Kennedy Capital Management, Inc.

Small Cap Core Commentary
1st Quarter 2022

The Market

While we generally expected the economy to bounce back as the pandemic eased, there have been a few surprises. Housing and other consumer-driven spending have been resilient in our view. Consumer debt/credit transactions have risen 31% from the same period in 2019, which we view as a remarkable statistic reflecting the unabashed loosening of the consumer purse strings. While this consumer spending has helped to drive earnings higher, the other theme that has recently been edging that out is the often feared one: inflation. One can examine many inflation statistics to demonstrate the point. One that resonates with us is the core CPI reaching levels unseen in about 40 years. We believe the battle between inflation on core goods, wage growth, and simply consumer spending (all of which are invariably intertwined) has led to stock market gyrations. Russell 2000® Value ("SCV") stocks have fought their way back above Russell 2000® Growth ("SCG") in 2022. YTD SCV has sharply exceeded SCG (-2.4% vs. -12.6%), and from the March 2020 lows, SCV has also outpaced SCG. Looking at the markets as a whole, we've found these dislocations have afforded us opportunities for pockets of outperformance.

Performance Recap

For the first quarter of 2022, the KCM Small Cap Core Composite returned -7.37% (gross of fees) and -7.58% (net of fees), compared to the Russell 2000® Index, which fell 7.53%.

Within the Small Cap Core Composite, sectors that we most heavily overweighted versus the benchmark were Consumer Staples, Consumer Discretionary, and Financials. Sectors that were significantly underweighted included Communication Services, Materials, and Health Care.

During the first quarter, our strongest relative outperformance was achieved in the Health Care, Consumer Staples and Information Technology sectors. On the negative side, Energy, Materials, and Consumer Discretionary had an unfavorable impact on performance. Stock selection remained the primary factor driving relative outperformance in the quarter.

The three stocks that were the most significant detriments to performance in the quarter included:

- A solutions provider for the medications management industry that came under pressure when mixed guidance was issued. We viewed revenue growth expectations favorably, but inflation is expected to weigh on earnings more than we had expected. We have thought favorably of the company's progression over the years, and we suspect others have as well. To not be able to more than offset inflationary cost pressures with price hikes likely surprised many. We remain positively inclined towards the company's future prospects.

- A supplier and distributor of building products that came under pressure during the quarter. We believe this largely revolved around its clear ties to the home building industry. Fear of the connection of potentially rising interest rates and the rate of new home construction, in our view, weighed on demand for stocks in this sector.
- A company that manufactures critical fluid delivery subsystems and components that was negatively impacted by supply-chain constraints in the semiconductor capital equipment industry. We expect this impact to be short-lived and believe that spending in the semiconductor space will be a tailwind for the company for many years to come.

The three best performing stocks in the portfolio included:

- A provider of oil and gas drilling systems that benefitted from the increasingly positive energy environment. As energy prices grew in recent months, we believe that demand for its drilling rigs was positively impacted. We expect this trend to continue for some time and believe the company to be well-positioned to capture growing demand.
- A distributor of food to grocery stores and restaurants that has been through some challenges throughout the pandemic, but we believe it has emerged in 2022 in a strong position. They recently reported earnings and issued guidance ahead of our expectations, and we see them as well-positioned to drive further shareholder value in 2022.
- A real estate investment trust that owns multi-family apartment buildings in various southeastern U.S. markets and has performed quite well during the first quarter. We are enamored with their strategy of buying buildings, improving them, and driving higher rental rates. We believe this has served them well in what we view as a strengthening multifamily leasing market.

Outlook

While we would characterize the current state of the economy as tenuous, we do not think that precludes one from discovering undervalued stocks. We remain hard at work analyzing trends and potential changing drivers of corporate performance. Internally, we are debating the pressures and opportunities for the consumer. Prices are unquestionably rising, but, at the same time, wages seem to be shifting higher, and jobs are relatively plentiful.

At Kennedy's morning meetings, we have focused more on interest rates than we typically do. Debates have covered the exposure that consumers have to rising rates (e.g., in the form of credit card debt, mortgages, and auto loans) and the benefits they will experience from rising wages and interest income from savings accounts. In a larger sense, we also discuss the environment around growth stocks. As you may have seen in our previous communications, we tend to view growth stocks as marginally less favorable than value stocks in a rising longer-term rate environment. Our logic goes as follows: growth stocks tend to derive more of their positive cash flows further into the future than value stocks; if interest rates are rising, we would put a higher discount rate on those companies' cash flow streams. In other words, we would lower our derived net present value. This is an ongoing debate, and the interest rate environment is far from certain. However, we believe that, if long-term rates are pressured to grow, that will drive investors to favor companies with more near-term cash flow generation. Given the aforementioned move in value stocks vs. growth stocks, we do not necessarily view this as a completely undiscovered phenomenon. However, we believe it merits continued close attention.

As always, we thank you for the opportunity to manage your account. Please don't hesitate to reach out with any comments or follow-up questions.

Sincerely,

Donald M. Cobin, CFA®
Portfolio Manager

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The Small Cap Core Composite contains fully discretionary small cap core accounts that are invested in a mix of small cap value and small cap growth companies, which Kennedy Capital Management, Inc. believes to have strong intrinsic value and growth rates above the Russell 2000® Index. For comparison purposes the composite is measured against the Russell 2000® 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 presented Gross of Fees do not reflect the deduction of investment advisory fees and include the reinvestment of all income. A client's return will be reduced by the advisory fees and other expenses incurred by the account as described in Form ADV Part 2A. For example, an annual advisory fee of 1% compounded quarterly over 10 years will reduce a gross 14.44% annual return to a net 13.24% annual return. Form ADV Part 2A is available upon request. The GIPS® are a set of standardized, industry-wide ethical principles that provide investment firms with guidance on calculating and reporting their investment results to prospective clients to ensure fair representation and full disclosure of an investment firm's performance history.

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The Russell 2000® 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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