DISCIPLINED EQUITY
SMIDCAP

GREAT LAKES ADVISORS
A WINTRUST WEALTH MANAGEMENT COMPANY

MANAGER COMMENTARY

First Quarter 2021

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MARKET REVIEW

If the 2021 equity markets could speak, they'd tell 2020 "Hold my beer..." Coming off an unprecedented 2020, 2021 kicked off with incredible short squeeze rallies in the Reddit "meme" stocks, causing severe *agita* for many highly respected hedge funds. Next, while we expected yields to rise, EPS growth to accelerate and spread, and a long-awaited value revival to take place, we did not foresee the violence of these rotations. In fact, Q1 2021 was the worst Treasury rout since 1980, the best performance for Bloomberg's Pure Value portfolio since 2000, and small caps once again outperformed the NASDAQ 100 Index.

Russell 2500

The Russell 2500 Index recorded a 10.9% advance during Q1, adding to a 27%+ gain from Q4, and capping an 89.4% gain over the past 12 months. Raise your hand if on 3/31/20 you predicted stocks would double over the coming twelve months.

Size/Style

- The small-cap Russell 2000 Index outperformed the smid-cap Russell 2500 by almost 2% during Q1, with small companies continuing to surge on both anticipated economic reopening and massive stimulus.
- This same sentiment - optimism regarding a strong recovery - allowed value stocks to widen their outperformance in the smid-cap realm to over 14% for Q1. While their edge was more pronounced in small-caps, midcap value stocks also outperformed by a wide margin during Q1. Over the past 6 months, smidcap value stocks have pulled into a dead heat with their growth counterparts for the trailing one year.

Russell 2500 Sectors

We saw slightly less consistent sector performance among smid-caps. Cyclicals are performing nicely:

- Cyclical stocks - especially late-stage cyclicals - continued to pace the Russell 2500 Index, led by Energy's 21% gain. Consumer Discretionary stocks also advanced strongly, climbing 21%. For the past 12 months, the Russell 2500 Energy sector has soared 193.6%, and the Consumer Discretionary group has added over 146%!
- Defensive sectors and the Tech sector were at the bottom of the performance list, as one would expect given extreme bullishness. The Health Care group performed worst, weighed down by the volatile Biotech industry. Utilities returned less than 2%, as did the Tech sector. For the past 12 months, the Utilities sector performed the worst, its safe haven status weighing against the group in this highly speculative environment.

FIRST QUARTER ATTRIBUTION

The SMidCap strategy advanced a solid 6.1% during the quarter, yet trailed the benchmark Russell 2500 Index's even larger 10.9% advance. The table on the following page breaks down the contributions from sector positioning and stock selection.

Sector positioning added 1.26% to active return:

- Underweighting the Technology sector added 67bps; the sector trailed the Russell 2500 Index by almost 10% during the quarter.
- Overweighting the Consumer Discretionary sector added 50bps to active performance. The sector trailed the R2500 return by over 10% during the quarter.

Stock selection within the respective sectors detracted 6.14% from active return, and the dramatic reversals within the market were on display as our two top contributors from Q4 fell into the top detractor category during Q1.

FIRST QUARTER ATTRIBUTION

SECTOR	GLA WEIGHTING	R2500 WEIGHTING	% ACTIVE	GLA RETURN	R2500 RETURN	% ADDED	SECTOR ALLOCATION	STOCK SELECTION	ACTIVE CONTRIBUTION
Comm. Services	6.47	2.94	3.53	-1.16	8.85	-10.01	-0.03	-0.64	-0.67
Consumer Disc.	18.88	13.31	5.58	17.14	21.38	-4.24	0.50	-0.70	-0.20
Consumer Staples	7.37	3.13	4.25	24.24	12.96	11.28	0.13	0.60	0.73
Energy	3.05	2.40	0.64	41.90	38.02	3.88	0.14	0.10	0.25
Financials	14.25	14.09	0.16	10.88	18.67	-7.79	0.10	-0.92	-0.82
Health Care	19.35	15.59	3.77	-14.35	-0.17	-14.18	-0.16	-3.37	-3.53
Industrials	9.68	15.91	-6.23	8.41	15.10	-6.69	-0.25	-0.62	-0.87
Technology	10.27	17.26	-6.99	0.00	1.25	-1.25	0.67	-0.13	0.54
Materials	6.20	5.32	0.88	17.58	14.44	3.15	0.03	0.19	0.23
Real Estate	3.26	7.42	-4.16	-1.36	9.99	-11.35	-0.01	-0.35	-0.36
Utilities	1.21	2.64	-1.42	-14.92	3.20	-18.12	0.12	-0.30	-0.18
Total	**100**	**100**		**6.05**	**10.93**	**-4.88**	**1.26**	**-6.14**	**-4.88**

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 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, the most surreal of Presidential races, a COVID vaccine, a change in control of the Senate decided in a run-off some 2 months after the general election, another $2T in fiscal stimulus, and finally the worst quarter for U.S. treasuries since 1980. Ho hum.

We weren't surprised to see much of what came to pass during the opening quarter of 2021, but we were once again taken aback by the speed and violence of the rotation. Then again, I suppose one would be foolish to have "expected" the most violent rotation since Ronald Reagan's first year in office!

The economic data looks quite good at this point, as does the vaccine rollout. There's every reason to be optimistic in the short run, but also cautious in the long run. Corporate profits have recovered nicely and remain near record levels. Equity markets remain volatile under the surface to be sure, but headline equity volatility has receded. A recession is really off the table, and in fact, GDP growth in the high single digits is the most likely scenario over the next couple of quarters.

Although commodity prices are on the rise, inflation numbers remain in check at this point – but merit careful study. Manufacturing hours worked are down a bit, and while payroll expansion is robust, we still have slack in the labor market to counter commodity inflation.

Housing remains incredibly strong, with prices up 10% y/y. But there may be some signs of rising mortgage rates taking a bite out of demand, with both permits and new home sales down slightly. However, at least some of this decline is also due to very long wait times for building materials.

Consumers appear to be in good shape. Household balance sheets are robust, with low debt levels and plenty of excess savings. This makes for solid consumer confidence numbers, and impressive retail sales growth.

Stock prices are certainly elevated if one uses any kind of backward-looking valuation metrics. Stocks are trading higher based on optimism for a broad, robust economic recovery – and that is what we have underway, by most all indicators.

Positioning:

While the SMidCap models did a nice job of adapting to a substantial increase in risk appetite during Q4, that particular rotation appears to have been short-lived. Indeed, the SMid models were "de-risking" during Q1, increasingly so as the quarter wore on. As the volatility preference faded, the value preference increased – particularly in the small-cap tier.

From a risk factor perspective, Earnings Yield, Value, and Yield factors posted the largest increases in exposure; Growth, Momentum, and Volatility all came in substantially.

In terms of Sector/Industry exposure, Financials became more attractive, Banks in particular. Consumer Discretionary, Materials, and the Utilities sectors also became more attractive. These bullish rotations were offset by a sharp reversal in the Health Care sector – most notably Biotech, and the Software industry.

In terms of stock selection characteristics, Forecasted Earnings Yield, Sales to Enterprise Value, Sales to Price, and Operating Cash Flow to Price all gained sharply. Risk factors (Stock-Specific Risk, Share Price, Market Cap) and Momentum declined sharply.

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. The sector weights are the average weight throughout the calendar quarter. Individual account returns may vary.

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