Kennedy Capital Management, Inc.

Small Cap Core Commentary
2nd Quarter 2022

The Market

We expect that this quarter will resound with investors for many years to come. The word "inflation" seems to have replaced "pandemic" as the media go-to and for water-cooler conversations -- a relief in some respects, but it brings along its own heavy weights. What is inflation, and why does it matter to market participants? When a family must allocate 20% more towards buying gas, paying rent, and providing meals, then a paycheck has less proclivity to be used for non-essentials. On a microeconomic scale, this can drive down demand for something like a new pair of jeans. The earnings of the jeans-maker inevitably falls. If earnings are to be driven lower by these circumstances, then the multiple of earnings that an investor will pay is pressured. On a macroeconomic scale, this is taking shape in the broader market. It has manifested itself in a drop of 17.2% in the Russell 2000® this quarter. As one might expect, Consumer Discretionary stocks have been amongst the worst performers. This has built on top of a weak start to the year, resulting in a 23%+ drop in Russell 2000® stocks this year.

Performance Recap

For the second quarter of 2022, the KCM Small Cap Core Composite returned -13.20% (gross of fees) and -13.40% (net of fees), compared to the Russell 2000® Index, which fell 17.20%. On a year-to-date basis, the respective gross, net, and benchmark numbers are -19.60%, -19.96%, and -23.43%. While we are pleased to have earned returns for our clients that compare favorably to our benchmark, we are dismayed with the loss of nearly 20% that our clients have suffered this year. The following discussion will provide some context around the weightings and individual stock performance that drove performance during the second quarter.

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

During the second quarter, our strongest relative outperformance was achieved in the Health Care, Consumer Discretionary and Information Technology sectors. On the negative side, Financials, Real Estate, and Utilities had an unfavorable impact on performance. Stock selection remained the primary factor driving relative outperformance in the quarter.

The stocks that were the most significant detriments to performance in the quarter were a REIT that owns various distribution centers, a company that engages in the sale and rental of heavy equipment and trucks, and a designer and manufacturer of aero structures. We believe that the REIT has come under pressure as market participants draw parallels between Amazon's reported capacity excesses and how that might transfer to the value of its properties. Furthermore, we generally expect that a rising interest rate environment will drive down the price of properties. Longer term, we believe that well-located distribution centers will become increasingly important nexuses in an e-commerce-focused world, resulting in higher valuations for companies such as this. Second, the heavy equipment and truck company issued debt to effect a merger in 2021. While we appreciate the merits of the transaction and expect the net benefit to be positive, we believe that certain investors have shunned companies with substantial debt. However, when we analyze this, we believe that the company can readily support the debt payments, and its cash flows justify a much higher equity value than the market is currently assigning. Third, we believe the market has unduly focused on the adverse short-term free cash flow dynamics and slower than expected ramp-up of Boeing 737-Max production for the aero structures company. To us, this is a classic example of market short-termism and hues well to our longer-term view of value creation.

The three best performing stocks in the portfolio included a clinical stage biopharmaceutical company, a chain of gas and convenience stores, and a company that sells used automobiles. The first company benefited from a buyout offer from a pharmaceutical company. While these types of transactions are difficult to predict, this generally adheres to our thoughts that larger pharmaceutical companies tend to buy promising biotech companies to supplement and/or replace their own research and development efforts. Second, the convenience store chain has recently been able to sharply increase earnings (e.g., EPS rose from $2.00 in Q1 2021 to $6.08 in Q1 2022). We believe that investors have been attracted to the company's widening gasoline margins and are beginning to appreciate the benefits of the mix shift and their recent acquisition. Third, the company that sells and finances used cars was able to report sharply higher than expected earnings in the quarter that ended in April 2022. The combination of passing along higher prices to consumers while controlling credit deterioration reflected well on the company, increasing its stock price. Our concerns about the intermediate term financial well-being of their consumer base drove us to sell this stock after it moved higher.

Outlook

The economy remains suspect. As noted earlier in this letter, there is ongoing debate about inflation, and we expect the risk of recession will weigh on the market. That being said, we believe our economy is resilient and that there will remain pockets of opportunity for strong companies to exploit. Additionally, we remain mindful of the frequent blurring of the health of the economy with that of the financial markets. While the two are doubtless intertwined, those who equate the two are missing the market's discounting mechanism. To offer a more descriptive example, if investors expect cash flows of a company to degrade severely over the next year before recovering, but we believe the market has valued this company as if cash flows will deteriorate for many more years, there could very well be an opportunity in the stock despite a worsening economic/fundamental outlook.

Additionally, risk tolerance often falls as an investor suffers losses or hears the constant drumbeat of economic hardship. This tends to limit investor demand for more speculative – however promising

– investments. While we expect this to limit opportunities in growth stocks, we believe that opportunities will present themselves to the patient, long-term investor.

So, while we do expect challenging times ahead, we believe we will continue to be able to discover situations where investors are failing to capture appropriate company values. As always, we thank you for the opportunity to manage your account. Please do not hesitate to reach out with any comments or follow-up questions.

Sincerely,

Donald M. Cobin, CFA®
Portfolio Manager

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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.

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