Kennedy Capital Management LLC

Extended Small Cap Commentary
1st Quarter 2023

With seeming parallels to last year's first quarter, the opening stanza of 2023 again heavily featured macro-driven forces resulting in a fairly volatile market, punctuated by reversals in sentiment outweighing company fundamentals. There was even a 'surprise' market shock partway through the quarter – the deposit pressure-led bank 'crisis' that hit in early March – which was this year's invasion of Ukraine, upending the markets briefly and leading to further concerns about the direction of policy and the economy. We observed exiting 2022 that the effects of the Fed's steep tightening program on both the economy and the market will take time to be fully realized; we'd argue that the pressures on the banks are a direct example of those effects, with others likely to follow. We also believe that time will likewise be required to fully divulge the opportunities that these effects will create. We'd assert that the shape of economic slowing, impacts to employment and the effects of higher costs of capital are all key questions to consider for investments over 2023 and further ahead.

Factors at Work in Q123

The first quarter of 2023 seemed to mostly echo the second half of 2022's push and pull between risk-on and risk-off positioning in the market. In our view, this volatility was mostly driven by the debate over a potentially persistent higher inflationary environment, the direction of Fed policy and the influence of those factors upon the real economy, particularly employment, earnings pressures, and the slowing of economic growth. The market continued to see outsized impacts from sentiment changes, as indicated by significant multiple compression on hard-landing fears and expansion on hopes that maybe the Fed will pivot away from a hawkish stance. We believe the market continues to be susceptible to exaggerated positioning and sentiment inflections in an environment with relatively low trading volumes, hesitation from fundamental investors, and macro-driven marginal flows. We'd anticipate at least some level of these dynamics to remain until we get a little more clarity around the Fed's policy plans and the direction of employment data that will give a better indication about the nature of the economic path.

The first calendar quarter was marked by a rally over its first half, followed by a sharp retreat on the back of bank pressures and the resultant market sentiment change during March. We'd maintain that the root underlying driver of this seesaw action over the last few quarters appears to be a market alternately concerned about the Fed's aggressive tightening stance and its commitment to fighting inflation (which risks pulling the U.S. into a potentially sharp recession), to one seeing relief as positioning or momentum highlights a path towards relaxing that stance. While we believe that there are indications of inflation having peaked, it remains elevated and is our view that the Fed is likely to follow through on its present course and hold short-term rates steady for some time. We expect lagged effects to continue pricing into earnings, economic forecasts, or market valuations.

While dominated by these macro effects, we still observed some signs of individual stock performance, particularly during earnings season. As the market digests the Q1 results and updated 2023 forecasts in April and May, we expect more divergence to appear, but until the market is a little more settled around the forward trajectory of Fed policy, we likewise expect to see choppy trading and potentially countervailing forces between company-specific performance and overall market sentiment and momentum. We would anticipate company-specific signals to improve as the market further evaluates the impacts of economic slowing and the potential for a new cycle.

For the first quarter of 2023, the Russell 2000® Value Index (R2V) finished down by -0.66%. Extended Small Cap returned -0.58% (gross of fees) and -0.75% (net of fees) for the quarter, bracketing the index, ahead of the R2V by 0.08% (gross of fees) and behind by -0.09% (net of fees). Relative performance was again solid through earnings season, with weakness during the quarter seen primarily as macro forces came to the fore, with some sharp impacts on the specific days with the most bank stock pressures. Attribution across sectors in Q123 was relatively balanced, as the portfolio saw positive contributions from Information Technology, Industrials, and Materials, with negative contributions from Energy, Consumer Discretionary and Communications Services. Selection was the larger component of overall attribution, although we did observe meaningful allocation effects in areas including Financials, Consumer Discretionary, and Information Technology. Additional performance information is included in the table below.

	1 Year	3 Years	5 Years	10 Years	Since Inception
Gross	-13.27%	23.71%	5.40%	9.07%	12.73%
Net	-13.83%	22.90%	4.71%	8.34%	11.82%
Index	-12.96%	21.01%	4.55%	7.22%	9.17%

Data as of 3/31/2023

Outlook

With the momentum of the market seemingly focused solely on expectations around Fed policy, the fading of inflation, and concerns over slowing economic growth, we still think that the evaluation of stock-specific forecasts could have a bit of a secondary role over the next quarter or two. As we enter earnings season, we'll watch for signs of better discrimination around potentially greater revisions to 2023 forecasts, and we'll look for the resilience of profitability and any company-specific capacity for growth; as the economic cycle progresses, we believe the market and individual stocks will start showing better response to underlying fundamentals. Like we observed last quarter, that may require a market assessment that the forward economic path towards a recovery is more visible, but as prospects for 2023 are discounted, it could begin to take shape.

