Mesirow

Equity market review

MESIROW EQUITY MANAGEMENT STRATEGIES

AUM: $1.0B as of September 30, 2023

- Small Cap Value
- Small Cap Core
- SMID Cap Value
- SMID Cap Core

"We believe the key to generating consistent investment returns is the selection of investment opportunities that possess attractive valuations and demonstrate identifiable catalysts that are expected to generate accelerating earnings and cash flow growth."

Kathryn A. Vorisek
Head of Equity Management,
Portfolio Manager

Leo Harmon, CFA, CAIA
Chief Investment Officer,
Portfolio Manager

Andrew Hadland, CFA
Director of Research,
Portfolio Manager

INVESTMENT OBJECTIVES

- Generate attractive risk-adjusted returns
- Consistently outperform the benchmark over a market cycle
- Participate in rising markets and protect capital in down market

Market commentary

Today's equity market environment reminds me of a quote from the legendary daredevil, Evel Knievel, who said "anybody can jump a motorcycle, the trouble begins when you try to land it." Over the last few quarters, we've discussed the lagged effects of monetary policy and, in particular, whether or not the Fed could successfully reduce inflation without creating a recession or material slowdown in economic activity. Generally, negative impacts of a Fed tightening cycle happen 12-24 months after significant monetary policy changes have been implemented. Accordingly, we are now at the point of the cycle where the rubber truly meets the road, and over the next few quarters we will have much more clarity related to growth and growth expectations.

Entering the year, we would have expected a much slower macro environment based on the historical linkages between Fed policy and future economic growth. But the environment proved more resilient than initially anticipated, as both earnings growth and economic activity, though slower on the margin, exceeded expectations. Part of this resiliency was created by fiscal and monetary stimulus which produced over $2 trillion in excess savings for the consumer. Excess savings, along with solid employment formation and rising wages, have buoyed the consumer and, at the very least, delayed the traditional lagged impacts of Fed policy. However, levels of inflation remain persistently high, which not only produces fodder for the Fed to keep interest rates higher for longer, but also introduces incremental recessionary fears adding more uncertainty to growth forecasts.

Past performance is not indicative of future results. Please see disclosures at the end of this commentary for additional, important information.

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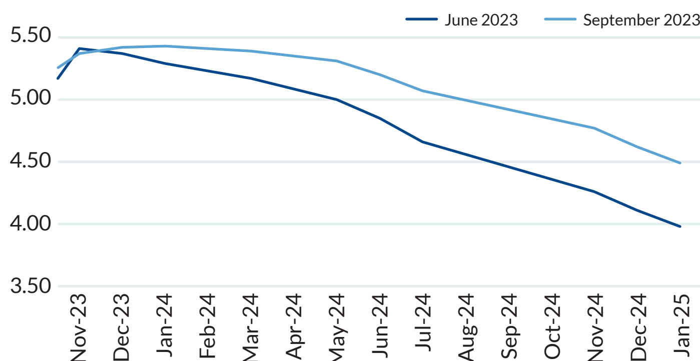
Interest rates to stay higher for longer as Fed battles inflation

As the quarter commenced, equity markets were in the midst of a significant rally as company earnings reports were much better than anticipated, employment gains continued to show strength, the panic related to the banking liquidity crisis diminished and the prospects of a potential recession were reduced and/or pushed into the future by many market participants. However, the reality of incessantly higher interest rates, slower marginal growth and the Fed intimating that rates will remain "higher for longer" (Figure 1) caused a sharp correction in prices in the latter part of the quarter, leading to the following results:

Index	3Q2023	YTD 2023
Russell 2000 Value Index	-2.96%	-0.53%
Russell 2000 Index	-5.13%	2.54%
Russell 2500 Value Index	-3.66%	1.95%
Russell 2500 Index	-4.78%	3.59%

Data as of 9.30.2023. Source: MEM, Bloomberg and FTSE Russell.

