DISCIPLINED EQUITY
SMIDCAP

GREAT LAKES ADVISORS
A WINTRUST WEALTH MANAGEMENT COMPANY

MANAGER COMMENTARY

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Jon Quigley, CFA®
Chief Investment Officer
Disciplined Equity

John D. Bright, CFA®
Senior Portfolio Manager
Disciplined Equity

Dmitri Prokhorov
Director of Research
Disciplined Equity

Lyn Taylor
Research Analyst

Deepesh Bhatia
Research Analyst

Aitemir Yeskenov
Data Engineer

Allen White, CFA®
Portfolio Specialist

Tom Goles
Senior Systems Engineer

MARKET REVIEW

While investors continue to adjust their collective outlook in response to the evolution of the COVID pandemic and massive government stimulus, the U.S. equity market reflected evolving consensus. The long-awaited value rally this spring was brought to a grinding halt in large part due to delta variant concerns, which resulted in a sharp decline in yields and a significant rotation into growth stocks. While this ruled the day early in the quarter, this effect faded as the worst fears of this variant being both severe and widespread faded. Concerns about a Fed leadership transition, the debt ceiling, and an evolving infrastructure bill did cast a pall over the market as the quarter came to a close.

Russell 2500

The Russell 2500 Index slipped 2.7% during Q3, with all of the decline happening during September. Year to date, the Index remains 13.8% higher, after a 20% gain in 2020.

Size/Style

Small-caps underperformed mid-caps during the quarter, but saw less of a correction during September.

- We observe growth stock outperformance was stronger up the cap spectrum during the first two months of the quarter. With growth underperforming across the board during the September correction, small-cap value ended the quarter having outperformed small-cap growth, while mid-value couldn't quite overcome growth's advantage.

Russell 2500 Sectors

We saw a bit more consistent relative sector performance among smid-caps. Cyclicals continue to perform nicely:

- The hyper-cyclical Financial Services and Technology sectors led the Index for Q3, albeit with modest returns of 1.7% and -1.7%, respectively.
  - » Late-stage cyclicals followed hyper-cyclicals, with the Energy, Producer Durables, and Materials sectors occupying the next spots on the sector performance list.
- Consumer Staples again posted weak performance, shedding 9.3% during Q3. Consumer Discretionary stocks were the next-worst performer, giving back 6.2%.

THIRD QUARTER ATTRIBUTION

The SMidCap strategy slid 4.8% during the quarter, trailing the benchmark Russell 2500 Index's 2.7% decline. While the portfolio outperformed the benchmark during the September drawdown, it wasn't enough to compensate for getting hit during the early summer growth rotation. The table on the following page breaks down the contributions from sector positioning and stock selection.

Sector positioning added 0.16% to active return:

- Overweighting the Consumer Staples and underweighting the Real Estate sector combined to detract 42bps; the former trailed the Russell 2500 Index by 5% during the quarter, while the latter outperformed by 2.6%.
- Overweighting the Energy sector proved fruitful, as the sector outperformed the Russell 2500 by 6.2%.

Stock selection within the respective sectors detracted 2.28% from active return.

MARKET OUTLOOK

These are unprecedented times – that much is for sure.

THIRD QUARTER ATTRIBUTION

SECTOR	GLA WEIGHTING	R2500 WEIGHTING	% ACTIVE	GLA RETURN	R2500 RETURN	% ADDED	SECTOR ALLOCATION	STOCK SELECTION	ACTIVE CONTRIBUTION
Comm. Services	3.20	2.87	0.33	-17.93	-11.25	-6.67	-0.08	-0.37	-0.45
Consumer Disc.	13.13	12.58	0.55	-9.99	-6.32	-3.67	0.05	-0.49	-0.45
Consumer Staples	7.40	3.04	4.36	2.01	-7.67	9.68	-0.22	0.67	0.45
Energy	5.18	3.31	1.88	-4.61	3.52	-8.12	0.50	-0.44	0.06
Financials	18.19	13.95	4.24	-1.09	2.28	-3.37	0.15	-0.56	-0.41
Health Care	16.25	15.53	0.71	-1.53	-4.62	3.09	0.00	0.47	0.47
Industrials	9.90	15.91	-6.02	-3.47	-3.72	0.25	0.04	0.05	0.09
Technology	13.78	16.56	-2.78	-10.84	-0.84	-10.01	-0.09	-1.37	-1.46
Materials	6.33	5.34	1.00	-9.02	-3.53	-5.49	-0.01	-0.35	-0.37
Real Estate	3.00	8.44	-5.43	4.16	0.03	4.13	-0.20	0.17	-0.03
Utilities	3.64	2.48	1.16	-4.85	-3.13	-1.72	0.05	-0.05	0.00
Total	**100**	**100**		**-4.80**	**-2.68**	**-2.12**	**0.16**	**-2.28**	**-2.12**

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

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.

Positioning:

With the economy still awash in liquidity and the impact of the delta variant showing signs of rolling lower, we see a percolating re-opening trade combined with positioning for inflation which may not be as transitory as we'd like to imagine. This interplay has led to another pop in Treasury yields since early August, and with this has come a rotation back out of growth and towards value, and especially small-cap value. Other **risk factors**, which appear favorable include earnings yield, leverage, and momentum.

From a **sector/industry** perspective, the increase in yields is starting to pull the Banks back into favor (Financial Services and Securities & Asset Management are already positive), and the reopening trade is leading to a resurgence of Energy Reserves stocks and retailers. Financials have swung into favor among sectors, but still trail the Consumer Discretionary and Retail sectors. Health Care is most out of favor, driven by the Biotech industry. Software is also unfavorable.

From a **stock selection factor** perspective, we again see the resurgent reopening hopes reflected in building price momentum (WRSI), increased emphasis on valuation (Sales/Price, Cash Flow/Price, Forecasted Earnings/Price), and solid quality (High ROA/ROE).

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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