Small Cap Value Equity
Q2 2022 Commentary

Market Review:

US small cap equity markets posted sharp declines in the 2nd quarter, as the Russell 2000 was down 17.2% and the Russell 2000 Value was down 15.3%. Following a difficult 1st quarter, it was the worst 1st half of a year for small-caps since 1973. It was a particularly difficult quarter for high-multiple Growth stocks as the Russell 2000 Growth was down 19.3%. The 1st half also marked the first time since 2001 that both stocks and bonds fell, as government and corporate bond prices declined sharply. The yield on the 10-year US Treasury began the quarter at 2.3%, increased to 3.5%, before ending the quarter at 3.0%.

From a global macroeconomic perspective, the dominant themes in the quarter were persistent inflation and the response from central banks. In the US, the Consumer Price Index eased slightly in the month of April to 8.3%, down from the 8.5% reading in March, leading many observers to surmise that inflation had peaked. However, this narrative was upended with a May reading of 8.6%, the highest level since 1981.[1] The Federal Reserve responded with a 75-basis point hike in the federal funds rate, following earlier hikes in the year of 50 and 25 basis points. The Fed also began its program of quantitative tightening, only three months after ending its program of quantitative easing. Chairman Powell said he sees inflation as the chief economic risk facing the US and controlling it as the central bank's top priority even if the process proves painful to consumers and businesses. Powell also said he could not guarantee a so-called soft landing for the US economy, with many economists and investors eyeing a potential recession.

Performance Analysis:

The Small Cap Value Equity strategy composite returned -10.4% (gross) and -10.6% (net of fees) for the second quarter of 2022 versus -15.3% for the Russell 2000 Value and -17.2% for the Russell 2000. Year-to-date, the strategy returned -8.2% (net), outperforming the Russell 2000 Value and the Russell 2000 which returned -17.3% and -23.5%, respectively.

Figure 1: Small Cap Value Equity Returns vs. Benchmark

June 30, 2022	QTD	YTD	1 Yr	3 Yr	5 Yr	10 Yr	Since Inception*
Small Cap Value (gross)	-10.4	-7.9	-5.8	13.9	9.2	8.1	11.6
Small Cap Value (net)	-10.6	-8.2	-6.3	13.2	8.5	7.4	10.8
Russell 2000 Value Index	-15.3	-17.3	-16.3	6.2	4.9	9.1	9.6

June 1992. Performance for periods greater than 1 year is annualized.* ***Past performance is no guarantee of future results.*

