Micro Cap Opportunities...Revealing Alpha Potential

Sean McMahon
Portfolio Manager, Micro Cap Investments

For over 40 years, Kennedy Capital Management LLC (KCM) has been actively and skillfully investing in companies at the smaller end of the market cap range; for nearly 30 of these years, we have been investing in micro cap companies. We define micro cap investments as publicly-traded companies between $30 million and approximately $1.7 billion in market capitalization. Given their size, we believe these companies are not as well understood or proactively followed. To delve into the opportunities and discuss the ambiguity of this space more fully, we invited our Chief Executive Officer, Don Cobin, CFA®, to interview Micro Cap Portfolio Manager, Sean McMahon.

Don Cobin:
With a three-year track record, double-digit returns, and a #1 rank within its universe, the Micro Cap Opportunities strategy has certainly been in the spotlight.[1] Given this enviable achievement, we wanted to direct a few pointed questions at Sean to shed some light on the micro cap space, some of the drivers of success, and what makes him tick.

Sean, please tell us, what are some of the attributes and opportunities unique to the micro cap universe?

Sean McMahon:
While I'll try to keep this brief, I believe the space has so many attractive features for investors that it is a challenge to pare down the list. To start but in no particular order:

- Given lower trading volume and market capitalization, Wall Street is not incentivized to cover these stocks, potentially driving poor information flow and pricing inefficiencies.
- Returns, particularly net of fees, can rival those in the private equity market yet the investments' liquidity is far greater.
- Access to senior management can be critical to understanding the strategic direction of companies. We find management teams more accessible at the lower end of the market cap spectrum.
- New products and/or services often have a meaningful impact on equity valuations for smaller companies.
- Institutional investors are less focused on micro cap which tends to allow for more pricing inefficiencies.

[1]*As of 12/31/2022. Source: eVestment Alliance and the U.S. Microcap Equity universe within. Rank is based on the 3-year period (gross of fees) against 31 composites.* ***Past performance is no guarantee of future results.*** *There can be no assurance that any strategy will achieve its objectives or avoid substantial losses.*

Pricing Inefficiencies [2]	MICRO CAP	LARGE CAP
Market Capitalization LOWER market cap often leads to lower trading volume, an environment that can lead to pricing inefficiencies	$30M to $1.7B	$13.8B to $2.2T
Universe of Companies MORE names typically means more opportunities for new products/services developments, which often have a meaningful impact on equity valuation	>2,000	500
Sell-Side Analysts Per Company LESS Wall Street coverage can leave information on the table, and therefore, pricing inefficiencies	4 (some have none)	19
U.S. Equity Strategies LESS institutional investors often allows for more pricing inefficiencies	77	1,201

[2]As of 12/31/2022. Source: eVestment Alliance and the U.S. Microcap Equity universe within. Rank is based on the 3-year period (gross of fees) against 31 composites. ***Past performance is no guarantee of future results.*** *There can be no assurance that any strategy will achieve its objectives or avoid substantial losses.*

Don Cobin:
You have almost 20 years of experience analyzing this universe and witnessing the rise and fall of micro cap companies. How would you encapsulate what sets you and KCM apart from peers?

Sean McMahon:
We are active across the growth-to-value spectrum, identifying early life cycle growers, emerging technology companies, and those that are evolving their strategic approaches to growth. We aim to identify and capture *change*, whether it's through an earlier-stage company or a "fallen angel." Along with our centralized research team of over a dozen sector-specific analysts, I have frequent and direct interaction with management teams, providing meaningful insights that are not shaped by Wall Street's biases. Finally, health care, which represents more than a quarter of our benchmark, is an area of acute focus. I've closely followed this sector for most of my career, and KCM has invested in innovative scientific talent to supplement our investment expertise. Several years ago, we launched a biotech fellowship program that taps Ph.D. candidates to deeply examine the science behind the companies we follow.

Don Cobin:
Taking a step back, how would you describe your philosophy and approach to risk management?

Sean McMahon:
Small cap inefficiencies are *amplified* within micro caps, offering strong opportunities for value creation from companies improving their business models, outgrowing their peers, or those simply overlooked by the market. The ongoing screens that we've developed over decades of experience help us sort through the detritus of the micro cap universe. While it may be tempting to concentrate a portfolio into fewer names, our large research team affords us the luxury of owning a wider array of quality stocks, minimizing the inherent volatility risk of the micro cap universe. We also work to contain risk by analyzing the likely downside of a security before we purchase it. For instance, should a potential catalyst not emerge in our favor, how secure are we in the downside valuation support?

