# Kennedy Capital Management LLC

## Small Cap Core Commentary
## 2nd Quarter 2023

### The Market

The second quarter of 2023 witnessed several significant market events that shaped the U.S. economy. First, the broader market surged, driven by robust corporate earnings and positive economic indicators, propelling major indices to all-time highs. However, concerns over inflation and rising short-term interest rates led to increased market volatility, with investors closely monitoring Federal Reserve decisions. The technology sector rebounded strongly, fueled by innovations in artificial intelligence. While the housing market has cooled since its post-COVID boom, building permits have begun to show signs of resurgence. Additionally, the labor market remains resilient despite some of the other economic concerns. Overall, the quarter reflected a delicate balancing act between optimism for economic growth and caution regarding potential headwinds in the U.S. financial landscape.

### Performance Recap

For the second quarter of 2023, the KCM Small Cap Core Composite rose +0.97% (gross of fees) and 0.74% (net of fees), compared to the Russell 2000® Index, which rose 5.21%. This was a disappointing quarter, although we continue to outperform our benchmark over 3 and 5 years as shown below. Additional performance information is included in the table below.

| | 1 Year | 3 Years | 5 Years | 10 Years | Since Inception |
|---|---|---|---|---|---|
| **Gross** | 4.86% | 12.65% | 5.44% | 8.29% | 12.40% |
| **Net** | 3.92% | 11.65% | 4.58% | 7.38% | 11.37% |
| **Index** | 12.31% | 10.82% | 4.21% | 8.26% | 8.80% |

Data as of 6/30/2023

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

During the second quarter, our strongest relative outperformance was achieved in Financials, Real Estate, and Communication Services. On the negative side, Industrials, Health Care, and Consumer Staples had an unfavorable impact on performance. Stock selection was a negative factor during the quarter, particularly within the Industrials sector. We were overweight the sector and saw our owned stocks fall more than 2%, while those in our benchmark rose.

The three stocks that were the largest detractors from relative performance during the quarter were a provider of voice, chat, and email customer experience solutions through contact centers, a distributor of natural and organic foods, and a company in the aerospace and defense industry.

The contact center solutions company has seen growth slow down along with the cooling of global economic growth. We have been investors in the company indirectly through the former parent corporation before it was spun off late in 2020 continuing through its time as an independent, publicly traded company. We are attracted to the returns generated in this business and believe that growth opportunities will be prevalent for many years. However, we did not properly anticipate the slowing earnings for 2023 and the resultant market dissatisfaction. We believe the cash flows generated by the business and the ability to create a stronger company through a recently announced acquisition will bear fruit and drive the stock higher over time.

The large domestic distributor of natural and organic foods has reported disappointing earnings recently. We continue to believe that a leading provider in this segment should have secular tailwinds looking forward; however, we have some concerns about management's ability to navigate profitably. We have had several recent discussions with senior management and are actively evaluating our position.

Finally, the technology company in the aerospace and defense industry has been unable to execute its business in a manner that we had expected. Supply chain challenges have played a part in their travails, but wider operational questions have developed as well. The company recently went through an examination of strategic direction and made some changes to management, which all appeared to weigh on the stock. We believe the company has a valuable franchise, but we are cognizant of the operational decline and are actively evaluating the company's likely path and our holdings.

Our best-performing stocks during the quarter included a provider of engineered equipment for the industrial gas, energy, and biomedical industries, a technology oriented defense company, and a narcolepsy focused pharmaceutical company.

The provider of engineered equipment for the industrial gas, energy, and biomedical industries announced a large acquisition during the fourth quarter of 2022. This seemed to drive a sharp refocusing of the markets – from the fundamentals of their business to the newly acquired leverage on their balance sheet and increasing European focus. The stock fell sharply at that time, but we appreciated the merits of the purchase and continued to own it, anticipating that their unique expertise and market positioning would eventually gain further recognition. It is therefore encouraging to see the stock on our top contributors list for the second quarter of 2023.

The defense company, which develops products for the U.S. military and others, has been a steady contributor to the portfolio since we added it in late 2022. We believe that the unusual structure of the business may have deterred some investors from the story when it first came to market in 2022. The market seems to have come to appreciate the merits of their business during 2023, and we have enjoyed a meaningful move higher in the stock as a result.

Finally, the pharmaceutical company that develops products to treat narcolepsy has shown excellent performance quickly. We purchased a small position during April 2023 and saw the stock move substantially higher by the end of the quarter. We believe that FDA approval of one of their products, along with designation as an "orphan drug," helped to drive increased enthusiasm by the investment community.

**Outlook**

As we look forward, the US economy faces several significant risks that could potentially impact its stability and growth. One of the key risks is the ongoing threat of inflation, which can clearly erode purchasing power, squeeze consumer spending, and disrupt business operations. At the same time, risks lie in the continued tightening of monetary policy. Poorly executed monetary tightening could have adverse effects on financial markets and on borrowing costs for businesses and consumers. It requires careful navigation by the central bank to strike the right balance between controlling inflation and maintaining economic growth.

Geopolitical tensions and economic isolationism represent additional risks. Ongoing hostilities, such as trade disputes between the US and China, have disrupted global supply chains and may hinder international trade. In addition to the horrible toll on human lives, the ongoing conflict between Ukraine and Russia has disrupted global economics and led to periodic increases in market volatility and investor uncertainty.

Finally, the potential for cybersecurity threats poses a significant risk to the US economy. As reliance on technology and digital infrastructure grows, the vulnerability to cyberattacks increases. A large-scale cyber breach targeting critical sectors like finance, energy, or transportation could disrupt operations, leading to financial losses, and undermine confidence in the economy.

To navigate these challenges, we employ a team of investment professionals here at Kennedy Capital Management. While we are not naïve enough to claim immunity to these threats, our awareness of them helps us to question the management teams of those companies we are researching. In addition to probing discussions about their inherent business prospects, we also work to understand how they are positioned to withstand these larger global concerns. We are certain that the companies in our portfolios will be subject to risks beyond their control, but we do work to create a portfolio that diversifies our exposure.

We have begun to see a resurgence in small cap markets even in advance of a clear economic recovery. This helps to remind us that the stock market is not merely a gauge on how our economy is currently faring, but more an amalgamation of what has happened, what is expected, and what other opportunities for investment exist. We look forward to researching, analyzing, and investing in these markets, and we thank you for allowing us to continue managing your assets.

Sincerely,

Donald M. Cobin, CFA®
Portfolio Manager

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*The Small Cap Core Composite invests in a mix of small cap value and small cap growth companies, which KCM 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.*

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