

Kennedy Capital Management, Inc.

Small Cap Growth Commentary 3rd Quarter 2022

Quarter Summary:

It was another difficult (and volatile) quarter for U.S. equity market returns, driven by macro factors as the peak and duration of higher interest rates continue to be debated and absorbed into both valuations and future earnings expectations. Broad inflation measures (CPI/PPI) continued to come in hot and the Federal Reserve aggressively increased the target federal funds rate two times during the quarter to 3.00-3.25%, the highest absolute level since 2008. Additionally, they made it clear that they will continue to move rates up and keep them there until inflation is under control. As a result, the two-year Treasury ended the quarter at 4.22% (up from 2.84%) and expectations of a broader and deeper recession increased. The result was a broadening out of negative equity returns with the S&P® 500 Index (large caps) -4.9% and the Russell 2000® (small caps) -2.2%, resulting in year-to-date declines of -23.9% and -25.1%, respectively. The Russell 2000® Growth Index (small cap growth) was actually an area of relative outperformance in Q3, with a positive return of +0.24%. Unfortunately, that is likely because this was already the hardest hit area in the first half of the year as the initial move up in rates had a disproportionate impact on high growth valuations, with the year-to-date decline of -29.3% still worse than the broader market averages. This recent move up in rates (along with the strong dollar) increases the risk of recession and thus broader earnings risk. These shifting concerns could also be seen within the Russell 2000® Growth Index, with the range of Q3 returns across sectors quite significant (from -18% to +8%). Health Care was the most significant positive contributor, driven by a recovery in Biotechnology stocks (+15.8% in Q3 to -29.0% YTD). Our strategy struggled relatively in this period due to structural underweights in both Biotechnology and Energy, in addition to several stock-specific issues within Health Care.

Performance:

The KCM Small Cap Growth (SCG) composite decreased -0.96% (gross of fees) and -1.15% (net of fees) for the 3rd quarter of 2022, underperforming the Russell 2000® Growth (R2G) Index, which increased +0.24%, by -120 bps (gross of fees) and -139 bps (net of fees). Year-to-date, the SCG composite decreased -31.08% (gross of fees) and -31.48% (net of fees), underperforming the R2G Index, which decreased -29.28%, by -180 bps (gross of fees) and -220 bps (net of fees). Additional performance information is included in the table below.

	1 Year	3 Years	5 Years	10 Years	Since Inception
Gross	-27.50%	7.19%	8.19%	12.43%	13.51%
Net	-28.05%	6.42%	7.44%	11.63%	12.70%
Index	-29.27%	2.94%	3.60%	8.81%	9.54%

Data as of 9/30/2022

On a relative basis, Information Technology and Consumer Staples were the best-performing sectors versus the benchmark. Information Technology benefited from the announced acquisition of one of our software holdings by a private equity firm. The strength in Consumer Staples was again led by a provider of branded, affordable cosmetic and skin-care products. The company has continued to demonstrate strong sales momentum primarily due to the launch of new brands. The company has also been successful in increasing prices, which should aid margins in the future, particularly as supply chain cost pressures ease.

Our largest detractors to relative performance for the quarter were Health Care and Communication Services. The greatest individual detractor in Health Care was a provider of medication management automation solutions to hospital and retail pharmacies. The stock declined in the quarter due to concerns about lower hospital capital expenditures in 2023 as the economy weakens. While we anticipate some order slowdown due to the economy, our channel checks indicate that the company's solutions are a higher priority item for hospital systems, and we believe the impact will be less severe than shares are beginning to reflect. Communication Services was impacted by a decline of a provider of digital advertising technology solutions, as digital advertising spending is expected to be under pressure as the economy decelerates. In addition, a recently announced advertising partnership within the sector has raised concerns that the company's market opportunity in connected TV advertising will be limited.

For the year-to-date period, relative performance was positive in the top outperforming sectors of Information Technology and Consumer Staples. Health Care and Energy were the largest detractors to performance.