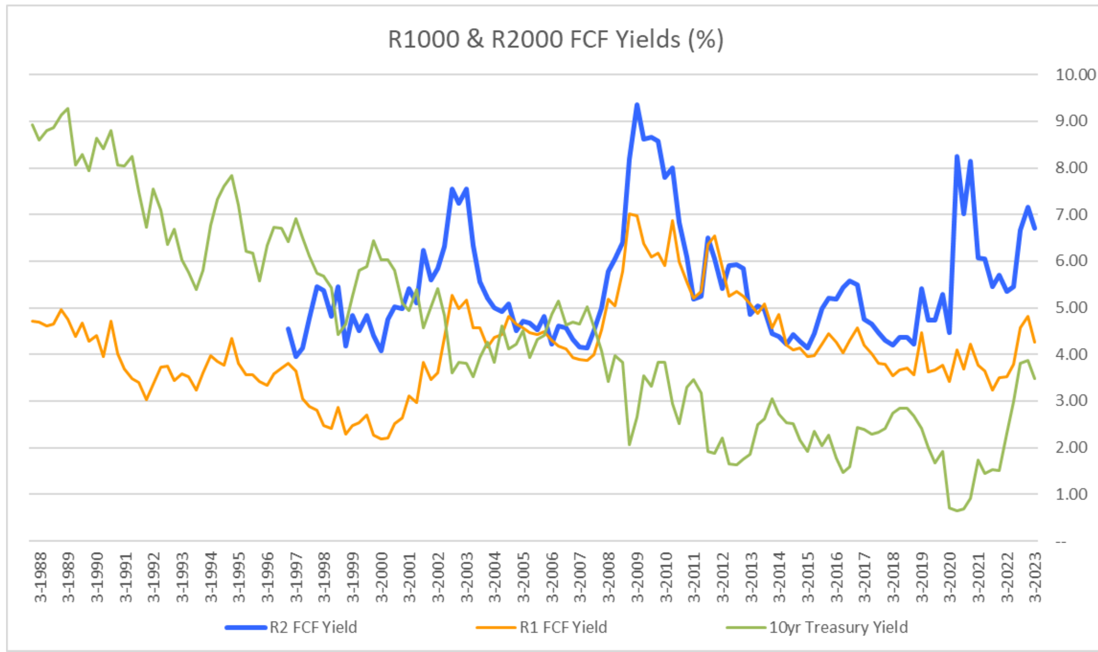
We don't think that the Fed is quite finished with its work fighting inflation and largely expect an elevated rate environment for more than a couple of quarters. Likewise, we believe that there will be significant and lagging impacts from the rapid tightening of financial conditions; this manifested in Q1 in regional banks and we expect effects to show up in other areas. The longer the Fed maintains what is seen as a restrictive policy, the stronger the impulse will be to curb hiring and the greater the chances for recession. From a real economy perspective, this likely pops up in employment figures, higher funding costs, and less capital available to the economy. We think impacts might be felt outside public equities, including places that saw significant inflows during the pandemic like cryptocurrency or venture capital. As the landscape develops, we anticipate many investment opportunities to present themselves in companies with strong or improving business models and compelling valuations that the market can recognize and reward.

As we can see in our usual free cash flow chart below, as Treasury yields have increased they have meaningfully closed the gap, but on a relative basis there remains support for equities. We'd again note the continued wide gap between small and large caps which we think is a key support for a sanguine small cap view exiting this economic turbulence. As a result, while we remain mindful of the effects of macro positioning, we expect company-specific opportunities to be available. We see the potential for leadership changes, based on the new range of rates, debt costs, and a focus that may shift more towards efficiency and returns. We therefore continue to seek opportunities within small cap and value stocks, our optimism based on three things: low relative valuations against longer term business potential (even under potentially stressed scenarios), what looks to us like a broad set of investment ideas starting to open up, and the underlying conditions of recovery within the economy ahead. We remain focused on how these factors play out over the year.

We continue to wish you, your families and stakeholders good health and safety. We deeply appreciate your interest and support.

Sincerely,

Michael Bertz, Ph.D., P.E., CFA®	Sean McMahon	Rob Van Bergen, CFA®
Portfolio Manager	Assistant Portfolio Manager	Assistant Porfolio Manager



Source: FactSet Research Systems Inc.

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The Extended Small Cap Composite invests in companies with a low relative P/E and price/book valuation. Such companies generally exhibit relatively lower analyst coverage and institutional ownership than other comparable companies in the Russell 2000® Value Index. The U.S. Dollar is the currency used to express performance.

Composite specific data provided within this presentation has been calculated from accounts that are discretionary as defined in this paragraph. The assets shown are derived only from discretionary accounts. Non-discretionary accounts, as defined by KCM, are accounts that are not included in the composite due to one or any combination of the following criteria: there were significant cash inflows or outflows within the account; the account's asset level did not meet the minimum requirement to remain in the composite; the account assets are managed by others using our non-discretionary model. The temporary removal of such an account occurs at the beginning of the month and the account re-enters the composite the month after the criteria has been met.

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The Russell 2000® Value Index measures the performance of small-cap value segment of the U.S. equity universe. It includes those Russell 2000® companies with relatively lower price-to-book ratios, lower I/B/E/S forecast medium term (2 year) growth and lower sales per share historical growth (5 year) . The Russell 2000® Value Index is constructed to provide a comprehensive and unbiased barometer for the small-cap value segment. The Index is completely reconstituted annually to ensure new and growing equites are included and that the represented companies continue to reflect value characteristics.

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Free Cash Flow Yield is an indicator that compares free cash flow and market cap.

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