DISCIPLINED EQUITY
SMIDCAP

GREAT LAKES ADVISORS
A WINTRUST WEALTH MANAGEMENT COMPANY

MANAGER COMMENTARY

Fourth Quarter 2020

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MARKET REVIEW

Did 2020 really just happen?! Despite U.S. equities getting absolutely demolished during the four weeks following February 2020 (the most rapid bull-to-bear transition in history), we finished the year about 20% higher for most main indices. This strangest of years did not disappoint during Q4, either; the stocks with the most volatile profiles led the market sharply higher, propelled both by the notion of more fiscal stimulus enabled by a possible blue wave and announcement of an effective COVID vaccine. Yes, 2020 really did happen - and none of us is likely to soon forget.

Russell 2500

The Russell 2500 Index recorded a 27.4% advance during Q4, ending the year shy of a 20% gain by the narrowest of margins.

Size/Style

- The small-cap Russell 2000 Index outperformed the smid-cap Russell 2500 by about 4% during Q4, with small companies surging on both anticipated lockdown recovery and the aforementioned fiscal stimulus.
- This same sentiment - optimism regarding a strong recovery - allowed value stocks to outperform in the smid-cap realm. While their edge was more pronounced in small-caps, midcap value stocks also outperformed during Q4. On the year, however, value underperformance was staggering.

Russell 2500 Sectors

Cyclicals surged to the top of the relative performance list, with a mix of late-stage and hyper-cyclicals reflecting the extreme bullish sentiment:

- After posting a narrow decline during Q3, the Energy sector soared 46.9% during the final quarter. Remarkably, the sector was still 11.1% lower for the year. Tech and Financials posted gains of over 30% for Q4, with Materials up nearly 30% as well. On the year, Tech and Health Care paced the Russell 2500, with gains of 53.2% and 48.5%, respectively.
- Defensive sectors lagged in this environment - yet still posted solid gains. Utilities performed worst, but added 18.02%. Consumer Staples were next lowest at 17%.

FOURTH QUARTER ATTRIBUTION

The SMidCap strategy advanced a solid 22.6% during the quarter, yet trailed the benchmark Russell 2500 Index’s even larger 27.4% advance. The table on the following page breaks down the contributions from sector positioning and stock selection.

Sector positioning detracted 0.70% from active return:

- Underweighting the Technology sector detracted 55bps; the sector topped the Russell 2500 Index by over 6% during the quarter.
- Underweighting the Utilities sector added 22bps to active performance. The sector trailed the R2500 return by over 9% during Q4.

Stock selection within the respective sectors detracted 4.05% from active return.

FOURTH QUARTER ATTRIBUTION

SECTOR	GLA WEIGHTING	R2500 WEIGHTING	% ACTIVE	GLA RETURN	R2500 RETURN	% ADDED	SECTOR ALLOCATION	STOCK SELECTION	ACTIVE CONTRIBUTION
Comm. Services	6.21	2.95	3.26	36.01	26.04	9.96	-0.02	0.61	0.60
Consumer Disc.	21.03	12.87	8.16	17.19	25.55	-8.36	-0.13	-1.91	-2.04
Consumer Staples	3.85	3.26	0.59	16.41	16.98	-0.56	-0.02	-0.23	-0.25
Energy	2.52	1.93	0.59	47.85	46.90	0.95	0.11	-0.01	0.10
Financials	10.66	13.89	-3.24	34.19	32.81	1.38	-0.35	0.40	0.05
Health Care	21.45	16.03	5.43	16.52	23.76	-7.24	-0.09	-1.44	-1.52
Industrials	12.20	15.37	-3.16	20.42	26.60	-6.18	0.10	-0.94	-0.84
Technology	8.66	17.52	-8.85	28.11	33.87	-5.76	-0.55	-0.46	-1.02
Materials	6.03	5.33	0.70	35.13	29.27	5.87	0.00	0.33	0.33
Real Estate	6.83	7.86	-1.04	16.06	19.50	-3.44	0.02	-0.40	-0.38
Utilities	0.54	2.98	-2.44	19.72	18.02	1.70	0.22	0.00	0.22
Total	**100**	**100**		**22.64**	**27.39**	**-4.75**	**-0.70**	**-4.05**	**-4.75**