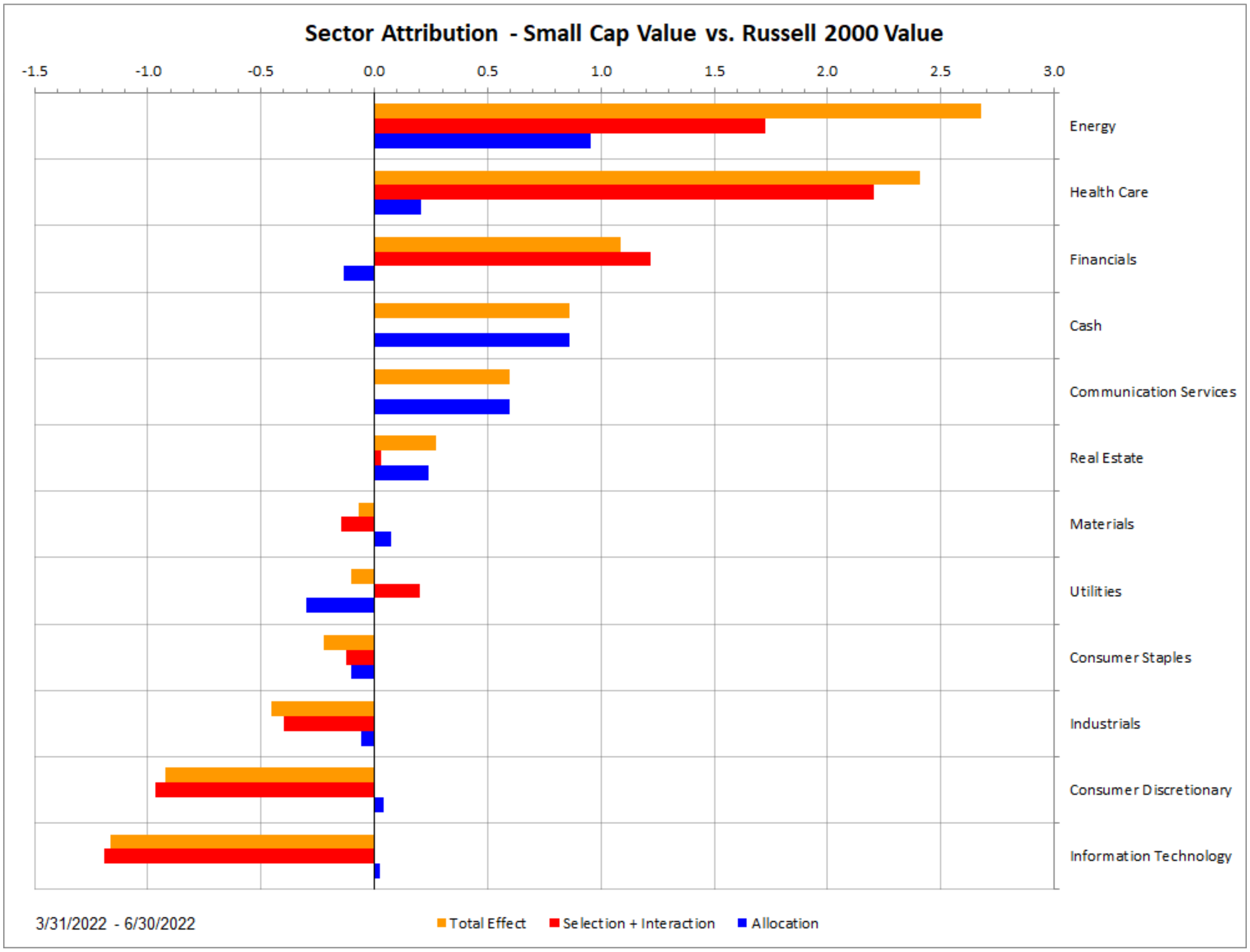
The broad-based second quarter market selloff left few winners. Inflation beneficiaries including the Energy sector delivered positive returns YTD within the Russell 2000 Value while Defensives (Utilities and Consumer Staples) declined significantly less than the market. Though Cyclicals (Financials, Materials, and Industrials) were weak, they outperformed long-duration Growth sectors (Information

[1] https://www.bls.gov/news.release/cpi.nr0.htm

Technology, Communication Services, and Consumer Discretionary). It was one of the strongest first halves for Small Cap Value over Growth in decades with the Russell 2000 Value (-17.3% total return) outperforming the Russell 2000 Growth (-29.5% total return) by 12.2 percentage points for the year and by 4.0 percentage points in the second quarter. Despite this relative outperformance, few areas of the market were immune to the indiscriminate selling late in the quarter as deleveraging, broad-based ETF selling pressure and systematic/algorithmic programs liquidating long equity positions overwhelmed markets.

Portfolio Attribution:

Attribution Effects – Small Cap Value Equity vs. Russell 2000 Value 3/31/2022-6/30/2022



Source: SCCM/Bloomberg, 6/30/2022.

The following attribution analysis of the Small Cap Value strategy utilizes the Russell 2000 Value Index as the benchmark of comparison for the second quarter of 2022.

Our strong stock selection and overweight allocation made ***Energy*** the largest contributor to performance. Energy was by far the top performing sector, as global supply and demand dynamics remained favorable, leading to higher oil and gas prices. Prices spiked following the imposition of sanctions against Russia, which is the world's third-largest oil producer. HF Sinclair (+14.3%) and Helmerich & Payne (+1.2%) reported strong earnings enabling them to strengthen their balance sheets, cover capital expenditures, and pay their dividends. Our strong stock selection and overweight allocation made ***Healthcare*** the second largest contributor to performance. Natus Medcal (+27.4%) announced the company would be acquired by ArchiMed in an all-cash deal. Haemonetics Corp (+3.1%) announced strong fourth quarter earnings for 2021 on the back of its hospital segment results. Our strong stock selection within ***Financials*** contributed to relative performance. While many of the banks declined on economic growth concerns related to inflation, others benefited from their ability to earn higher net interest margins. First Interstate BancSystem (+4.9%) benefited from its asset sensitive balance sheet and its recent acquisition of Great Western Bancorp.

