

Kennedy Capital Management LLC

Micro Cap Commentary 1st Quarter 2023

Market Review

The Russell Microcap® Index declined 2.83% in the first quarter of 2023 as liquidity concerns in the regional and community bank industry drove equity valuations lower, particularly in the month of March. Microcap regional banks declined nearly 18% during March as the disruption in the industry took center stage. Seven of the 11 Russell Microcap sectors delivered positive performance in the quarter, but this was overcome by the impact of negative returns in Financials, Consumer Staples, Health Care, and Real Estate.

Performance Recap

The KCM Microcap Composite returned 2.44% (gross of fees) and 2.21% (net of fees) in Q1, outperforming the Russell Microcap® Index by 527 basis points (gross) and 504 basis points (net). Favorable stock selection added 459 basis points to relative performance in the quarter, with the most significant outperformance in the Health Care and Industrials sectors. On a trailing 12-month basis, the KCM Microcap strategy has outperformed the benchmark by 1,264 basis points (gross) and 1,191 basis points (net). Additional performance information is included in the table below.

	1 Year	3 Years	5 Years	10 Years	Since Inception
Gross	-5.29%	27.44%	9.12%	12.12%	14.89%
Net	-6.02%	26.37%	8.14%	11.07%	13.82%
Index	-17.93%	17.19%	2.96%	7.27%	6.10%

Data as of 3/31/2023

The best relative performing sector in the Microcap portfolio this quarter was Health Care, adding 319 bps of outperformance. Financials and Consumer Discretionary underperformed in the quarter, detracting 75 bps and 50 bps, respectively, from relative performance. Stock selection in regional banks was nearly neutral in the quarter, detracting 28 bps from performance.

Outlook

Since the failures of Silicon Valley Bank and Signature Bank, our team has undertaken a comprehensive analysis of a broad range of variables that are expected to impact bank valuations in the coming months. It is in environments like this where the depth of our research team allows us to undertake the labor-intensive effort (there are 220 regional banks in the Russell Microcap) required to build conviction in our stock selection and portfolio construction.

While the backdrop continues to evolve, the following are a few important takeaways from our analysis:

- 1) While many banks saw an elevated outflow of deposits in mid-March, this activity has begun to stabilize, and some banks are now seeing healthy inflows.
- 2) There is a broad range of balance sheet profiles across the regional bank group, which yields a variety of risk profiles in the industry. We factor the risk profile of the balance sheet, along with the market valuation of the equity in our stock selection decisions. We don't attempt to make a "top-down" call on the sector and tend to have a diversified mix of banks in the portfolio.
- 3) Interest rate moves will be a key differentiator for relative performance over the next several quarters. If market sentiment shifts toward an accommodative monetary policy, banks with higher levels of perceived risk are likely to outperform.
- 4) Investor focus over the last several weeks has been on the deposit base and the makeup of a bank's securities investments, with the credit profile of the loan book taking a backseat. We believe that as the year progresses, credit is likely to take on a greater focus from investors (particularly if recessionary conditions ensue).

At this time, the microcap portfolio is roughly equal-weight banks compared with the Russell Microcap[®] Index. While we anticipate that degrading net interest margins will yield negative earnings estimate revisions and lower return on equity performance in the near term, we see compelling valuations in our holdings. We are likely to modulate this weighting lower if we see the potential for intensifying credit pressures. Our team continues to broaden the aperture of the types of data we include in our analysis, as there are few analogous periods to the current environment.

Thank you for your support, and please don't hesitate to reach out with any questions or concerns.

Sincerely,

Christian J. McDonald, CFA[®]
Portfolio Manager

Sean McMahon
Portfolio Manager

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The Micro Cap Composite invests primarily in micro cap companies (market cap generally in line with Russell Microcap® index market caps) which have strong intrinsic value. For comparison purposes the composite is measured against the Russell Microcap® 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.

Performance returns are presented gross and net of investment advisory fees and include the reinvestment of all income. Gross of fee returns reflect the deduction of transaction costs and custodian fees but do not reflect the deduction of investment advisory fees. Net of fee performance is calculated using gross returns less the actual applicable annual management fee applied monthly. **Past performance is not indicative of future results.** A client's return will be reduced by the advisory fees as described in Form ADV Part 2A and other expenses incurred by the account. For example, an annual advisory fee of 1% compounded quarterly over 10 years will reduce a gross 14.44% annual return to a net 13.32% annual return. Form ADV Part 2A is available upon request.

The performance figures reported herein are unaudited, may be based upon information obtained via electronic data sources ("feeds") and may be subject to change. Data feeds from many of KCM clients' selected custodians are obtained through third party sources, and are used to compare custodial data to KCM's client account records as frequently as daily. Monthly, KCM reviews clients' account holdings along with cash and share quantities against the custodial statements. In some instances, variances may exist between final audited custodial information and the information KCM obtains via such data feeds. Generally, any such variances are researched and reconciled within thirty days of the period end.

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Sector Weightings are subject to change at any time. Sectors are based on the Global Industry Classification Standard ("GICS") classification scheme. Both are measured as a percentage of the total composite in terms of asset value as of the date indicated on page 1. Individual client portfolios may be different based on variations in security purchase price and date, and individual client restrictions.

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Allocations to various assets classes change over time and deviate from any stated or targeted percentages of a total portfolio as a result of market conditions and reallocation decisions. Therefore, nothing herein reflects a static portfolio allocation that will remain the same or match stated target allocations of asset classes.

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The Russell Microcap[®] Index measures the performance of the microcap segment of the U.S. equity universe. Microcap stocks make up less than 2% of the U.S. equity market (by market cap, as of the most recent reconstitution) and consist of the smallest 1,000 securities in the small-cap Russell 2000[®] Index, plus the next 1,000 smallest eligible securities by market cap. The Russell Microcap[®] Index is constructed to provide a comprehensive and unbiased barometer for the microcap segment trading on national exchanges, while excluding lesser-regulated OTC bulletin board securities and pink-sheet stocks due to their failure to meet national exchange listing requirements. The Index is completely reconstituted annually to ensure new and growing equities are reflected and companies continue to reflect appropriate capitalization and value characteristics.

The Russell Microcap[®] is used as the benchmark. The Index is unmanaged and represents total returns including reinvestment of dividends. The benchmark is used for comparative purposes only and generally reflects the comparable risk or investment style of the Firm's strategy. The investment portfolios underlying the Index are different from the investments in the portfolios managed by the Firm. Certain accounts may also use other benchmarks not listed in the GIPS composite report. The Verification and Performance Examination Report does not cover the benchmark returns included in the GIPS composite report.

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