FIGURE 1: IMPLIED FUTURE FED FUNDS RATES – JUNE 2023 VS SEPTEMBER 2023

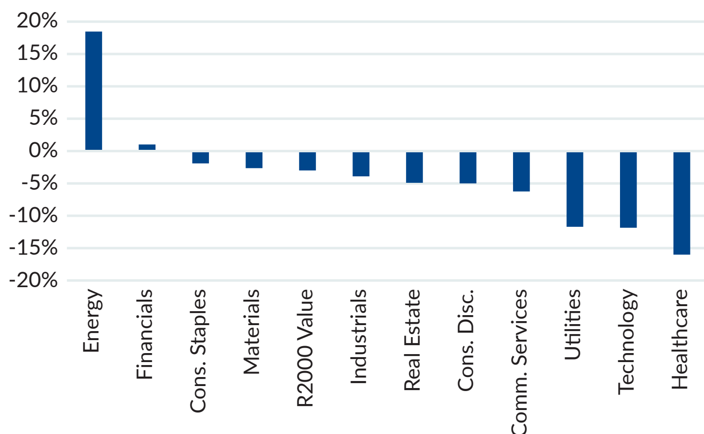


Data as of 9.30.2023. Source: MEM using data from Bloomberg, LP.

The Energy sector dominated in the third quarter

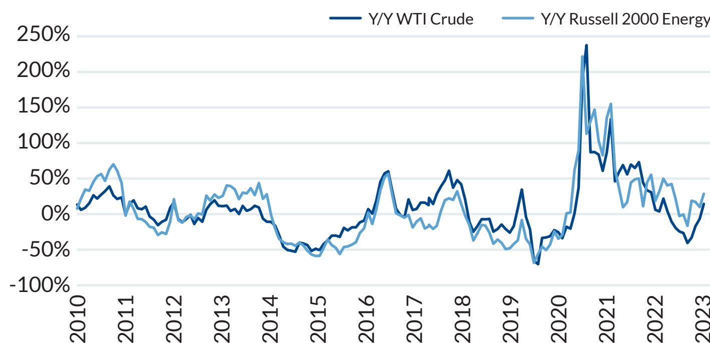
For the quarter, market leadership was driven by some inflationary characteristics: Energy was by far the best performing sector (Figure 2) and one of only two to produce positive returns, boosted by the rise in oil prices (Figure 3). Materials, Financials and Consumer Staples also outperformed the market.

FIGURE 2: PERFORMANCE BY SECTOR – RUSSELL 2000 VALUE INDEX



Data as of 9.30.2023. Source: MEM using data from Furey Research Partners.

FIGURE 3: ENERGY SECTOR VS CRUDE OIL PRICES



Data as of 9.30.2023. Source: MEM using data from Bloomberg, LP.

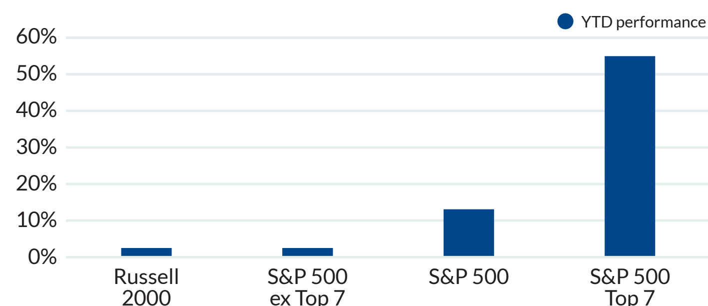
Small cap underperformance attributed to seven large companies

Healthcare and Technology were the worst performing sectors of the market, reversing some of the significant gains from traditional growth in the first half of the year.

As a result, value indices were able to outperform growth. However, the broader rally into small cap stocks reversed as large cap modestly outperformed despite the retracement in large technology stock names. Year to date, large cap performance continues to be driven by several of the largest, mostly tech-related companies with small cap performance closer to parity when these companies are excluded (Figure 4).

Past performance is not necessarily indicative of future results.

FIGURE 4: **PERFORMANCE BY SELECT INDICES**

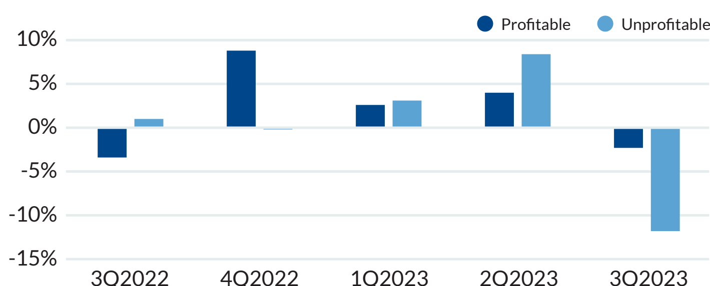


Data as of 9.30.2023. Source: MEM using data from Furey Research Partners. Top seven: Apple, Microsoft, Amazon, Nvidia, Alphabet Tesla and Meta.

