Small/Mid Cap Managed Account

Quarterly Review

- The US equity market continued to grind higher in the second quarter supported by a backdrop of earnings sustainability in the post pandemic period. The S&P 500® Index posted its fifth straight quarterly gain and its second-best first half gain since the dot com bubble. Central bank liquidity, fiscal stimulus, continued traction for the COVID-19 vaccine, reopening of the economy momentum, and outsized earnings helped lead to a bullish tone. Concerns in the quarter included stretched stock valuations, looming Federal Reserve tapering, the potential for higher inflation, profit margin headwinds from higher input costs, and peak corporate earnings. The path of least resistance for stocks has been higher for the better part of the past fifteen months. Domestic stocks finished higher for the period across all market capitalization ranges and investment styles. Most notable, in our view, was the outperformance of large-cap stocks over smaller-cap stocks, with the Russell 1000® Index up 8.5% for the period versus a 5.4% return for the Russell 2500™ Index and a 4.3% return for the small cap Russell 2000® Index. Growth stocks outperformed value, with the Russell 2500™ Growth Index up 6.0% versus a 5.0% return for the Russell 2500® Value Index primarily driven by strong gains for growth stocks during the month of June. Loss-making companies led the Russell 2500 returns in the quarter as lower quality outperformed in the month of June.
- On the surface the quarter seemed normal, but there were some interesting dynamics underneath. During the first half of the quarter high quality factors led and the small/mid cap portfolio outperformed the index. The second half was led by low quality factors which caused the portfolio to lag the index. One of the key factors that contributed to underperformance was a concentration of performance in the top 10 contributors in the Russell 2500™ Index (combined an approximate 1.5% weight) which contributed almost 100 basis points to the 5.4% return of the index. This concentration was most pronounced in June where the top 10 contributors accounted for nearly 60% of the index' performance.
- The Loomis Sayles Small/Mid Cap Core portfolio modestly underperformed the Russell 2500™ Index during the second quarter due to a difficult month of June, yet returns are still tracking modestly ahead of the benchmark year-to-date. Negatively affecting relative return was lagging performance in the information technology sector as an underweight to the strongly performing software industry and weakness across several individual stocks contributed to the underperformance. The return lag was modestly offset by a typical underweight in the biotechnology industry which had slight negative return for the quarter and strong stock selection within the industrials sector.

- Quarterly performance in stock selection was particularly strong in the industrials, health care and the financial sectors. Among individual stocks Vertiv Holdings Co. and Avantor Inc., were the top two positive contributors for the quarter.
- Vertiv Holdings Co., a provider of critical data infrastructure such as power and thermal solutions to data center operators, as well as other telecom and commercial/industrial communication networks. Vertiv was added to the portfolio in July of 2020, shortly after the COVID-19 induced trough in the market. Demand conditions in Vertiv's Data Center, Enterprise and small and midsized business end markets has remained strong, as initials plans to implement video, virtual private networks and other contingency plans tied to COVID-19 have seemingly evolved into a more permanent embrace by enterprises of outsourcing, cloud computing, and increased remote work applications.
- Avantor, is a global provider of products and services to customers in the biopharma, healthcare, education & government, and advanced technologies industries. Products distributed and manufactured include materials and consumables, as well as equipment, instrumentation and services. Demand from health care related end markets has increased during the COVID-19 pandemic, resulting in robust earnings and the ability for accelerated debt reduction. The mix of proprietary products sold has also increased, raising prospects for sustained growth and higher margins. With an improving balance sheet and steady yet accelerating growth prospects, Avantor shares have been revalued higher since our initial investment in October of 2019.
- Detracting from performance was a number of individual stocks in the information technology sector which delivered a meaningful negative variance. During the quarter positions in Churchill Downs Inc. and ON Semiconductor Corp, were the bottom two detractors from performance.
- Churchill Downs, a gaming business that includes not only the iconic racetrack but also multiple casino and gaming businesses, experienced a tough period during the pandemic but has recovered very strongly into 2021. The stock performed well into March, but languished somewhat in the second quarter as investors turned to other gaming stocks that would likely benefit from the recovery. The company is distinct in that it has multiple levers for growth, with significant expansion in historical racing machine properties, rapid growth in its TwinSpires electronic gaming business, expansion into sports betting on a profitability-focused model, and other capital investments that altogether should help drive strong operating cash flow growth. Management has shown themselves to be disciplined and shareholder-friendly previously and good stewards of capital.
- ON Semiconductor Corporation is a designer and manufacturer of semiconductor products that perform power switching/conversion, circuit protection and signal amplification. While the company reported an in-line with expectations quarter and guided next quarter higher, gross margin initiatives are beginning to show early results. The new CEO is looking to reduce internal manufacturing capacity, consolidate foundry partners, and walk away from lower margin business. Some combination of structural margin improvement or M&A is not in the stock, however, we believe there is opportunity. Business trends are currently robust - inventory across the entire supply

chain is lean providing good visibility near term despite the stock declining in the quarter.

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Outlook

- We remain committed to identify inefficiencies in the small/mid cap market resulting in stock prices and valuations not accurately reflecting our assessment of the underlying value of the corporate enterprise. This approach is applied consistently over time, regardless of the current market environment.
- While many forms of inefficiency may exist, we focus on companies that are misunderstood, underfollowed or in the midst of a "special situation" where we believe we can use our strengths in the form of our time horizon, resource deployment or a willingness to solve complex situations. We require fundamentally sound business models, capable management teams and financial stability. Fundamental to our process are specific, company specific catalysts on the horizon to sustain, enhance, or highlight the fundamental outlook.
- These principles are applied consistently over time, regardless of the current market environment. With a margin of safety and a proper time horizon, our goal is to achieve an attractive total return for our investors, while managing to an appropriate level of risk.