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

MARKET OUTLOOK

Not-so-bold Prediction: 2019 – 2021 will go down in history as one of the more unique periods for U.S. equities. From an incredibly swift bear-to-bull transition to start 2019, to the Fed easing and injecting liquidity at the end of a long economic expansion in late summer 2019, to COVID/shelter-in-place/#WFH, to unprecedented monetary response, to the most surreal of Presidential races, to a COVID vaccine, and finally a change in control of the Senate decided in a run-off some 2 months after the general election. This latter combination means a shift in balance from monetary to fiscal stimulus to carry us through to the light at the end of the COVID tunnel. Let's just hope that light isn't from an oncoming inflation train.

On balance, economic news looks quite good, although time will tell whether this is simply Red Bull economics.* Leading Economic Indicators are recovering to break-even, and corporate profits have rebounded swiftly to pre-COVID levels, with strong profit margins. Credit markets are rich, but well-behaved. Easy credit conditions, plus the aforementioned expected forthcoming spike in fiscal stimulus, plus the developing herd immunity is resulting in a shift toward more economically-sensitive cyclical and small cap stocks. We are concurrently at a risk for rising yields, which would likely have the impact of an improving outlook for Banks as the curve steepens, a rotation toward beleaguered value stocks, and an eventual compression of P/E ratios.

Prices are well-contained at the turn of 2021, but year-over-year comps will lead to a spike in inflation numbers. This one-time impact may be further boosted as consumers release pent-up demand, given their robust collective balance sheet. Outside of this, the economy has plenty of excess capacity which should keep underlying price pressure from building to exorbitant levels. Unemployment levels, while improving nicely, should stay above prior cyclical lows, as we sort through the permanent damage on small services businesses caused by sheltering in place.

A particular highlight for 2020 is the robust housing market. All indicators are at record highs: permits, starts, sales (new and existing), and prices. Affordability, however, is consequently suffering. Any meaningful rise in rates can take the air out of this segment quickly – this will be key to watch as we hit the summer and fall of 2021 – with summer and fall being seasonally weak regardless. Something else to watch for is the dramatically weakened U.S. Dollar. This means foreign goods become more expensive to U.S. consumers – but can also be a boon to the U.S. manufacturing industry.

Typically, we'd look to prevailing valuation levels and the economic outlook to inform market outlook. However, any metrics using trailing sales, earnings, cash flow, etc. are invalid in the current situation. Instead, the strength of the rebound will determine whether or not the market is fairly priced at present. At a minimum, we expect the aforementioned rotations. And if yields rise as expected, this may undercut both multiples and the relative attractiveness of stocks versus bonds. As always:

> *"I know a lot of people have very strong and definite plans that they've worked out on all kinds of things, but we're subject to a tremendous number of outside influences and the vast majority of them cannot be predicted. So my idea is to stay flexible."*
>
> \- Henry Singleton, longtime CEO of Teledyne

Positioning:

The SMidCap models responded to a decidedly risk-seeking environment during Q4. Volatility became the largest positive tilt from a risk factor perspective, followed by Earnings Variability. Earnings Yield and Dividend Yield are most out of favor. In contrast with our LargeCap models, we see a continued tilt to growth stocks within the style buckets, and less of a cap bias.

Health Care swung sharply into favor, driven by Biotech and Drug industries. Again in contrast to the LargeCap models, Financials remain out of favor here, paced by Banks and REITs.

From a return-driver perspective, we again see large changes from 3 months ago. Volatility has swung quite sharply into favor, now inclusive of Analyst Estimate Dispersion. Quality remains negative, as do most valuation metrics. Growth characteristics are muted (no big positives or negatives), as are technical indicators, both short- and intermediate-term.

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*Coined by Bob Rodriguez, the longtime stalwart manager of FPA Crescent Fund, Red Bull economics is an economy juiced by outsized monetary and/or fiscal stimulus.

The data in the attribution table represent the returns for each sector and for the gross returns for a representative composite account for one quarter ending the current calendar quarter. Individual account returns may vary.