DISCIPLINED EQUITY

SMIDCAP

GREAT LAKES ADVISORS

A WINTRUST WEALTH MANAGEMENT COMPANY

MANAGER COMMENTARY

Third Quarter 2020

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MARKET REVIEW

Yet another surprisingly strong quarter for U.S. Equities, despite mixed signals with respect to ongoing coronavirus flare-ups, progress on a vaccine, additional rounds of government stimulus, and growing socio-political angst. Perhaps we're climbing the proverbial wall of worry, perhaps the unprecedented fiscal and monetary policy from this spring is the impetus... or more likely both.

Russell 2500

The Russell 2500 Index recorded a 5.9% advance during Q3, backing a 26% Q2 advance - but remaining 5.8% lower for the calendar year.

Size/Style

- The 500 largest stocks in the Index narrowly outperformed the Russell 2000 Index.
- Despite yet another head fake from mid-May to early June, growth once again dominated value in both the mid-cap and small-cap segments, recording a 5% advantage in each market cap group. Growth stocks have a substantial lead over value stocks for the 3, 5, and 10 year periods.

Russell 2500 Sectors

We saw more consistent relative sector performance among smid-caps, with a strange dichotomy atop the list:

- Consumer Discretionary and Consumer Staples topped sector performance for the quarter.
  - » This was a second consecutive stellar quarter for Discretionaries, which have soared 61.2% the past 6 months.
- Financials and Utilities continue their poor relative performance, dropping 1.4% and 0.5%, respectively.
  - » In contrast to the Consumer Discretionary sector, the Utility group has advanced just 1.9% over the past 6 months.
- Energy stocks faded from the top performer in Q2 to a 0.2% decline.

THIRD QUARTER ATTRIBUTION

The SMidCap strategy advanced about 7.3% during the quarter, topping the benchmark Russell 2500 Index's 5.9% gain. The table on the following page breaks down the contributions from sector positioning and stock selection:

Sector positioning added 1.59% to active return:

- Overweighting the Consumer Discretionary sector added 68bps; the sector topped the Russell 2500 Index by over 10% during the quarter.
- Underweighting the Financial sector added an additional 54bps to active performance. The sector trailed the R2500 return by over 7% during Q3.

Stock selection within the respective sectors detracted 0.14% from active return.

MARKET OUTLOOK

Following a quantitative investment discipline allows us to bypass emotion in the investment process. The world's greatest detective, Sherlock Holmes, knew:

"The emotional qualities are antagonistic to clear reasoning."

–Sherlock, *The Sign of Four*

SECTOR	GLA WEIGHTING	R2500 WEIGHTING	% ACTIVE	GLA RETURN	R2500 RETURN	% ADDED	SECTOR ALLOCATION	STOCK SELECTION	ACTIVE CONTRIB
Comm Services	6.23	3.06	3.17	17.74	9.33	8.42	0.11	0.49	0.60
Consumer Disc.	19.68	12.38	7.29	11.13	15.97	-4.84	0.68	-0.86	-0.18
Cons. Staples	2.20	3.36	-1.16	-19.18	8.42	-27.61	-0.04	-0.73	-0.77
Energy	2.03	2.30	-0.27	-17.10	-15.89	-1.21	0.07	-0.05	0.02
Financials	6.44	13.83	-7.39	-3.21	-1.30	-1.91	0.54	-0.07	0.47
Health Care	23.08	15.97	7.11	12.85	7.97	4.87	0.16	1.09	1.25
Industrials	12.10	15.12	-3.02	5.97	9.52	-3.55	-0.11	-0.46	-0.56
Technology	11.91	17.01	-5.10	6.97	5.72	1.25	0.12	0.49	0.61
Materials	5.08	5.37	-0.29	7.35	8.73	-1.38	-0.02	-0.07	-0.09
Real Estate	11.26	8.46	2.80	-0.67	-0.69	0.01	-0.17	0.03	-0.14
Utilities	0.00	3.14	-3.14	0.00	-1.75	1.75	0.25	0.00	0.25
TOTAL	**100**	**100**		**7.34**	**5.88**	**1.46**	**1.59**	**-0.14**	**1.46**

Source: GLA and Bloomberg. Performance numbers are gross of fees.

This does not, however, mean we don't acutely feel the tumult of the equity market, the political to and fro, the suffering caused by the COVID-induced economic shutdown, or the social unrest in our great country. And judging by the exceptional noise in the U.S. equity market – noise often below the surface and unobserved to those who follow the headline indices – investors are clearly not immune to wild swings of emotion. Our discipline allows us to have an upset stomach mid-day, but execute by process.

On to the Economic Review:

- Profits are down, volatility is up, and doubts about the path of recovery are manifest.
- To combat this, the Fed and Treasury are maintaining easy conditions, which have resulted in positive economic surprises since May. Will positive surprises hold for the rest of the year?
- Despite the easy conditions, underlying demand weakness has resulted in well-contained prices.
- This demand weakness is reflected in soft commodity prices, with the exception of gold.
- Marginal growth in doubt regarding the future of the Dollar as the reserve currency often results in rising gold prices.
- Why the marginal increase in doubt? Money Supply is up 23% year over year, and Debt to GDP ratio has soared to 136%.
- The economy shed an unprecedented number of jobs this spring. To date, we've recovered about half of these positions.
- Despite the job losses, rate cuts from last fall plus an additional leg down this spring have led to an incredibly robust housing market.
- Stable, strong house prices combined with a solid rebound in equity markets have left asset-heavy households better off, and have abated the slide in consumer confidence.
- It's also true that those whose household wealth is driven primarily by income are suffering inordinately – thus the "k-shaped recovery" description is accurate.
- Retail sales have rebounded nicely, with a shift to online shopping having accelerated.
- The Inventory to Sales ratio is very low, and a precursor to a demand shock at some point. ISM Manufacturing and Non-manufacturing indices are indicating expansions ahead – so poor Industrial Production numbers may fade in the months ahead.

In terms of where this leaves equity markets, the sole truth is poor visibility. Stocks remain very expensive relative to fundamentals, but the duration of the poor EPS numbers is an unknown. A high P/E ratio based on a non-recurring event means little. We can say that stocks are rich at this point – but it's hard to know just how expensive. One thing we do know is stocks are certainly more attractive than bonds, sporting a 1-3% yield premium – despite their low earnings yield.

We'll continue to follow our systematic approach rather than guess what may or may not lay ahead. To bring it back home, we evoke one more quote from Mr. Holmes in *The Sign of Four*:

"I never guess. It is a shocking habit — destructive to the logical faculty."

Positioning:

The SMidCap models show dampened risk aversion. Positive biases include Momentum, Growth, and Currency Sensitivity. Negative biases

include Value(!), Dividend Yield, and Earnings Yield. MidCap Growth is the only style box in favor; small-caps are quite out of favor.

As was true at the beginning of Q3, Health Care stocks (especially Biotech & Medical Services) are preferred by the model, while Financials (Banks, Equity REITs) are most out-of-favor.

From a return-driver perspective, we again see large changes from 3 months ago. Volatility is no longer a negative tilt, and is mostly positive (Analyst Estimate Dispersion is the exception). Quality has fallen negative, as have most valuation metrics. Growth characteristics such as 5 Year Sales and Earnings Growth are in favor, and our positive momentum tilts – both short and longer-term- have strengthened as well.

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