Stock selection detracted from relative performance within ***Information Technology.*** Comtech Telecommunications (-41.8%) declined after the company reported weaker than expected earnings and guidance as it is experiencing negative impacts from the supply chain and the Russia/Ukraine conflict. Stock selection within ***Consumer Discretionary*** detracted from relative performance. Shares of Denny's (-38.6%) and Ruth's Hospitality (-28.3%) declined after weaker than expected earnings results on the back of higher food and labor costs.

Portfolio Changes:

Purchases

ANI Pharmaceuticals (ANIP) is a specialty pharma company that develops, manufactures and markets branded and generic prescription drugs. In addition to its proprietary drug manufacturing and distribution business of oncolytics, narcotics, complex formulations, and steroids, ANI operates as a contract manufacturer. The company has a successful track record of re-commercializing or purchasing abbreviated new drug applications (ANDA's), but shares have been oversold since its management shake up in 2020. ANI should be able to achieve double-digit revenue growth from an improved generic cycle and its introduction of its recently FDA approved Cotrophin gel, which is used to treat arthritis, multiple sclerosis, epileptic spasms in infants, and collagen disorders. Moreover, ANI has improved its cost structure after acquiring Novitium and recently announced the restructuring of its manufacturing capabilities. We purchased shares at 19x forward earnings.

Natus Medical (NTUS) is a medical device company that focuses on screening products. Approximately 30% of its revenues are from the newborn channel, 45% from the neurodiagnostic market, and 25% from the hearing aid fitting market. Our thesis was partially based on the new CEO change that occurred earlier this year and his strategy to gain share in consumables, expand internationally, and reduce non-core assets. During the second quarter, Natus Medical announced it's being acquired by ArchiMed, a healthcare focused private equity firm, in an all-cash deal representing a 29% premium ($1.2 billion) to Natus' closing price on April 14. We purchased shares before the announced acquisition at 16x forward earnings.

RLJ Lodging Trust (RLJ) is a self-advised and self-administrated real estate investment trust. The company owns mostly premium-branded, high-margin hotels and operates focused-service and compact full-service hotels in 23 states. RLJ is well-positioned to benefit from its urban exposure and a recovery in corporate and group travel. Moreover, its management team has a track record of strong capital allocation. The company also has a competitive advantage because of its strong liquidity and financial flexibility. Future catalysts for shares include positive long-term demand trends and its ability to generate incremental profit from hotel conversions, margin initiatives and revenue enhancements. We purchased shares at 10x forward P/FFO.

Spire Inc (SR) is a public utility company involved in the retail distribution of natural gas. The company serves residential, commercial, and industrial customers in Missouri, Alabama, and Mississippi. Spire's gas utility business accounts for over 90% of company revenue and its other segments operate natural gas and liquid propane storage fields. Spire's ability to increase its rate base through its pipeline replacement should provide attractive growth. ESG initiatives such as renewable natural gas, leak prevention, and carbon neutrality could also lead to a multiple re-rating for shares. More favorable regulatory developments could also serve as a potential catalyst. We purchased shares at 18x forward earnings.

Varex Imaging (VREX) designs, manufactures and sells x-ray imaging components such as x-ray tubes, flat panel detectors, imaging software, voltage connectors and energy inspection accelerators used in a range of applications such as radiographic and fluoroscopic imaging, mammography, computer tomography and computer-aided detection. The company operates under two segments: Medical and Industrial and is a leading provider of imaging solutions to companies such as Siemens, GE, Philips, Toshiba, and Canon. The Industrial segment accounts for 20% of revenue and is used in security and industrial inspection applications, such as airport security, cargo screenings and ports and boarders. The reopening of the economy will lead to an increased volume of medical procedures and cause a lift in demand for Varex's imaging components. With over 10% of its revenue coming from China, the company's sales will accelerate once China lifts its Zero-Covid policy. We purchased shares at 18x forward earnings.

Vector Group (VGR) is a discount cigarette manufacturer and the fourth largest tobacco company in the US. The company manufactures cigarettes under its Eagle, Liggett, Montego, Pyramid, and Montego brands. Vector recently spun off its Douglas Elliman real estate company and is well positioned to benefit as a pure-play discount tobacco business that can take advantage of consumers trading down because of inflationary pressures. We expect the company to gain significant market share and attract investors in an uncertain economic environment because of its strong dividend yield and ability to generate strong free cash flow. Additionally, its competitive position was strengthened recently when a Korean discount tobacco company exited the US market. We purchased shares at 9x forward earnings.