I am fortunate to be a part of an organization with a well-developed Investment Policy Committee. Comprised of senior leaders in investment and compliance at KCM, this team provides a forum to review and discuss risk trends.

"I am attracted to companies that can drive cash flow by improving asset turns – in other words, balance sheet improvements."

Don Cobin:
When evaluating companies, what are some of the key characteristics you seek when adding a new investment to the portfolio?

Sean McMahon:
While there is no specific set of rules for each portfolio holding, certain themes resurface repeatedly.

I'll begin by mentioning my investment focus is on finding companies that are executing *change*, and management accessibility provides insight into what creates shareholder value. I regularly observe management's reaction during times of financial underperformance, and I often find investment opportunities at discounted values during these times given that most investors have "moved on" to other ideas. These turnaround situations may require finding a management team that is willing to take some "short-term pain" to reorient the business toward long-term, sustainable growth. However, I am careful to avoid those management teams that allocate shareholder capital without adequately weighing the potential returns on invested capital. For example, I have seen struggling companies decide to significantly increase their salesforce in an effort to quickly grow revenues; oftentimes, though, if the current team cannot generate revenue growth, adding additional salespeople won't fix the problem.

Over the years, I've been able to find many opportunities where a shrinking company has generated significant equity outperformance. For example, a consumer packaged food company that intentionally lowered its revenues was one of our strongest performing holdings in 2022. The stock's strength was partially driven by management's decision to cut low-margin products within their fruit business, ultimately resulting in significant positive EBITDA generation in 2022 compared to a loss in the prior year.

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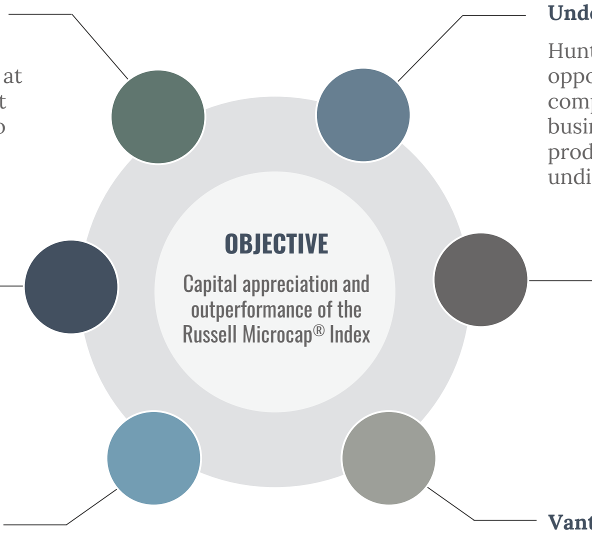
Besides a focus on improving corporate earnings through sales or margin improvement, I am attracted to companies that can drive cash flow by improving asset turns – in other words, balance sheet improvements. Ultimately, increasing cash flows from higher sales or from the balance sheet can drive higher equity valuations. For example, companies that don't have strong market positions may have to invest more into working capital to attract clients (e.g., elongate accounts receivable payments or raise inventory levels) which ultimately compresses corporate returns. When evaluating an investment opportunity, we try to understand how management is investing shareholder capital and if they have an opportunity to be more efficient; this potentially allows a company to "unlock" cash that can be reinvested into higher returning activities.



Exploit Inefficiencies

Seek pricing inefficiencies, often existing in companies at the lower-end of the market cap range, due to little or no sell-side research coverage.

Undervalued Catalysts

Hunt for value creation opportunities such as companies improving their business models, creating new products/services, or with undiscovered assets.

Growth-to-Value Spectrum

Core approach focused on early life cycle growers and emerging technology companies.

Independent Analysis

Sector-specific analysts provide labor intensive, proprietary, bottom-up research and ideas – often outside of the benchmark.

Innovative Talent

20+ year equity research internship program; Launched a biotechnology fellowship program given the increase in early life cycle companies populating the Russell Microcap® Index.

Vantage Point

Frequent and direct interaction with management teams in a pursuit to gain unique insight and contrarian thought.

