FUNDAMENTAL EQUITY

SMALL CAP

GREAT LAKES ADVISORS

A WINTRUST WEALTH MANAGEMENT COMPANY

MANAGER COMMENTARY

Third Quarter 2021

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MARKET REVIEW

The Russell 2000 Index returned -4.4% in the third quarter of 2021. GLA's Small Cap portfolio returned -2.7%, outpacing the index by 164 basis points. Year-to-date, the portfolio is up +18.4% versus the Russell 2000 index of +12.4%, outperforming the index by 600 basis points.

The equity markets pushed through August, but fell in September as investors became more cautious and the mixed economic data unnerved confidence about the current economic recovery. The resurgent Delta variant, inflation concerns, and supply chain issues added to the worries. This was the first negative return for the Russell 2000 Index since the first quarter of 2020.

Digging deeper, however, the sector performance did not reconcile with all of these worries. Typically, in uncertain times, the defensive areas of the market tend to outperform the more cyclical ones. That was not the case in the quarter. The best performing sectors were Energy and Financials. Energy was a beneficiary of higher oil prices, and Financials benefited from higher interest rates. On the flip side, the worst performing sector was Health Care, a sector that is typically considered a defensive area of the market.

From a factor perspective, small cap value (-2.9%) once again outperformed growth (-5.6%) in the quarter. In fact, this has been the case for all three quarters so far this year. While it's nice to see value outperform growth, the more relevant factor for our portfolio is the outperformance of quality (earners, higher returns on equity, and lower leverage) versus lower-quality in the quarter.

In previous letters, we've highlighted that the pandemic environment was one of the worst periods for quality investing. Historically, quality wins over the long-term, and we believe it should rebound similarly to what value recently experienced. Our portfolio is in great position, as we believe the companies we own are superior to that of the index. Additionally, our portfolio on almost all valuation metrics is trading at a discount to the index. We expect this to be a winning combination longer-term.

THIRD QUARTER ATTRIBUTION

The GLA Small Cap portfolio's value declined -2.72% in the quarter, but it enjoyed a solid relative performance, besting the Russell 2000 Index by 164 basis points. The outperformance was driven by both sector allocation (+87 basis points) and stock selection (+76 basis points). Our underweight position in Healthcare, the worst performing sector, was the major contributor to the positive sector allocation. We had strong stock selection across the board, helping us outperform in seven of the eleven economic sectors. The key contributors were Health Care, Financials, and Real Estate. Offsetting this was weak stock selection in Energy and Industrials.

Contributors

- Healthcare was our best performing sector on a relative basis, adding 188 basis points of alpha. As noted above, our underweight position, particular in the biotechnology industry (which accounts for 9% of the Russell 2000 Index and declined 12% in the quarter) helped us to outperform, but our strong stock selection drove the bulk of the alpha. Four of our five healthcare holdings were up. In aggregate, our stock selections were up 4% versus -10% returns for the sector.
- Similar to the healthcare sector, strong stock selection across the board in Financials drove our 63 basis points of outperformance. Six of our nine holdings were in positive territory.

Detractors

- The Industrial sector detracted 113 basis points on an attribution basis.
- The portfolio's Energy sector dinged our relative performance by 86 basis points.

THIRD QUARTER ATTRIBUTION

SECTOR	GLA WEIGHTING	R2000 WEIGHTING	GLA RETURN	R2000 RETURN	SECTOR ALLOCATION	STOCK SELECTION	ACTIVE CONTRIBUTION
Comm. Services	2.32	1.17	-16.00	-3.09	0.03	-0.31	-0.27
Consumer Disc.	16.22	12.67	-6.23	-9.57	-0.16	0.54	0.38
Consumer Staples	0.26	3.08	-5.62	-5.40	0.04	-0.01	0.02
Energy	3.40	3.53	-20.02	1.99	-0.10	-0.76	-0.86
Financials	22.68	18.95	3.16	1.20	0.19	0.44	0.63
Health Care	9.66	19.53	4.13	-9.91	0.59	1.29	1.88
Industrials	18.46	14.03	-8.63	-1.25	0.20	-1.32	-1.13
Technology	12.68	15.83	-2.20	-4.67	0.02	0.30	0.32
Materials	7.49	4.16	-1.77	-4.47	-0.00	0.20	0.20
Real Estate	3.33	4.26	12.55	-0.07	0.01	0.39	0.40
Utilities	--	2.47	--	-3.63	-0.02	--	-0.02
Cash	3.53	--	0.01	--	0.09	--	0.09
Total	**100**	**100**	**-2.72**	**-4.36**	**0.87**	**0.76**	**1.64**

Source: FactSet. Performance numbers are gross of fees.

MARKET OUTLOOK

These are unprecedented times – that much is for sure.

Do record high profit margins fueling record high corporate profits justify a pricy stock market? Do incredibly easy financial conditions? So far, they have. Rapid expansion of the Fed's balance sheet, huge fiscal stimulus, and record low real yields are fueling a sharp corporate recovery – but have also fueled inflation. Strong increases in crude oil and many other commodities have led to a 40 year high in PPI; the jury remains out on whether this will continue to fuel consumer price increases.

The stimulus has certainly also boosted the jobs market, with payrolls – and wages – still growing solidly. The housing market has also been a significant beneficiary of easy conditions and COVID-driven re-prioritization. New home permits, starts, and sales remain solid, existing home sales continue at a robust pace, and the Case-Shiller indices are each up close to 20% year over year. Kind of reminiscent of 2003-2005.

Industrial production has continued its strong recovery, and ISM readings indicate this will continue. Global shipping has awoken from its long slumber, and the Baltic Freight Index is up quite sharply – to 13 year highs.

So yes, stimulus has gotten investors wonderful stock price appreciation up through now, but caution is certainly warranted at these lofty levels.