DISCIPLINED EQUITY

SMIDCAP

GREAT LAKES ADVISORS

A WINTRUST WEALTH MANAGEMENT COMPANY

MANAGER COMMENTARY

Second Quarter 2021

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MARKET REVIEW

U.S. equities continued to push sharply higher during the second quarter, fueled by very easy monetary policy and massive fiscal stimulus. Valuations are stretched here, with investors cumulatively betting the robust earnings rebound continues WHILE bond yields also remain low. Disappointment on either side of the equation could lead to heightened volatility and/or a pullback in equities.

Russell 2500

The Russell 2500 Index recorded a 5.4% advance during Q2, bringing its first half advance to 17%.

Size/Style

- The small-cap Russell 2000 Index trailed the smid-cap Russell 2500 by about 1% during Q2, a reversal of modest small-cap outperformance early in the year.
- Growth stocks modestly outperformed value stocks within the Russell 2500 after posting a substantial advantage (about 6.7%) during June. June's performance was a stark reversal of the value rotation which ran from mid-February through mid-May.

Russell 2500 Sectors

We again saw a bit more consistent relative sector performance among smid-caps. Late-stage cyclicals held up better here than in the large-cap space:

- The Energy sector again led the Russell 2500 Index, gaining 14.5% during the second quarter. The sector is already 38.6% higher for the year. Materials stocks also continued their recent run of solid performance.
- Defensive sectors, meanwhile, continue to underperform. Utilities recorded a scant 0.1% advance, and Consumer Staples added only 0.8%.

SECOND QUARTER ATTRIBUTION

The SMidCap strategy advanced a solid 4.8% during the quarter, narrowly trailing the benchmark Russell 2500 Index's 5.4% advance. The table on the following page breaks down the contributions from sector positioning and stock selection.

Sector positioning detracted 0.25% from active return:

- Overweighting the Consumer Staples and underweighting the Real Estate sector combined to detract 51bps; the former trailed the Russell 2500 Index by 1.5% during the quarter, while the latter outperformed by 3.9%.
- Overweighting the Energy sector proved fruitful, as the sector outperformed the Russell 2500 by nearly 18%.

Stock selection within the respective sectors detracted 0.35% from active return.

MARKET OUTLOOK

The surprises keep coming. Despite unprecedented stimulus (and talk of much more to come), and signs of building price pressure (especially in PPI and manufacturing prices paid), Treasury yields actually moved lower on the quarter, the curve flattened, and real yields hit the most negative on record. This is largely due to massive purchases from the Treasury. The markets are focused on whether inflation will be "transitory", or if the observed price increases will lead to something similar to the early 80's.

With yields halting their increase, the long-awaited value rotation retraced its strong run of outperformance, sliding sharply during June. Rising yields increase the discount rate for future earnings, making growth stocks less attractive. Declining yields have the opposite effect. We expect value to outperform growth after this recent setback.

SECOND QUARTER ATTRIBUTION

SECTOR	GLA WEIGHTING	R2500 WEIGHTING	% ACTIVE	GLA RETURN	R2500 RETURN	% ADDED	SECTOR ALLOCATION	STOCK SELECTION	ACTIVE CONTRIBUTION
Comm. Services	2.72	2.93	-0.21	9.86	12.43	-2.57	-0.03	-0.03	-0.06
Consumer Disc.	16.86	13.85	3.01	-3.85	3.81	-7.66	0.09	-1.42	-1.33
Consumer Staples	9.12	3.16	5.96	1.42	0.97	0.45	-0.28	0.07	-0.21
Energy	3.64	2.71	0.93	24.71	23.30	1.42	0.15	0.03	0.17
Financials	19.28	14.66	4.63	5.34	2.54	2.80	-0.11	0.54	0.43
Health Care	14.22	14.41	-0.19	2.40	4.84	-2.44	0.06	-0.41	-0.35
Industrials	10.93	16.35	-5.41	5.50	3.10	2.40	0.11	0.26	0.37
Technology	13.11	15.85	-2.74	9.72	7.96	1.76	-0.01	0.08	0.07
Materials	6.26	5.71	0.54	17.31	6.12	11.19	-0.01	0.66	0.64
Real Estate	1.63	7.81	-6.18	4.91	9.28	-4.37	-0.23	-0.09	-0.32
Utilities	2.23	2.56	-0.33	-4.17	-0.10	-4.06	0.03	-0.04	-0.01
Total	**100**	**100**		**4.78**	**5.38**	**-0.60**	**-0.25**	**-0.35**	**-0.60**

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

The strong stimulus is showing its impact in many areas. Corporate profits hit an all-time high in Q1. Capacity Utilization has moved higher – but remains at a moderate level. Commodity prices continue to edge higher, as do input prices such as lumber, steel, and concrete. The labor market continues to recover, with about 70% of the jobs lost during COVID now recouped. The housing market remains very strong, with the highest year-over-year increases in home prices in 15 years. Industrial Production and purchasing indices are also strong. Lastly, the preponderance of good news has buoyed consumer confidence.

The next quarter or two should inform the Fed's future policy far more than the past quarter or two. More stimulus (infrastructure bill, anyone?) offset by tax raises will come into play, and year-over-year changes in economic data will become more meaningful as COVID-hampered periods drop from the observations. The conversation will start to turn to tapering as the Fed evaluates the quantity of their monthly asset purchases, and how long this should continue.

As for equity markets, we'll need plenty of robust, profitable growth to justify valuations here – especially if inflation is not transitory.

Positioning:

With the economy awash in liquidity but the economic rebound not looking as powerful as hoped, forecasted returns for growth stocks have improved sharply in both the mid-cap and small-cap market segments. Overall, small-caps remain more attractive than mid-caps as we enter Q3.

From a risk factor perspective, the SMidCap models do have an aggressive stance, with Volatility, Leverage, and Earnings Variation the most significant positive biases. Earnings Yield had been a strong positive bias, but has now reversed into a negative tilt.

In terms of Sector/Industry exposure, Health Care became significantly more attractive during Q2, especially Biotech, Medical Products, and Drugs. An improved forecast for Computer Software has also elevated the outlook for the Tech sector. Conversely, the flattening yield curve drove a reduced outlook for Banks and Thrifts.

In terms of stock selection characteristics, higher volatility (idiosyncratic risk, beta, low share price) swung back into favor after a brief respite. A number of Value and Quality characteristics became less attractive, with Forecasted Earnings yield, Earnings-based Return on Capital, and Earnings/Debt all declining 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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