FUNDAMENTAL EQUITY

SMALL CAP

GREAT LAKES ADVISORS

A WINTRUST WEALTH MANAGEMENT COMPANY

MANAGER COMMENTARY
Third Quarter 2020

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MARKET REVIEW

After several months of strong positive gains in the equity markets, September was a volatile month for the equity markets, with all domestic equity indexes posting negative returns. The Russell 2000 index declined 3.3%, giving it a gain of 4.9% for 3Q2020.

Small-cap cyclicals led the way in 3Q2020, with the Consumer Discretionary sector as the clear standout, accounting for nearly half of the index returns. Retailers, casinos, restaurants, and hotels drove the bulk of the sector gains driven by the combination of federal stimulus getting pumped into the economy and corporate earnings coming in better than feared.

Quality continues to underperform in the small cap space as risk was rewarded to companies with little to no earnings, as well as high debt, all performing relatively better. Glittery growth stocks continued to outpace dull value stocks. The Russell 2000 growth index advanced 7.2% versus 2.6% for the Russell 2000 value index. Year-to-date, growth is massively outperforming value by 25.4%.

September also proved to be a challenging month for the GLA Small Cap Portfolio. Heading into the Labor Day weekend, the portfolio's absolute and relative performance for the quarter were strong. The portfolio was up nearly 9%, and it was solidly ahead of the Russell 2000 index by 200 basis points. It was nice to see value outperforming growth by 220 basis points. As we have noted in the past, while the R2000 index increasingly morphs into a growth index, we have remained disciplined to our value-oriented investment approach. So, when value outperforms growth, we expect our portfolio to outpace the benchmark.

However, market sentiment quickly turned after Labor Day. The growth index went on a huge relative performance run, outperforming the value index by 640 basis points. Growth was up 1.4% while value declined nearly 5.0%, and as a result, our performance suffered. The portfolio gave back all of its alpha that it had achieved in the prior two months plus more, ending the quarter up 1.4% which lagged the Russell 2000 index by 350 basis points.

Needless to say, our recent performance has been disappointing. To understand the diversion of our performance versus the benchmark, it might help to understand the specifics of our valuation process. We estimate our companies' normalized free cash flows (FCF) over a three to five year timeframe, and then discount those FCF to come up with what we believe is the intrinsic value of a company. We do not make investment decisions based on short-term noise. Instead, we take a long-term view, looking to take advantage of near-term uncertainty by investing in high-quality businesses at attractive prices.

Today, in a period of high uncertainty, the market has become even more myopic than we would have expected. The market has dramatically sold off our companies whose value lays in the gradual recovery from COVID impacts, and it has instead piled into companies with good growth "stories", momentum stocks, or companies that may only temporarily benefit from short-term changes in behavior or government stimulus. We are reminded of the adage "be fearful when others are greedy, and be greedy when others are fearful." The market has been far too greedy with respect to the near-term beneficiaries of COVID, and it has been far too fearful of companies that will only temporarily suffer.

Looking forward, we remain optimistic about the future prospects of our portfolio. We expect to outperform, largely due to owning discounted names, but also by avoiding the overvalued parts of the market. Eventually, the pendulum will swing back to the value investing camp, and when it does, that should provide us with a major tailwind. In the meantime, we will remain focused on staying the course, maintaining a long-term focus, and taking advantage of buying opportunities made available by the COVID-19 crisis.

THIRD QUARTER ATTRIBUTION

The portfolio's underperformance relative to the index was primarily driven by holdings in three sectors: Industrials, Technology, and Consumer Discretionary. On the positive side of the ledger, we outperformed in Financials.

SECTOR	GLA WEIGHTING	R2000 WEIGHTING	GLA RETURN	R2000 RETURN	SECTOR ALLOCATION	STOCK SELECTION	ACTIVE CONTRIB
Comm Services	3.05	1.34	3.05	-4.81	-0.17	0.21	0.05
Consumer Disc.	15.89	13.58	11.46	18.39	0.34	-1.00	-0.66
Cons. Staples	0.95	3.34	8.85	8.68	-0.08	-0.01	-0.09
Energy	3.19	1.89	-17.40	-10.49	-0.25	-0.31	-0.56
Financials	19.47	18.76	4.57	-0.99	-0.08	1.14	1.06
Health Care	8.42	19.93	4.06	4.65	-0.06	0.10	0.05
Industrials	21.38	14.49	-0.80	9.04	0.24	-1.97	-1.74
Technology	14.44	14.42	-3.29	2.95	-0.00	-0.92	-0.92
Materials	5.19	4.40	-4.19	7.04	0.00	-0.59	-0.59
Real Estate	3.35	4.40	-7.54	-0.87	0.05	-0.20	-0.15
Utilities	0.00	3.32	0.00	-3.72	0.27	0.00	0.27
Cash	4.66	0.00	0.03	0.00	-0.22	0.00	-0.22
TOTAL	**100**	**100**	**1.39**	**4.93**	**0.01**	**-3.55**	**-3.54**

Source: FactSet. Performance numbers are gross of fees.

MARKET OUTLOOK

The world's greatest detective, Sherlock Holmes, knew:

"The emotional qualities are antagonistic to clear reasoning."

–Sherlock, *The Sign of Four*

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.

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.

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."

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