Kennedy Capital Management LLC

Small Cap Core Commentary
4th Quarter 2023

The Market

The positive boost to the market during the fourth quarter was delivered by the Federal Reserve. Having burnished its reputation as a force of slowly measured change over recent years, the now overused term “fed pivot” quickly graced the pages of the financial press. We’ve noted the pressure the Fed has applied to the domestic economy during 2023, largely through its interest rate controls, but also through its “higher for longer” jawboning. Market participants roundly welcomed the late-quarter change.

At the same time, the continuing geopolitical unrest has been an unbalancing force to the global economy. While unfortunately, the Ukrainian-Russian battles have continued without resolve, tensions in the Middle East have jumped sharply. The human toll is sickening and of primary concern. However, global markets, after absorbing and adjusting to COVID and Eastern European-related supply chain disruptions, are now in the grip of further disruptions. Almost all companies have some connection to global trade flows, and operating personnel need to think two steps ahead to figure out how to plan their businesses for 2024. The resultant market volatility we’ve seen has almost become the norm.

Performance Recap

For the fourth quarter of 2023, the KCM Small Cap Core Composite returned 11.00% (gross of fees) and 10.75% (net of fees), compared to the Russell 2000® Index, which rose 14.03%. On a year-to-date basis, the respective gross, net, and benchmark numbers are 5.38%, 4.43%, and 16.93%. Looking back a year ago, we had outperformed our benchmark nicely in 2022 (-16.00% net of fees vs -20.44%) but were disappointed not to have been able to turn in positive overall returns for our clients. This year, we earned positive returns for clients but did not capture nearly as much of the rising market as we would have expected. The following discussion will provide context around the weightings and individual stocks that drove performance during the fourth quarter. Additional performance information is included in the table below.

	1 Year	3 Years	5 Years	10 Years	Since Inception
Gross	5.38%	4.28%	10.27%	7.50%	12.39%
Net	4.43%	3.35%	9.35%	6.59%	11.37%
Index	16.93%	2.22%	9.97%	7.16%	8.94%

Data as of 12/31/2023

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

During the fourth quarter, our strongest relative outperformance was achieved in Information Technology, Materials, and Real Estate. On the negative side, Health Care, Industrials, and Consumer Discretionary had an unfavorable impact on performance. Stock selection was a negative factor during the quarter, particularly in the Health Care sector but also in Industrials.

The three stocks that were the most significant detriments to performance in the quarter were a provider of tracking devices for solar installations, a manufacturer of engineered equipment for the industrial gas, energy, and biomedical industries, and a supplier of systems for proppant and chemical management to oil and gas drillers. The provider of tracking devices for solar installations in the U.S. underperformed our expectations due to several factors. Revenue expectations fell as projects were delayed due to module availability and uncertainty around the Inflation Reduction Act. Also, high interest rates altered economics for developers, leading to further uncertainty. The manufacturer of engineered equipment for the industrial gas, energy, and biomedical industries delivered revenue for the third quarter of 2023 below expectations. The company attributed this slower growth primarily to supply chain delays. Given the high growth expectations for 2024, this reset in 2023 seems to have dented investor sentiment. Finally, the supplier of systems that provide proppant and chemical management to oil and gas drillers has been negatively impacted by the drop in rig counts in 2023. While we are encouraged by the company's earnings growth in 2023, we realize that the business is somewhat beholden to oil and natural gas price fluctuations. The company has kept its leverage in check, which has been a factor in helping it to maintain its earnings strength.

The three best-performing stocks in the portfolio were a provider of endpoint security, an operator in the insulation distribution and installation space, and a developer of software that helps to manage a company's data in the cloud. The provider of endpoint security software was a stock we purchased in October 2023. We believed that the company participated in a high-growth segment of software but that expectations were mixed due to reports of various competitors. Its third-quarter earnings report and outlook helped to dispel fears of weaker spending, driving the stock higher. While the new home market has been volatile in 2023, the operator in the insulation distribution and installation space has been able to grow revenue and, more importantly, earnings each quarter. Its outlook has been buoyed by acquisitions in recent years as well as solid execution. Finally, another information technology stock we purchased in 2023 has provided solid returns. The company provides software that helps to manage a company's data in the cloud. As data growth has proliferated, partly as a result of artificial intelligence innovations, its solutions have gained traction. After slow topline growth for several quarters, revenue and earnings growth accelerated in the third quarter, as have forward expectations.

Outlook

The past three months have brought both encouraging and sobering developments that warrant an update to our investment outlook. While our initial concerns around inflation, interest rates, and their economic impact remain, recent data hints at a potential easing of pressures. However, geopolitical tensions and lingering supply chain disruptions inject a necessary dose of caution.

Central banks have exhibited a delicate balancing act – taming inflation while fostering continued, albeit subdued, economic growth. This cautious approach aligns with our earlier thesis that investor confidence hinges on the perception of near-term stability. Initial signs suggest this may be taking shape, potentially driving fund flows towards equities, including small caps.

We remain confident in the long-term potential of small caps and believe their agility, focus on innovation, and ability to capitalize on niche markets make them well-positioned to navigate challenging times. We have carefully chosen companies within the portfolio that demonstrate these strengths and remain committed to proactive portfolio adjustments as circumstances unfold. We thank you for allowing us to continue to manage your assets and look forward to the future – whatever the economy may bring.

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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