Kennedy Capital Management LLC

Extended Small Cap Commentary
4th Quarter 2023

In many respects, the market entered 2023 at opposite conditions from its entry into 2022, particularly in terms of sentiment, expectations and economic growth or inflationary positioning. After a difficult 2022 from a total return perspective, investors were much more cautious coming into 2023. While there were plenty of quarter-to-quarter shifts of those sentiments, the ultimate outcome of the year was much more favorable in terms of absolute returns. The market effects we observed in 2023 were, on the other hand, driven just as much by larger macro influences vs. individual company performance. We believe that's because we're not fully through the late-cycle focus on the Fed and the delicate dance between tightening economic conditions and underlying resilience that will determine if the economy (and the Fed) can stick the landing. To be sure, there were many great and poor individual company performers over the year, as well as some meaningful fundamental drivers that impacted forward expectations and valuations (bank liquidity concerns, AI, or the impact of weight-loss drugs). However, the dominant undercurrent in our opinion was the relationship between expectations for inflation and the dynamics of what the Fed will do with rates, driving multiple rallies and pullbacks over the year. These environments can sometimes swamp the effects of individual selection, meaning outperformance can be a function of getting onsides vs. rate expectations or another factor like perceived safety.

We continue to believe that the lagged effects of the Fed's steep tightening program have yet to be fully realized and are still working through the economy. At the same time, however, the market appears to now be wrestling with how aggressively to price in an upcoming rate *cut* program. We therefore look for additional fits and starts as the market moves through these considerations, with many opportunities developing from these delayed impacts. We expect that, while macro forces will remain a key influence, we are nearing a stage in the overall market cycle that could provide a more consistent reward to stock picking, partly due to a higher rate regime (i.e., *not zero*) and as concerns over economic growth subside and settle into a more sustainable trajectory.

Factors at Work in Q4 and 2023

Similar to what we noted at the conclusion of 2022, each successive quarter over 2023 likewise felt like an extension or amplification of the market's concerns, only this year was much more about the nature and timing of the Fed's endpoint on its aggressive tightening vs. the prior year's worries about a sustainably higher inflationary environment. Both sets of concerns drove macro positioning around either fear of their impacts or relief that the worst had passed, corresponding to alternating beta-style risk-off and risk-on market movements. While it's been nearly two years of these dynamics, we expect that they could last a further couple of quarters as clarity on the Fed's end goals and the durability of the U.S. economy with respect to that policy more firmly takes hold.

The fourth quarter of 2023 saw oversold conditions in October give way to a broadening soft landing narrative, which, especially following the Fed meeting in early December that the market took as a signal of the hoped-for "pivot" towards upcoming rate cuts from the Fed, led to a very strong finish for the year. We continued to see those hopes for a shift in Fed policy run alongside economic data that sometimes suggested otherwise. Much as in prior quarters, these broad and often monotonic factors drove money flow into blunt instruments, implying a heavily sentiment-driven regime.

With a quarter still dominated by these macro effects, we observed less value given to individual stock differentiation, although the earnings season was a little better. As we approach the reporting season for Q4 results, we anticipate finding opportunities where fundamental results and outlooks are better than implied positioning. We're watching for milestones indicating how well the market has calibrated expectations around business volumes, pricing or cost pressures, and especially how company-specific outlooks for 2024 will be revised. Choppy trading could be present as the market sorts between single-stock performance and overall sentiment and momentum, and we look for company-specific signals to get stronger as the market more fully digests any impacts of economic slowing and the potential for a new cycle.

For the fourth quarter of 2024, the Russell 2000® Value Index (R2V) finished at +15.26%. Extended Small Cap returned +13.28% (gross of fees) and +13.09% (net of fees) for the quarter, trailing the R2V by -1.98% (gross of fees) and by -2.17% (net of fees). Relative performance was solid through most of October and earnings season but faded as the strong rally's pace proved difficult to match, especially following the Fed meeting in December. Attribution across sectors in Q423 was relatively balanced, as the portfolio saw positive contributions from Energy, Information Technology, and Utilities, with negative contributions from Industrials, Health Care and Consumer Discretionary. Selection was the larger component of overall attribution, although we did observe meaningful allocation effects in areas including Energy and Health Care and a significant ~50bps drag from cash. Additional performance information is included in the table below.

