FUNDAMENTAL EQUITY
SMALL CAP

GREAT LAKES ADVISORS
A WINTRUST WEALTH MANAGEMENT COMPANY

MANAGER COMMENTARY
Second Quarter 2021

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MARKET REVIEW

Small Cap stocks continued their grind higher during the second quarter of 2021, as the Russell 2000 Index advanced 4.3%. The strength of the economic recovery and robust earnings from companies helped lift the market higher.

From a sector perspective, it was a mixed bag, but generally speaking, cyclicals outperformed defensive sectors. All sectors were in positive territory except for Utilities. Energy, a low weighting in the Russell 2000, was by far the best performer, up 23%. Consumer Discretionary, Real Estate (defensive), and Information Technology outperformed while Health Care, Consumer Staples, Industrials (cyclical), Materials (cyclical), and Utilities underperformed.

Excess risk-taking continues to prosper in Small Caps. Lower quality factors (i.e. high beta, high leverage, and negative earnings) continue to lead the index. A clear example of this is the "meme" stocks, which continue to dominate the financial media. AMC stock was up 455% in the quarter (2,573% YTD) and it contributed 15% of the benchmark return. That's pretty amazing, but is it sustainable?

The continued ongoing tug-of-war being played out between the markets and the U.S. Federal Reserve has replaced good, bottom-up fundamental analysis with macro, top-down factors driving investor sentiment. Market participants are moving baskets of stocks based on the direction of where interest rates may be heading in the near-term. The value versus growth trade is a good case in point.

The start of the quarter saw the continuation of last quarter's trend where investors favored more economically sensitive reopening (value) stocks versus high-growth, high multiple (growth) stocks. As a result, value trounced growth by more than 700 basis points in the first half of the quarter. However, we saw a complete reversal of the trend in the second half of the quarter where growth stocks beat value stocks by 700 basis points, as the 10-year Treasury yield that began the quarter at 1.70% ended the quarter at 1.45%.

While we do not forecast macroeconomic variables such as interest rates to make investment decisions, we do believe interest rates should trend higher over time as economic activity normalizes. The Fed has already stated that they expect to be entering into a tightening cycle in 2023 (could be earlier). Historically, in the early stage of the tightening cycle, value tends to outperform growth on a relative basis, which should provide a nice continued tailwind for value.

As we examine the characteristics of our portfolio, we like how it is positioned. Our portfolio is full of cash-generating, quality companies with above-average returns on capital and healthy balance sheets. On an absolute basis, the portfolio trades at a 25% discount to our base-case values, and relative to the Russell 2000 Index, the portfolio is trading at roughly a 30% discount to NTM P/E. These dynamics should serve us well for both the near-term volatility and the long term outperformance.

SECOND QUARTER ATTRIBUTION

The GLA Small Cap portfolio returned 4.03% in the second quarter of 2021, slightly underperforming the Russell 2000 benchmark's return of 4.29%. The Russell 2000 Value edged out the Russell 2000 Growth by 64 basis points, returning 4.56% and 3.92%, respectively. Year to date, the GLA Small Cap portfolio is outperforming the R2000 Index by more than 400 basis points, with the GLA Small Cap return at 21.74% versus the R2000 Index at 17.53%.

Strong stock selection in the Industrial, Healthcare, and Financial sectors drove 228 basis points of positive alpha in the quarter. However, that was offset by a negative 230 basis points of relative performance in the Consumer Discretionary, Communication Services, Information Technology, and Energy sectors.

SECOND QUARTER ATTRIBUTION

SECTOR	GLA WEIGHTING	R2000 WEIGHTING	GLA RETURN	R2000 RETURN	SECTOR ALLOCATION	STOCK SELECTION	ACTIVE CONTRIBUTION
Comm. Services	1.82	1.08	-25.08	6.53	0.02	-0.63	-0.61
Consumer Disc.	15.80	15.64	0.53	9.35	0.08	-1.34	-1.26
Consumer Staples	--	3.23	--	2.07	0.08	--	0.08
Energy	3.91	2.51	7.01	23.01	0.32	-0.62	-0.31
Financials	22.60	19.15	3.02	1.65	-0.08	0.29	0.22
Health Care	7.79	18.04	14.06	2.95	0.17	0.74	0.91
Industrials	22.48	14.72	7.87	1.42	-0.21	1.35	1.14
Technology	11.49	13.94	2.16	5.27	-0.03	-0.40	-0.43
Materials	7.88	4.90	3.75	3.90	0.11	-0.04	0.07
Real Estate	3.98	3.88	3.55	8.02	0.02	-0.15	-0.13
Utilities	--	2.68	--	-2.22	0.18	--	0.18
Cash	2.25	--	0.01	--	-0.11	--	-0.11
Total	**100**	**100**	**4.03**	**4.29**	**0.53**	**-0.79**	**-0.26**

Source: FactSet. Performance numbers are gross of fees.

Contributors

- Industrials was our best performing sector on a relative basis, adding 114 basis points of outperformance. In aggregate, our Industrial holdings were up 7.9% which outperformed the sector return of 1.4% for the benchmark
- In Healthcare, strong stock selection and our zero exposure to the underperforming biotechnology industry contributed 91 basis points of outperformance.
- In Financials, we outperformed by 22 basis points.

Detractors

- Consumer Discretionary was our worst performing sector, detracting 126 basis points of relative performance.
- The Technology sector detracted 43 basis points on an attribution basis.
- Energy was the best performing sector in the quarter, advancing 23%. While we had a slight overweight position in the sector, our holdings underperformed, detracting 31 basis points from our relative performance.

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.

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.

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 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 approximately2,000 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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