# Kennedy Capital Management, Inc.

## Small Cap Growth Commentary
## 1st Quarter 2022

Don't fight the Fed.  Small capitalization growth stocks experienced a rough start to 2022 as market participants internalized higher discount rates and slowing economic growth as it became clear that the Federal Reserve would begin to move more aggressively to combat the continued evidence of persistent inflation. Credit markets saw a rapid move upward in both short- and long-term rates, with U.S. 10-year nominal yields rising above 2.5%. As a result, "growth factors" were the main determinant of relative performance in the period, with the companies having the highest growth characteristics declining the most, regardless of sector or profitability (CFROI). And as expected, this shift to the tightening phase of the cycle brings heightened risk to the trade-offs between growth and interest rates and where, exactly, the balance between the two will settle out. This has meant elevated market volatility, particularly in the highest growth interest-rate sensitive areas of the market. To orchestrate a soft landing, we will need to see commodity prices settle back down (possible as COVID supply chain issues subside) while consumer/business demand slows but remains healthy (possible with strong balance sheets and high employment levels). Unfortunately, while this was already expected to be a tricky transition period, it has been exacerbated by a major unforeseen geopolitical event, the invasion of Ukraine by Russia. This has led to a further spike in commodity prices, in particular energy, as sanctions and disruptions impact global supplies. The result has been an extremely strong Q1 performance by energy-related companies as they benefit, while almost every other sector suffered from the risk that this crowds out demand and topples us into a recession. Unfortunately, our portfolio's structural lack of ownership in the Energy sector (due to its poor history of returns & dependence on volatile commodity price forecasts) meant this was a meaningful headwind for relative performance vs. the index in this period.

**Performance:**

The KCM Small Cap Growth (SCG) composite decreased -12.90% (gross of fees) and -13.06% (net of fees) for the 1st quarter of 2022, underperforming the Russell 2000® Growth (R2G) Index, which decreased -12.63%.

On a relative basis, Information Technology and Consumer Discretionary were the best-performing sectors versus the benchmark in the first quarter.  The strength in Information Technology was led by a provider of identity access management software such as single sign-on and multi-factor authentication. In 2021 they completed development of their re-architected platform, along with new Advanced Services capabilities, and is seeing strong customer adoption that is driving accelerating sales growth.

The strength in Consumer Discretionary performance was led by a company that owns and operates casinos in Reno, NV and Blackhawk, CO. The company has been upgrading select properties to expand the customer profile and take advantage of less-restrictive betting limits. Shares of stock outperformed in the quarter due to positive results on the continued execution of this strategy.

Our largest detractors to relative performance for the quarter were Energy and Industrials. The portfolio does not own any positions within the Energy sector, which was strong in the quarter due to macroeconomic factors driving up the price of oil. Within Industrials, the worst contributor was a manufacturer of wood-alternative decking and railing systems. During the quarter, the company issued 2022 guidance that included higher expected costs as the company re-instated marketing spend to invest for future growth. In addition, rising interest rates caused building materials stocks to decline as investors question where demand for large-ticket, housing-related items will settle out in the near term. We continue to hold the position as we like its leadership position in the composite decking space and believe the company will continue to capture share from wood over many years.

Outside of Energy and Industrials, our second worst individual stock contributor in the quarter was a manufacturer of mobile and other manufactured housing. The stock underperformed in the quarter as some investors fear that rising interest rates will severely impair its demand. While we acknowledge that manufactured housing has some economic sensitivity, we also believe that the large backlog, improved customer financing options and affordability of manufactured homes versus other alternatives makes the company an attractive longer-term holding. As such, we continue to hold our shares.

**Outlook:**

Higher rates were expected and are necessary to reign in potentially destructive inflation and speculative excesses. However, the energy and political shocks were not anticipated and are making this transition even trickier. Inflation remains the main macro variable that we continue to monitor very closely as it is the key risk to both the economy (real growth) and capital markets (particularly growth stock valuations). In addition, we are also closely monitoring the impact of inflation and higher interest rates on demand. Both consumers and corporations have money to spend – their balance sheets are extremely healthy; employment levels are high & credit is still good – but visibility is low on how long this can be sustained. As COVID recedes, so far, the data suggests an overall “resilient consumer” as spending shifts back toward services from goods. This should also help to rebalance demand & supply to reduce inflationary pressures. But the risk is that the pig is already in the python and this surging inflation and now higher interest rates will eventually start to choke off discretionary spending and lead to GDP declines. We expect that the markets will remain in a volatile tug-of-war between growth and defensive factor positioning until this is settled.

While the first quarter declines were spread broadly across all areas of high growth due to adjusting to higher discount rates, we expect to see greater differentiation as the year progresses and it becomes clearer where demand trends are more sustainable. We continue to lean into the areas where we have the greatest confidence that demand is sustainable and with management teams that have proven that they can execute. Focusing on businesses with strong return characteristics and pricing power should also help us to avoid the biggest pitfalls.

Thank you for your continued confidence in the Kennedy Capital team. Should you have any additional questions, please do not hesitate to contact us.

Sincerely,

Jean Barnard, CFA®
Portfolio Manager

Ryan Dunnegan, CPA
Portfolio Manager

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