Sales

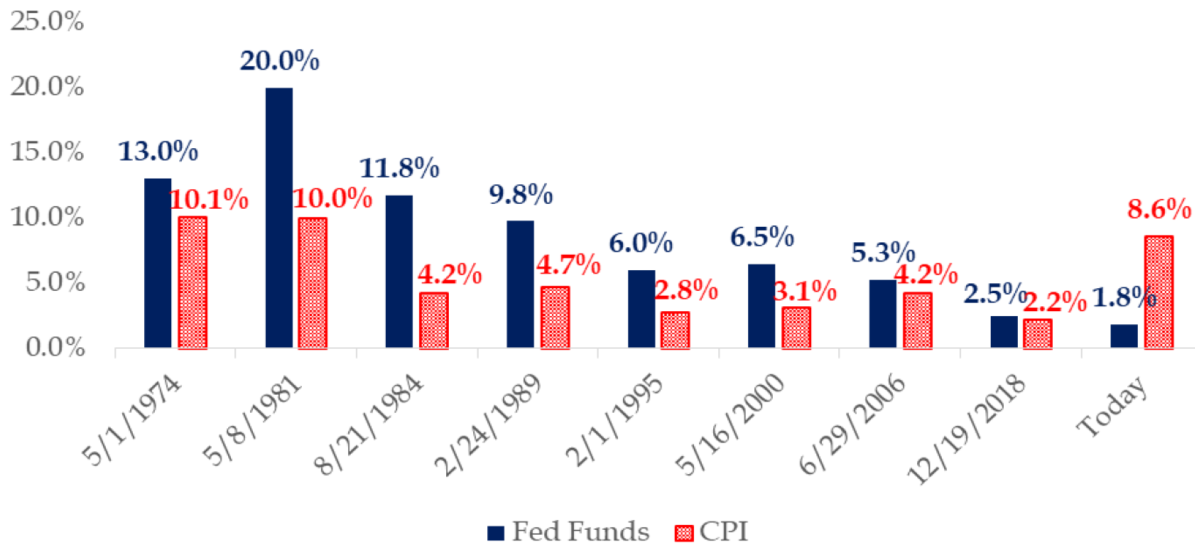
First Bancorp (FBNC) was sold in the strategy during the quarter based on concerns over the bank's loan growth trends.

Market Outlook:

The equity market downturn that began in January 2022 hit bear market territory in the 2^{nd} quarter as decades-high inflation, expected to peak by mid-year, has remained persistently high. As a result, global central banks accelerated rate hikes throughout the quarter serving to withdrawal liquidity and tighten financial conditions, pressuring almost all asset classes. All the while, the surging US dollar, widening credit spreads and increasing pockets of economic weakness have further raised alarm. Fears of a potential recession driven by a combination of monetary tightening and weakening growth soon shifted to concerns that the Federal Reserve will not be aggressive enough to bring inflation down. This view rests on the belief that a prolonged period of inflation will lengthen the Fed tightening cycle, increasing the odds of recession.

The track record of the Fed engineering a soft landing while raising interest rates is poor. That coupled with a multi-decade paradigm shift at the Fed clearly prioritizing price stability (inflation) over growth, suggests that the Fed will continue raising interest rates until inflation has broken convincingly. Over the past half century of Fed rate hike cycles, the Fed Funds rate has ended at levels higher than CPI (Figure 3). There has only been once instance, during the 1994-1995 cycle, when the Fed tightened above the neutral rate that didn't result in recession. Today, given the wide spread between the Fed Funds rate and CPI, either inflation will need to fall significantly, or Fed tightening has a way to go. That being said, a recession could be short and shallow in nature given the strength of consumer finances, a well-capitalized banking system and market excesses that have already corrected considerably.

Figure 2: Fed Funds Rate and CPI at the End of Prior Tightening Cycles



Source: Strategas Research, Historical Tightening Cycles, 6/27/2022. **Past performance does not guarantee future results.**

The current bear market in small-caps has seen a 32% drawdown at its low point and has digested the growing macro concerns and discounts a probable risk of a recession. Examining the historical profile of bear markets over the last half century (bear markets since 1953) in terms of duration and magnitude can aid investors in how far we are in the current cycle (Figure 3). Over one third of the bear markets over this time period (4 out of 11) have been relatively short at less than 8 months in duration. The median drawdown in these eleven bear markets has been 34%. In this cycle, small-cap forward P/E multiples have contracted by 40% as consensus Russell 2000 EPS estimates call for positive year-over-year growth this year. Around recessions on average, the peak-to-trough decline in the forward P/E multiple declines 33% (Figure 4).