	1 Year	3 Years	5 Years	10 Years	Since Inception
Gross	12.93%	9.40%	12.08%	7.84%	12.87%
Net	12.19%	8.69%	11.35%	7.13%	11.96%
Index	14.65%	7.94%	10.00%	6.76%	9.46%

Data as of 12/31/2023

Outlook

We believe as many market participants gained confidence in the soft-landing narrative, a tradable fourth quarter rally developed, boosted by enthusiasm coming out of the December Fed meeting. Communications from the Fed after that meeting have tempered some of that enthusiasm, and it remains our view that, barring some marked deterioration in the underlying economic data, the Fed is likely to be cautious about cutting too swiftly, keeping short-term rates relatively steady (and non-zero) for some time, with any cuts coming slowly. We expect lagged tightening effects to continue working their way into earnings, economic forecasts, and market valuations. In the real economy, we can still see some indications of rising stresses, although it does appear that the worst of inflation is likely behind us. The markets, on the other hand, are trying to reconcile all these inputs to arrive at a cohesive set of economic expectations.

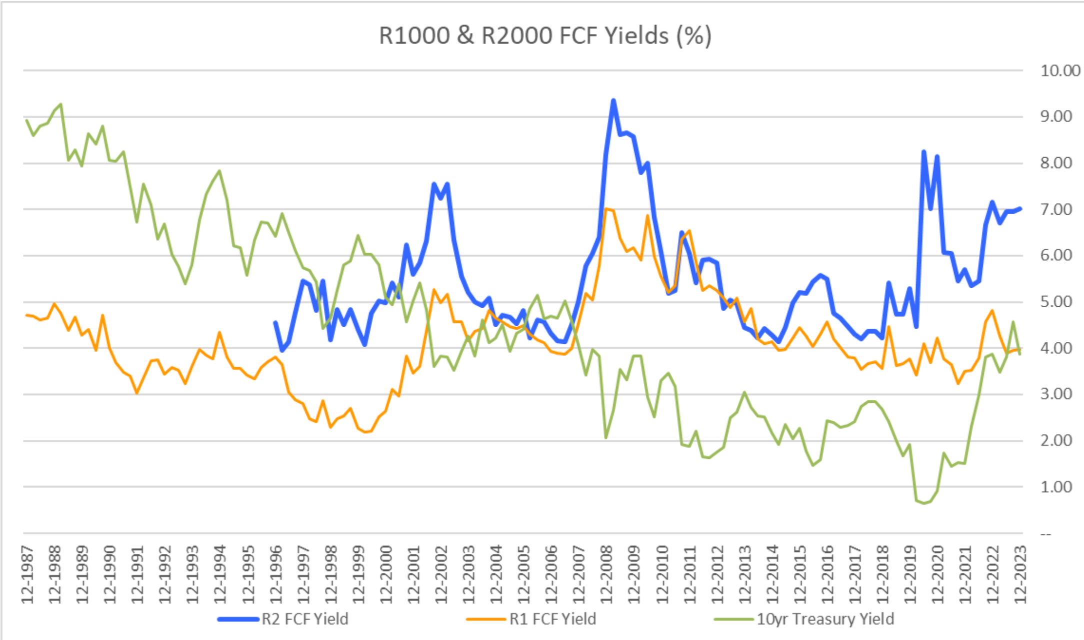
We wrote last quarter that the momentum of the market seemed focused primarily on Fed policy, fading inflation, and slowing economic growth. This is likely to remain a leading part of the equation, but as we enter earnings, we'll also get forecasts into 2024 and will be watching closely for signs of greater confidence around those. We think that resiliency of profitability and any company-specific capacity for growth will be rewarded and believe as the economic cycle progresses that the market and individual stocks will start showing better response to underlying fundamentals.

As we can see in our usual free cash flow chart below, Treasury yields have closed the gap to large caps but are perhaps plateauing. We'd again note the wide spread between small and large caps supports a bullish small cap view exiting this economic turbulence. While we remain mindful of the effects of macro positioning, we expect company-specific opportunities to be more plentiful in the quarters ahead, with the potential for leadership changes based on a new range of rates, debt costs, and a focus that may shift more towards efficiency and returns. Our process and experience tell us that attractive investment opportunities arrive during periods of uncertainty and volatile or bearish sentiment. We thus continue to seek them out within small cap and value stocks; our optimism is based on three things: the availability of low relative valuations against longer term business potential, what looks like a broadening set of investment ideas starting to open up, and the underlying conditions of recovery within the economy ahead. We are increasingly focused on how these factors play out over the next 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.
FCF Yield for each of the R1000 and R2000 indices represents the total free cash flow (FCF) of the components of the index divided by the total market capitalization of those components. It is a measure of the cash flow provided by the businesses represented in each index and is presented for comparison to the cash flow (yield) provided by current 10-year U.S. Treasury bills.

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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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