Lastly, innovation is a key characteristic I seek in evaluating companies. This may require investment and some level of risk, but we look to limit this risk by evaluating the entire business using a fundamental, bottom-up approach. As I noted earlier, we have the luxury of having a large group of industry specialists at KCM that supports this analysis. Ultimately, our investment style results in passing on far more opportunities than presented given our unwillingness to accept certain risks related to current market position, management decisions, or balance sheet.

Don Cobin:

To round out this conversation, please tell us about your journey. Have certain mentors or books inspired you or helped to shape your investment framework?

Sean McMahon:

Having started my career as an intern with KCM, I have a deep appreciation for my colleagues at the firm. I was incredibly fortunate to have Dick Sinise, one of the cofounders of KCM, share his expertise with me for more than a decade. We spent countless days, nights, and weekends simply talking stocks; a book can't duplicate that. At the same time, Dick impressed upon me the importance of spending time with my family. I'm fortunate to have an understanding spouse who allows me to work late nights and two daughters that help ground me in my life. In the end, KCM fed my hunger for stock-picking, provided an entrepreneurial environment to foster growth, and allowed me to develop a repeatable process that persists through volatile markets. I am looking forward to piloting this strategy to continued success and ultimately being a mentor for many others along the way.

Don Cobin:

Sean, I appreciate what you've shared with us today. It can be difficult for portfolio managers to divulge their recipes for success, but I think you've given us a window into the key ingredients you use.

For more information on our micro cap investment strategies, please visit:
https://www.kennedycapital.com/micro-cap-opportunities/
https://www.kennedycapital.com/micro-cap/

Biographies

Don Cobin, CFA®
President, Chief Executive Officer, and Portfolio Manager

Mr. Don Cobin is responsible for directing the business affairs of the firm. Don also serves as Chairman of the Board of Directors. In addition, Mr. Cobin serves as the Portfolio Manager for the Small Cap Core strategy. Don began his investment career in 1993 and served as Director of Research at Delaware Investments and prior to that as an investment analyst at Conseco and WR Huff. From 2002 until 2007, Mr. Cobin was a senior investment professional at Matador Capital Management. Don joined KCM in February 2007 as an analyst and later became Portfolio Manager in November 2007. Mr. Cobin earned a B.A. from Emory University and his M.B.A. from The Wharton School of the University of Pennsylvania.

Sean McMahon
Portfolio Manager, Micro Cap Investments

Mr. Sean McMahon joined KCM in 2005 after gaining experience in equity analysis through his internship at KCM and started the Micro Cap Opportunities strategy in January of 2020. Sean is also Portfolio Manager on our Micro Cap strategy and Assistant Portfolio Manager on our Extended Small Cap strategy. With 19 years of investment experience all tenured at KCM, Sean has focused the majority of his career on analyzing micro cap companies as well as names within the health care sector, many of which started out as micro cap investments and have grown into leaders in their respective industries. Mr. McMahon earned a B.S. in Business Administration from the University of Missouri – St. Louis and an M.B.A from Washington University.

About Kennedy Capital Management LLC

Founded in 1980, St. Louis-based Kennedy Capital Management LLC (KCM) delivers investment strategies to corporate and public pension funds, endowments, foundations, multi-employer plans and high-net-worth individuals. As a registered investment adviser, KCM specializes in the management of small and mid-cap strategies across the growth-value spectrum and, as of December 31, 2022, managed $3.72 billion in assets. KCM integrates environmental, social, and governance (ESG) considerations into its research process and has nearly 20 years' experience managing socially responsible client accounts. For more information, visit **www.kennedycapital.com**.

Important Disclosures

Data as of 12/31/2022.

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Past performance is no guarantee of future results. *There can be no assurance that any KCM strategy or investment will achieve its objectives or avoid substantial losses. Returns are presented gross and net of investment advisory fees and include the reinvestment of all income. Gross of fee returns reflects 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. 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.*

Micro Cap Opportunities Composite invests primarily in micro cap companies (market capitalization is generally in line with the Russell Microcap® index) that have opportunities to grow within their respective markets. 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.

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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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.

EBITDA *or earnings before interest, taxes, depreciation, and amortization is a measure of a company's profitability of the operating business only, thus before any effects of indebtedness, state-mandated payments, and costs required to maintain its asset base.*

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