High quality factors regained the upper hand in the third quarter

After trailing the market over the first half of the year, higher quality attributes returned to prominence in the third quarter as profitable companies significantly outperformed their unprofitable counterparts (Figure 5).

FIGURE 5: **PERFORMANCE BY PROFITABILITY**

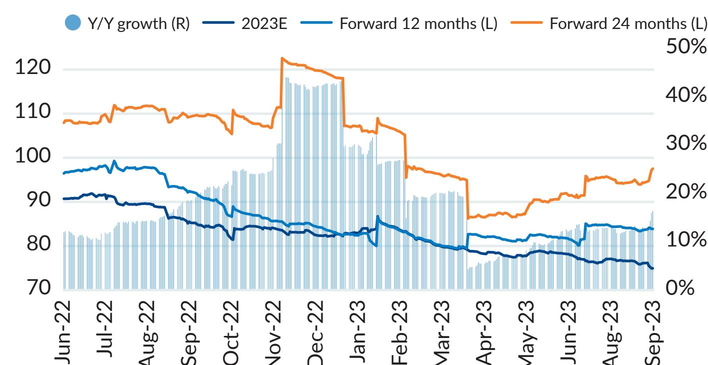


Source: MEM using data from Furey Research Partners.

Revisions for 2023 moved lower but outlook for growth improved

Equity markets continue to oscillate in a broad trading range. The rally that began last fall on the prospects of lower interest rates in a "soft landing" environment and accelerated through the second quarter of this year has begun to lose momentum. We believe the markets will continue to be range bound until there is some resolution related to economic growth or earnings forecasts lend some transparency to corporate expectations. Current earnings expectations continue to decline, though consensus earnings forecasts have found some footing and should help drive better results if validated over the next few quarters (Figure 6).

FIGURE 6: **RUSSELL 2000 EARNINGS EXPECTATIONS**



Data as of 9.30.2023. Source: MEM and Bloomberg, LP.

Conclusion

In the meantime, we continue to monitor several factors that may influence our tactical portfolio positioning:

- The Fed's tolerance for inflation above its 2% baseline
- Incremental economic growth, particularly over the next two quarters
- The impact of higher energy prices
- Timing and duration of a potential recession
- The impact of higher rates on liquidity and credit for both businesses and consumers
- Pricing power and margin stability
- Pace of employment formation
- Earnings revisions and changes in the growth cadence for 2023 and 2024

In many respects, some indicators (higher mortgage rates, negative growth in leading economic indicators, lower money supply and weaker regional surveys) still reflect a level of stress in the environment which can only be mitigated through positive economic growth. In addition, some supportive elements of the market (excess savings) have now been somewhat exhausted. While the Fed's policy actions in this cycle have, thus far, produced relatively benign results, we are mindful of the lagged affects and will continue to evaluate the environment for opportunities to drive excess performance.

Past performance is not necessarily indicative of future results.

Benchmark definitions:

The Russell 2000 Index offers investors access to the small-cap segment of the US equity universe. 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 includes the smallest 2000 securities in the Russell 3000.

The Russell 2000 Value Index offers investors access to the small-cap value segment of the US equity universe. The Russell 2000 Value is constructed to provide a comprehensive and unbiased barometer of the small-cap value market. Based on ongoing empirical research of investment manager behavior, the methodology used to determine value probability approximates the aggregate small-cap value manager's opportunity set.

The Russell 2500 Index measures the performance of the small to mid-cap segment of the US equity universe, commonly referred to as "smid" cap. The Russell 2500 Index is a subset of the Russell 3000® Index. It includes approximately 2500 of the smallest securities based on a combination of their market cap and current index membership.

The Russell 2500 Value Index measures the performance of the small to mid-cap value segment of the US equity universe. It includes those Russell 2500 companies with lower price-to-book ratios and lower forecasted growth values. The Russell 2500 Index is constructed to provide a comprehensive and unbiased barometer for the small to mid-cap segment. Both indices are completely reconstituted annually to ensure large stocks do not distort the performance and characteristics of the true small to mid-cap opportunity set and that the represented companies continue to reflect value characteristics. (Source: Russell).

The S&P 500 is widely regarded as the best single gauge of large-cap US equities. There is over USD 9.9 trillion indexed or benchmarked to the index, with indexed assets comprising approximately USD 3.4 trillion of this total. The index includes 500 leading companies and covers approximately 80% of available market capitalization. Please see the following GIPS disclosure for additional benchmark definitions.

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Contact us

portfoliospecialist@mesirow.com | 312.595.7300

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