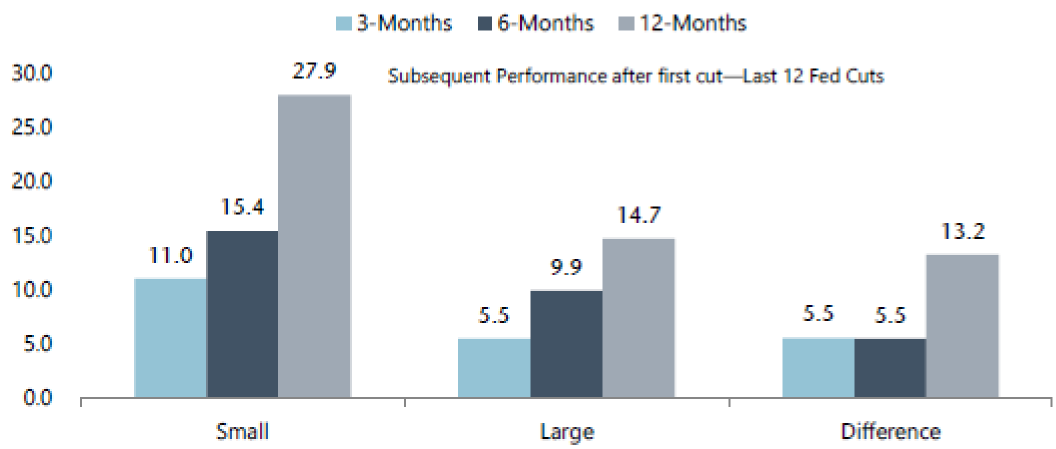
KLA Corp (KLAC) – We exited our position in KLA Corp soon after we received shares in the company following its acquisition of one of our portfolio companies.

Verint Systems (VRNT) – We exited our position in Verint Systems based on valuation grounds, and concerns over its ability to meet its long-term financial targets.

Market Outlook:

The equity market rally that rose to record highs by the end of the second quarter was driven by a significant turn in global central banking policy with the Federal Reserve now expected to cut interest rates this year, as a result of weakening US economic data and macro uncertainties including the outcome of the US-China trade war and the impact of the tariffs on the economy. The current state of "bad news is good news" for the market is evidenced by the flattening yield curve alongside peak equity levels. Valuation expansion has accounted for nearly all of the rally year-to-date, as earnings expectations have continued to decline throughout the year.

Figure 2: Fed cuts have favored small caps in the past

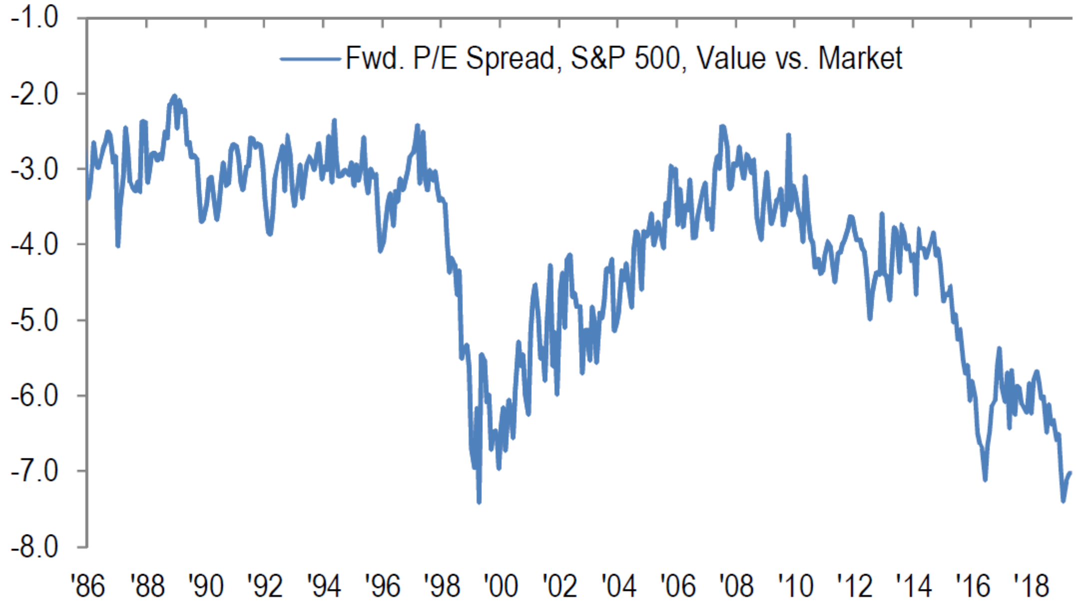


Source: Jefferies, SMID Strategy 7/17/2019. The graph is for illustrative purposes only and does not reflect information about any fund or other account managed or serviced by Schafer Cullen Capital Management.

At this juncture, the global slowdown may simply be a "soft patch" or a deeper mid-cycle slowdown. This uncertainty caused US yields to fall precipitously in the quarter and the S&P equity risk premium (Earnings Yield less 10-year Treasury Yield) rose to 320 basis points, one standard deviation above the long-term average. However, with overall growth expectations declining, the current increase in the ERP may be justified. Since January 2019, S&P 500 consensus earnings estimates for 2019 have declined nearly 6% to +8% year-over-year (Ned Davis Research, June 2019). Meanwhile, equity markets have been relatively range-bound over the past 18 months as "risk off" (Growth and Defensive) outperforms on the slowdown narrative while "risk on" (Financials and Cyclicals) outperforms on a recovery narrative. With markets now pricing in an imminent recovery, the question is whether renewed monetary easing will be enough to offset broadly slowing global growth.

A key feature of this record bull market is the persistent outperformance of Growth over Value. By almost any measure, Growth is trading at a historic valuation premium to Value and fund flows into Growth and Technology funds are at extreme levels. Value is trading at its largest discount to the market and offers the largest premium over the last 30 years.

Figure 3: Forward Price/Earnings Spread – Value vs. Market



Source: JP Morgan, The Value Conundrum, 06/07/2019. Past performance is no guarantee of future results.

The considerable outperformance of Growth over Value has been attributed to the indexation and saturation of passive products which are pro-momentum, the perception that disruptive technologies have impaired wide swaths of companies in the Value space, and unconventional monetary policy (negative interest rates, quantitative easing). A number of events could trigger a reversal, including a market decline resulting in the liquidation of passive vehicles, increasing technology regulation or a reversal of the extreme crowding in Growth stocks.

With multiple expansion the major contributor to returns this market cycle, the underperformance of Value can partially be attributed to the greater benefit Growth has experienced from multiple expansion. Valuation dispersion within the S&P 500 and Russell 2000 is at cycle highs, marking a significant hurdle for future returns on the most richly valued part of the market.

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.

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The S&P 500 Index is an unmanaged index of 500 large-capitalization publicly traded U.S. stocks representing a variety of industries. The Russell 1000 Value Index measures the performance of the large-cap value segment of the US equity universe. Comparisons to indices are inherently unreliable indicators of future performance. The strategies used to generate the performance may vary from those used to generate the returns depicted in the indices. An individual cannot invest directly in an index. Schafer Cullen Capital Management makes no representation as to the methodology used to generate the returns of any indices mentioned.

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