DISCIPLINED EQUITY

SMIDCAP

GREAT LAKES ADVISORS

A WINTRUST WEALTH MANAGEMENT COMPANY

MANAGER COMMENTARY

Third Quarter 2018

Jon Quigley, CFA
Chief Investment Officer
Disciplined Equities

John D. Bright, CFA
Senior Portfolio Manager
Disciplined Equities

Dmitri Prokhorov
Research Analyst

Lyn Taylor
Research Analyst

Deepesh Bhatia
Research Analyst

MARKET REVIEW

U.S. equities again moved solidly higher across the board during the quarter. Unlike the second quarter, small-cap stocks underperformed large-cap stocks, with investors likely rotating due to reduced fear about the impact of new tariffs.

Year to date, growth stocks have outperformed value stocks by a significant margin - in some segments by an even wider margin than what we experienced in 2017. Overall, the Russell 2500 Index has advanced over 10% for the year.

Size/Style

Within the R2500, small-cap stocks faded during September, surrendering the slight performance advantage the group had enjoyed over mid-caps for most of Q3.

- From a style perspective, growth topped value in both mid-caps and small-caps. Growth stocks had a slightly larger edge among mid-caps than among small-caps.
- Thus far during 2018, growth stocks have again substantially outperformed value stocks.

Russell 2500 Sectors

We again saw a bit more consistency of relative sector performance among smid-caps. Late-stage cyclicals are performing nicely:

- Health Care stocks continue to record solid returns, and trailed only the Technology sector during the third quarter. These are also the top two performers year to date.
- Energy, on the other hand, slipped from being the top-performing sector during Q2 to being one of the poorest performers during Q3.
- Year to date, the Materials group has been the poorest performing sector - the only group showing a loss.

THIRD QUARTER ATTRIBUTION

The SMidCap strategy advanced about 5.6% during the quarter, topping the benchmark Russell 2500 Index's 4.7% return. The table on the following page breaks down the contributions from sector positioning and stock selection.

In total, sector positioning added 0.21% to active return:

- Overweighting the Technology sector contributed 29bps to active return, as the sector outperformed the total benchmark return by nearly 6% during Q3.
- Underweighting the Industrials sector detracted 19bps, as the sector outperformed the Russell 2500 Index by about 2%.

More importantly, stock selection within the respective sectors added 0.66% to active return:

- Stock selection within the Consumer Discretionary sector was outstanding.
- However, stock selection was poor within the Communication Services sector.

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SECTOR	GLA WEIGHTING	R2500 WEIGHTING	% ACTIVE	GLA RETURN	R2500 RETURN	% ADDED	SECTOR ALLOCATION	STOCK SELECTION	ACTIVE CONTRIB
Comm Services	2.78	3.08	-0.30	-10.81	6.02	-16.83	-0.01	-0.59	-0.60
Consumer Disc.	16.40	11.78	4.62	8.00	2.37	5.63	-0.10	0.90	0.80
Cons. Staples	4.83	2.73	2.10	-3.77	-1.41	-2.35	-0.12	-0.14	-0.26
Energy	6.60	4.56	2.04	6.28	0.38	5.90	-0.18	0.44	0.26
Financials	14.82	15.77	-0.94	1.64	0.96	0.68	0.07	0.11	0.18
Health Care	16.18	13.01	3.17	13.65	10.28	3.37	0.17	0.53	0.70
Industrials	9.01	15.36	-6.36	3.59	6.79	-3.20	-0.19	-0.27	-0.46
Technology	19.74	15.44	4.31	9.07	10.52	-1.45	0.29	-0.23	0.06
Materials	3.60	5.57	-1.98	13.83	0.72	13.10	0.08	0.45	0.53
Real Estate	5.81	9.33	-3.53	-8.11	0.17	-8.28	0.19	-0.54	-0.35
Utilities	0.23	3.37	-3.13	-0.20	4.22	-4.42	0.02	0.00	0.02
TOTAL	**100**	**100**	**0.00**	**5.57**	**4.70**	**0.87**	**0.21**	**0.66**	**0.87**

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

MARKET OUTLOOK

The U.S. economy is surging, interest rates are slowly normalizing, and U.S. equity markets are continuing to surge higher.

Corporate profits hit yet another record level, and profit margins continue to sit close to 10%. Quality spreads remain subdued on the economic strength, but the absolute level of both 10-year Treasuries and the Fed Funds rate have pushed slowly higher over the past couple of years. Add to this a yield curve which is precariously close to inverting, and we can see the interest rate environment is morphing into a state which should eventually dampen economic growth at the margin. One might argue we are already seeing signs of this via a more slowly growing housing market.

Price pressures remain well-contained, however. Although capacity utilization is over 78% and WTI crude oil has pushed north of $70/bbl, headline CPI is 2.7% - and only 2.2% ex Food & Energy. Corporate earnings calls have alluded to building input price pressure in some segments of the economy – but apparently not enough to curtail extremely strong business confidence. Industrial production has surged to over 3% growth on the back of a white-hot September 2018 Manufacturing ISM Report on Business survey reading (14-year high).

Against this solid economic growth, employment conditions are excellent. Beyond the bullish headline U-3 and U-6 unemployment rates and non-farm payroll numbers, weekly manufacturing hours worked is hovering at all-time highs, and unemployment duration near a cyclical low. Labor productivity is growing at an acceptable rate, and the Employment Cost Index is rising at a moderate rate as well.

The robust employment market has bolstered consumer confidence to an 18-year high, and this has led to retail sales increasing at a rate of over 6% per year – very strong indeed. This is pretty Goldilocks, even if the world outside of the economy and stock market doesn't quite feel that way at times.

The SMidCap model remains biased against stocks with high earnings yield, high estimate dispersion, and high dividend yield, favoring instead companies with strong short-term price momentum and high asset turnover rates. From a style perspective, the model still prefers growth over value. Health Care (Medical Services) and Technology (Software and Internet) stocks are most in favor, while Financials (Banks, Equity REITs) are most out-of-favor.

For more information, please contact us at:
marketing@greatlakesadvisors.com or 312-553-3700

The data in the attribution table represent the returns for each sector and 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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