



## MANAGER COMMENTARY

*First Quarter 2021*

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## MARKET REVIEW

The first quarter of 2021 was a strong one for small cap stocks, with the Russell 2000 Index advancing 12.7%. Investors have bought into the narrative of a global economic boom, lifted by the loose fiscal and monetary stimulus and the pent up consumer savings awaiting to be deployed as the economy reopens. This, in conjunction with the rapid rise at the long end of the yield curve has sparked a significant rotation away from high-growth, high multiple stocks into the more economically sensitive reopening stocks.

The change in market leadership could clearly be seen in the sector performance as last year's losers - energy, materials, financials, and industrials - were the leaders in 1Q21, while last year's winners - technology, healthcare, and staples - were the laggards. So, not surprisingly, given its higher exposure to cyclical sectors, the Russell 2000 Value Index significantly outperformed the Russell 2000 Growth Index (21.2% versus 4.9%).

Other areas in the small cap market that outperformed were the smallest market capitalization stocks as well as some of the highly levered, deep cyclical companies. Meanwhile, quality (as measured by return on invested capital) underperformed.

Looking forward, the market could remain volatile as investors grapple over growing corporate profits and rising inflationary pressures that could bring on higher interest rates. Today, the Consumer Price Index data indicates that inflation is tame. However, given what we are hearing from our management teams regarding higher input costs and supply shortages, it's a decent bet that CPI (and interest rates) will be higher in the future.

We believe this backdrop will continue to favor value over growth on a relative basis as stocks with the longest duration (companies with little to no near-term cash flows) will be negatively impacted the most in a rising rate environment. Our portfolio is full of companies that generate tons of free cash flows today (or shorter duration) which should be less impacted with higher rates. Moreover, we value companies with strong competitive advantages, sustainable free cash flow growth, and solid financial positions which should help them to navigate the changing conditions.

## FIRST QUARTER ATTRIBUTION

The GLA Small Cap portfolio enjoyed a strong quarter on an absolute and relative basis, gaining 17.0%, and outperforming the Russell 2000 Index, which was up 12.7%. The portfolio's outperformance relative to the index was driven by holdings in three sectors - Healthcare, Technology, and Communication Services. We underperformed in the Materials, Energy, and Consumer Discretionary sectors.

### Contributors

- Healthcare was our best performing sector on a relative basis, adding 279 basis points of alpha. A combination of our underweight position in the biotechnology industry (which accounts for 9% of the Russell 2000 Index and declined 4% in the quarter) and strong stock selection drove the outperformance. In aggregate, our stock selection was up nearly 20% versus flat returns for the benchmark.
- Strong stock selection in the Technology sector contributed 226 basis points of outperformance.

### Detractors

- The Materials sector detracted 84 basis points on an attribution basis. Investors have flocked to the commodity producers as a way to play the reflation trade. Historically, we have not had much exposure to the commodity producers due to their undifferentiated products, sub-par returns on capital, and use of high leverage. Our investments in the Materials sector are focused on value-added producers that are generally insensitive to the commodity prices as they are able to pass on the higher input costs due their strong competitive positions. Put simply, our holdings did not keep pace in the sharp rebound.



## FIRST QUARTER ATTRIBUTION

SECTOR	GLA WEIGHTING	R2000 WEIGHTING	GLA RETURN	R2000 RETURN	SECTOR ALLOCATION	STOCK SELECTION	ACTIVE CONTRIBUTION
Comm. Services	2.66	1.22	86.90	17.73	0.15	1.47	1.61
Consumer Disc.	15.54	14.62	20.39	25.95	0.20	-0.93	-0.72
Consumer Staples	0.74	3.14	9.56	15.62	-0.02	-0.05	-0.07
Energy	3.95	2.17	6.53	43.19	0.52	-1.23	-0.70
Financials	21.49	18.23	17.28	17.53	0.19	-0.04	0.15
Health Care	6.76	19.78	20.23	0.09	1.60	1.19	2.79
Industrials	22.82	14.67	13.02	14.77	0.12	-0.44	-0.33
Technology	11.25	15.13	24.39	5.21	0.25	2.01	2.26
Materials	7.07	4.46	2.45	19.91	0.42	-1.26	-0.84
Real Estate	3.57	3.71	17.41	9.69	0.10	0.40	0.50
Utilities	--	2.70	--	4.81	0.31	--	0.31
Cash	4.08	--	0.01	--	-0.66	0.00	-0.66
<b>Total</b>	<b>100</b>	<b>100</b>	<b>17.02</b>	<b>12.69</b>	<b>3.26</b>	<b>1.07</b>	<b>4.33</b>

Source: FactSet. Performance numbers are gross of fees.

- While we underperformed the Consumer Discretionary sector by 72 basis points relative to the benchmark, we are generally pleased with our overall stock selection.
- The portfolio's Energy sector dinged our relative performance by 70 basis points. Similar to the Materials sector, the best performing companies were those that were directly impacted by the higher oil prices (levered exploration and production stocks). While the benefit of higher oil prices is not as immediate for our oil equipment suppliers, higher oil prices should eventually drive increased equipment purchases. We are encouraged by the outlook for both companies.

## 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 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.

### GLA PRELIMINARY RETURNS AS OF MARCH 31, 2021<sup>1</sup>

	QTD	1 YR	3 YR	5 YR
GLA Small Cap	17.02%	80.26%	10.57%	12.40%
Russell 2000 Index	12.70%	94.85%	14.76%	16.35%
Russell 2000 Value Index	21.17%	97.05%	11.57%	13.56%

1. PERFORMANCE STATISTICS ARE GROSS OF FEES AND PRELIMINARY AS OF MARCH 31, 2021, BASED ON A REPRESENTATIVE ACCOUNT.

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.

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The Small Cap composite includes all discretionary portfolios managed with the Firm's small cap approach. The Firm's small cap approach employs small capitalization, principally U.S.-based or Canadian-based equities with an ability to generate an attractive cash flow return on investment. The composite is benchmarked to the Russell 2000 Index. Portfolios subject to substantial client imposed restrictions are excluded from this composite. Prior to June 30, 2012, the minimum portfolio size for inclusion in the Small Cap composite was \$250,000. After June 30, 2012, the minimum portfolio size for inclusion in the Small Cap composite is \$1,000,000. Accounts meeting the above criteria will be added to the Small Cap composite the first calendar month following their full investment in the strategy. Accounts are removed from the composite, while retaining their prior historical performance in the composite, at termination of the Firm as investment manager, when the value of the account drops below \$750,000 for a period of nine consecutive months, or when investment policy guidelines are instituted substantially restricting implementation of the small cap approach. Terminated portfolios will be removed from the Small Cap composite after the last full month of active management. Accounts within this composite do not employ leverage. The composite inception date was June 30, 2008; and the composite was created on June 30, 2012. All cash reserves and equivalents are included in returns. Returns are time weighted and include reinvestment of dividends, income and gains. The value of assets and returns is expressed in U.S. dollars. All holdings available upon request. Market commentary is available at [www.greatlakesadvisors.com](http://www.greatlakesadvisors.com) or upon request.

The benchmark selected for comparison of returns for the Small Cap Composite is the Russell 2000 Index, a subset of the Russell 3000® Index representing approximately 10% of the total market capitalization of that index, and includes approximately 2,000 of the smallest securities based on a combination of their market cap and current index membership. The Russell 2000 Growth index consists of 2,000 companies in a group of 3,000 U.S. companies in the Russell 3000 Index that exhibit a growth probability. The Russell 2000 Value index consists of 2,000 companies in a group of 3,000 U.S. companies in the Russell 3000 Index that also exhibit a value probability.

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