Figure 3: Recession Risk Largely Discounted by Small Caps

Small caps have typically sold off 36% (vs. ~30% for large caps) during US recessions… where the recent selloff already represented ~80% of the historical avg. recessionary selloff

	Small caps			
Recession	**Peak date**	**Trough date**	**% decline**	**# of months**
3Q53-2Q54	2/28/1953	9/30/1953	-11%	7
4Q57-2Q58	5/31/1957	12/31/1957	-21%	7
3Q60-1Q61	5/31/1961	10/31/1962	-26%	17
1Q70-4Q70	11/30/1968	6/30/1970	-49%	19
1Q74-1Q75	4/30/1972	12/31/1974	-54%	33
2Q80-3Q80	2/8/1980	3/27/1980	-27%	2
4Q81-4Q82	6/15/1981	8/12/1982	-29%	14
4Q90-1Q91	10/9/1989	10/30/1990	-34%	13
2Q01-4Q01	3/9/2000	10/9/2002	-46%	31
1Q08-2Q09	7/13/2007	3/9/2009	-60%	20
1Q20-2Q20	1/16/2020	3/18/2020	-42%	2
		Median	**(34%)**	**14**
		Avg.	**(36%)**	**15**
	Avg. since 1980		**(40%)**	**16**

Source: BAML, US SMID Cap Strategy, 7/19/2022. **Past performance is no guarantee of future results.**

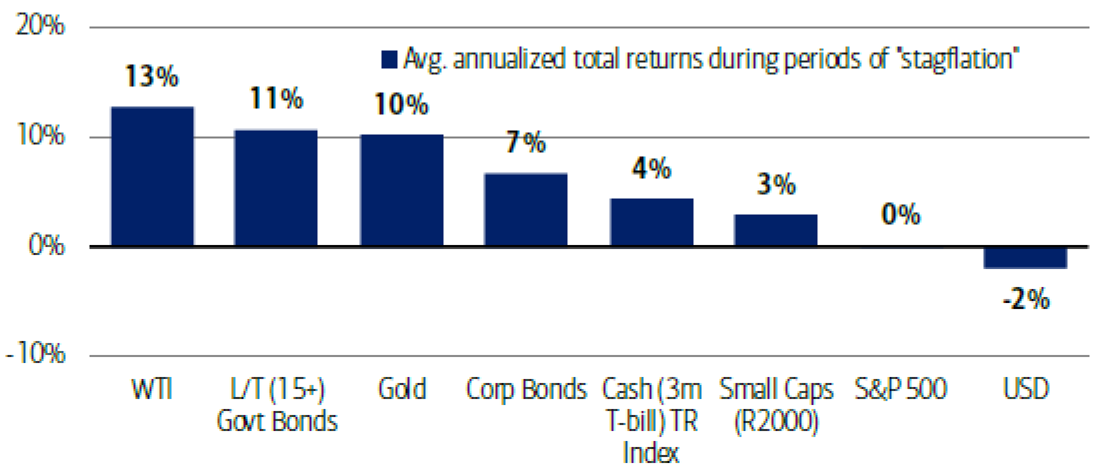
Figure 4: Small Cap Recession Forward P/E Multiples

Fwd P/E Peak	Fwd P/E Trough	P/E Peak Value	P/E Trough Value	Peak-to-trough decline	Earnings Peak	Earnings Trough	Peak-to-trough earnings decline	Number of months after (before) P/E trough did earnings peak	Number of months after (before) P/E trough did earnings trough	Index Peak date	Index Trough date	% decline	Number of months after (before) P/E troughed did index trough	Number of months after (before) earnings peaked did index trough	Number of months after (before) earnings troughed did index trough
5/31/86	11/30/87	16	9	-41%	6/30/86	3/31/87	-74%	-17	-8						
5/31/90	10/31/90	13	8	-34%	12/31/91	3/31/93	-46%	14	29	10/9/89	10/30/90	-34%	0	-14	-29
10/31/93	1/31/95	15	13	-18%											
5/31/96	7/31/96	16	14	-15%											
3/31/98	8/31/98	19	13	-32%	12/31/99	6/30/00	-7%	16	22						
3/31/00	11/30/00	19	13	-30%	3/31/03	9/30/05	-69%	28	58	3/9/00	10/9/02	-46%	22	-6	-36
3/31/02	2/28/03	19	14	-28%											
1/31/04	4/30/05	20	16	-20%											
3/31/06	11/30/08	19	11	-42%	12/31/09	6/30/12	-73%	13	43	7/13/07	3/9/09	-60%	3	-10	-40
4/30/10	8/31/10	17	13	-21%											
4/30/11	9/30/11	17	12	-30%	6/30/14	6/30/15	-13%	33	45						
12/31/13	2/29/16	19	15	-19%	9/30/17	9/30/18	-12%	19	31						
11/30/17	12/31/18	19	14	-29%											
12/31/19	3/31/20	17	13	-25%	12/31/20	3/31/22	-24%	9	24	1/16/20	3/18/20	-42%	0	-9	-24
5/31/20	10/31/20	19	16	-16%											
2/28/21	6/30/22	19	12	-40%											
	Avg:	18	13	-28%			-40%	14	31						
	Avg. (recessions)	17	11	-33%			-53%	16	39						

