

Kennedy Capital Management, Inc.

SMID Cap Growth Commentary 2nd Quarter 2022

Quarter Summary:

Equity markets experienced significant declines in the second quarter of 2022. The dynamics driving this were largely a continuation of the shocks that began in the 1st quarter. The invasion of Ukraine by Russia stretches into its 5th month and is a major source of commodity inflation worldwide (particularly grain and energy feedstocks). Global supply chains remain volatile as the world recovers from the aftereffects of the COVID-19 pandemic. While we have seen pockets of supply chain improvement during the 2nd quarter, new, highly transmissible COVID-19 variants (such as BA.5) threaten the sustainability of these improvements. Unfortunately, these events continue to exacerbate the greatest economic concern: persistent inflation. The Federal Reserve awoke to this risk during the quarter with a 75-basis point rate hike in June (an increase from the 50-basis point increase they initially telegraphed). Another 75-basis point increase is now expected in July as inflation shows little sign of peaking.

Performance:

The KCM SMID Cap Growth (SCG) composite decreased -18.98% (gross of fees) and -19.11% (net of fees) for the 2nd quarter of 2022, outperforming the Russell 2500™ Growth (R2500G) Index, which decreased -19.55%, by +57 bps (gross of fees) and +44 bps (net of fees). Year-to-date, the SCG composite decreased -30.18% (gross of fees) and -30.40% (net of fees), underperforming the R2500G Index, which decreased -29.45%, by -73 bps (gross of fees) and -95 bps (net of fees).

On a relative basis, Industrials and Consumer Discretionary were the best-performing sectors versus the benchmark. The strength in Industrials was led by a company that manufactures and sells various components and sub-systems for aerospace and defense applications. After a period of disappointing results, the company is being pressured by activist shareholders to either show progress toward their long-term targets or consider various strategic alternatives. In addition, the medium-term outlook for the stock has improved primarily due to increased defense spending in Europe. The strength in Consumer Discretionary was led by a retailer specializing in beauty products such as makeup, hair care and fragrances. The company demonstrated strong sales momentum in the quarter as demand for its products accelerated. Furthermore, it saw a reduction in supply-chain constraints and successfully initiated price increases that should benefit the 2nd half of 2022.

Our largest detractors to relative performance for the quarter were Information Technology and Real Estate. Within Information Technology, the worst contributor was a company that manufactures and sells semiconductors primarily for the telecommunications and industrial markets. The stock was weak during the quarter as concerns of a cyclical slowdown impacted the entire semiconductor sector. In addition, the company announced a sizeable acquisition that will

require meaningful debt financing. We continue to own the position as we believe its specific end markets are more resilient and expect that management can extract significant value from this new acquisition. The weakness in Real Estate was due to a real estate investment trust focused on serving medical cannabis cultivators across the United States. The stock's fundamentals have remained robust, and we believe the share weakness is due to concerns surrounding the financial health of its tenants. We see little to no tenant risk and believe the end markets are recession resilient. Therefore, we continue to hold the position.

For the year-to-date period, relative performance was positive in the top outperforming sectors of Health Care and Consumer Discretionary. Information Technology and Energy were the largest detractors to performance.

Outlook:

At some point, rate increases will have the desired effect of reducing demand; however, there remains a great deal of uncertainty as to whether the Federal Reserve's actions will simply reduce demand on the margin (the "soft landing") or if more dramatic demand destruction awaits. Signals pointing to either outcome remain decidedly mixed. We are beginning to see whispers of demand declines in the form of discounted pandemic-related consumer goods (such as outdoor furniture and casual clothing), but this is largely offset by robust spending on consumer experiences (such as travel). It is likely much of this spending was pre-planned (long-awaited summer vacation travel after COVID-19), but consumers have accumulated significant cash reserves during the pandemic to both fund discretionary spending and offset the burden of higher costs on consumer staples. Also helping is that the U.S. unemployment rate remains at historically low levels.

Further complicating the Federal Reserve's job and muddying U.S. corporate earnings are a variety of international dynamics. We previously mentioned the rise of COVID-19 variants and their threat to global supply chains. As we enter July, this threat is manifesting in the form of new lockdowns in China as the country continues to enforce a zero-COVID policy. Further outbreaks in this region risk re-tightening supply chains and bolstering inflation globally. Conversely, COVID-stability in this region would ease inflationary pressures and allow company management teams to proceed with greater clarity. A second international dynamic is the impact of the strong dollar, which, at the time of writing, is now at parity with the Euro. Minimally, this will be a drag on reported U.S. company earnings, but additionally, the strong dollar is an added stress on emerging market economies and heightens the risk of a crisis.

As we enter 2nd quarter earnings season, we remain focused on individual company results and respective outlooks. We've highlighted some of the economic puts and takes in this letter and expect company management teams to discuss much of the same until greater clarity emerges. The next 6 months should be very telling regarding exactly how much inflation will subside and how much real demand will be impacted. Within the portfolio, we take a diversified and balanced approach to growth investing. We continue to focus on companies where we have the greatest confidence in long-term sustainable demand with management teams who can execute each investment's individual strategy. We believe this approach will best position the portfolio in the event the Fed is

successful in the near-term or if high inflation persists into 2023. We will look to be more aggressive in adding new investments to the portfolio when we begin to see signs that inflation has peaked.

Sincerely,

Jean Barnard, CFA®
Portfolio Manager

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Assistant Portfolio Manager

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