Outlook:

We expect the short term will continue to be dominated by inflation and interest rates vs. the resulting level demand destruction. The path forward is increasingly tricky as these tensions are balanced in a globally levered financial system. We have seen the initial cracks on each side: inflation will lessen (majority of industrial commodity prices have round tripped, freight costs down) and demand will weaken (apparel, new houses, channel inventories). The questions now focus on how this all works its way through the pipeline into magnitudes, time frames, and any specific nuances to this business cycle (they all rhyme but are never exactly the same!). Tactically, we need to be aware of the range of outcomes and the impact on the overall portfolio. In that regard, we would remind you of our last letter where we noted that "the next 6 months should be very telling" for these items. We are only several months into this discovery process and expect at least another quarter of data will be needed before we have greater clarity. This process simply takes time – there is no way to rush it. Patience is particularly important. But at some point, visibility on these key macro inputs will settle out and the market will again focus on individual company earnings execution. We spend the majority of our time preparing the portfolio for that day – determining how the new environment impacts our company's returns and earnings, what unique opportunities they have for growth, and where the greatest value gaps exist in the market. We are fully aware that our portfolio of

companies must be able to navigate the next 12 months but are keeping our focus on the 3–5-year growth opportunities.

As we enter this crucial 3rd quarter earnings season, we will remain focused on individual company results and listening to their respective outlooks. We continue to hold slightly greater cash balances than typical and, once we see signs that inflation has clearly peaked, expect to be more aggressive in adding (or increasing existing) investments where we have conviction in the medium-term earnings potential vs. market expectations. Valuations and expectations have declined significantly, presenting increasingly more attractive long-term opportunities to consider.

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

Important Disclosures

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The Small Cap Growth Composite invests in growth securities of predominately small companies that generally have a market capitalization that is reflective of the Russell 2000® Growth Index. The Manager seeks companies with durable business models able to deploy assets into growing sets of opportunities providing superior rates of return. For comparison purposes the composite is measured against the Russell 2000® Growth 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.

Returns are presented gross and net of investment advisory fees and include the reinvestment of all income. Gross of fee returns reflect the deduction of transaction costs and custodian fees but do not reflect the deduction of investment advisory fees. Net of fee performance is calculated using gross returns less the actual applicable annual management fee applied monthly. **Past performance is not indicative of future results.** A client's return will be reduced by the advisory fees as described in Form ADV Part 2A and other expenses incurred by the account. For example, an annual advisory fee of 1% compounded quarterly over 10 years will reduce a gross 14.44% annual return to a net 13.32% annual return. Form ADV Part 2A is available upon request.

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date indicated above. Individual client portfolios may be different based on variations in security purchase price and date, and individual client restrictions.

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The Russell 2000® Growth Index measures the performance of the small-cap growth segment of the U.S. equity universe. It includes those Russell 2000® companies with relatively higher price-to-book ratios, higher I/B/E/S forecast medium term (2 year) growth and higher sales per share historical growth (5 year). The Russell 2000® Growth Index is constructed to provide comprehensive and unbiased barometer for the small-cap growth segment. The Index is completely reconstituted annually to ensure new and growing equities are included and that the represented companies continue to reflect growth characteristics.

The Russell 2000® Index measures the performance of the small-cap segment of the U.S. equity universe. The Russell 2000® Index is a subset of the Russell 3000® Index representing approximately 7% of the total market capitalization of that index, as of the most recent reconstitution. It includes approximately 2000 of the smallest securities based on a combination of their market cap and current index membership. The Russell 2000® is constructed to provide a comprehensive and unbiased small-cap barometer and is completely reconstituted annually to ensure larger stocks do not distort the performance and characteristics of the true small-cap opportunity set.

The Russell 2000® Growth Index 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.

The S&P 500® is widely regarded as the best single gauge of large-cap U.S. equities. According to our Annual Survey of Assets, an estimated USD 13.5 trillion is indexed or benchmarked to the index, with indexed assets comprising approximately USD 5.4 trillion of this total (as of Dec. 31, 2020). The index includes 500 leading companies and covers approximately 80% of available market capitalization.

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