Source: BAML, US SMID Cap Strategy, 7/19/2022. **Past performance is no guarantee of future results.**

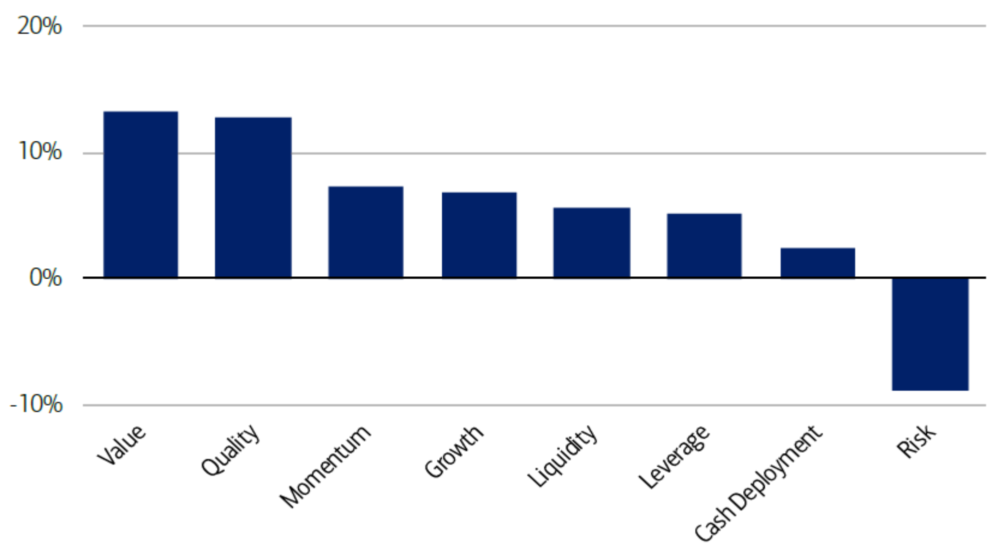
We see small-caps benefiting from a services and domestic capital expenditures recovery. Moreover, small-caps tend to be better equipped to adjust prices in periods of high inflation partly because of the group's pricing power and ability to make quick changes. Small-caps have outperformed large-caps in secular inflationary periods including the 1960's, the late 70's, and the early 80's. The last time small-caps traded at such a significant historical discount to large-caps as they do today was in 2000. Even in periods of stagflation, small-caps have outperformed large-caps (Figure 5). Also, Value and Quality within small-caps tend to outperform during Fed hiking cycles since 1989 (Figure 6). Historically, the outperformance for small-caps over large-caps after the third rate hike is strong in favor of the smaller size segment. Since 1954, the six months after the third rate hike, small-caps were up on average 10.6% vs. 6.0% for large-caps.

Figure 5: Average Annualized Total Returns During Stagflation



Source: BofA Securities, 4/4/2022.
Past performance does not guarantee future results. You cannot invest directly in an index.

Figure 6: Russell 2000 Factor Group During Fed Hiking Cycles Since 1989



Source: BofA Securities, 1/21/2022. Median top-bottom quintile (Q1-Q5) annualized returns of each Russell 2000 factor group during Fed hiking cycles since 1989.
Past performance does not guarantee future results. You cannot invest directly in an index.

The current valuation of our portfolio remains attractive - the strategy trades at 10.9x forward earnings versus 14.8x for the Russell 2000 Value (Q2).

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.