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Executive Summary

The Russell 2000 Index, a proxy for small cap equities, rose 2.74% in 1Q23 ("1Q"), a modest positive return which belied significant intra-quarter volatility. Equities began 2023 with a ferocious rally in January as the macro debate pivoted from "hard or soft landing" to "soft or no landing" fueled by resilient consumer spending and persistent strength in the labor market; both seemingly unfazed by aggressive Federal Reserve ("Fed") tightening. However, confidence in that narrative eroded come February as inflation remained stubbornly hot, suggesting the Fed would need to continue raising rates in order to achieve price stability.

Overview

In early March, the failure of Silicon Valley Bank and the emergence of a regional banking crisis catalyzed a sell-off in risk-based assets across the board. Silicon Valley Bank fell victim to a classic "run on the bank"; a consequence of customer concentration in technology/life sciences, a high percentage of uninsured deposits, losses on ordinarily safe (if held to maturity) government bonds, poor risk management and lax regulatory oversight.

Stocks rallied back into positive territory in the final week of the quarter as regional bank deposits appeared to stabilize and the Fed downshifted to a 25 bps hike, recognizing that tighter lending standards will likely weigh on both economic activity and inflation. The 10-year U.S. Treasury yield declined from 3.79% to 3.48% during 1Q23. Mirroring the volatility in equities, the intra-quarter trough-to-peak increase for the spread-to-worst on the JPM U.S. High Yield ("HY") Index was 126 bps. Nonetheless, spreads actually declined from 511 bps to 499 bps in 1Q. The best performing sectors in the Russell 2000 Index included Information Technology ("IT"), Consumer Discretionary and Industrials, while Financials, Energy and Healthcare were the bottom performing sectors. Weighed down by weakness in the banking sector and the decline in interest rates, value underperformed growth while large caps outperformed small caps.

Micro Cap Equity

Our Micro Cap Equity strategy outperformed its benchmark, the Bloomberg Micro Cap Index, during 1Q as top contributors included the Healthcare, Materials and IT sectors. Within Healthcare, our exposure to healthcare services was pivotal as it was one of the better performing subgroups of the quarter. After being hampered by Covid and aggressive wage inflation leading to staffing shortages, healthcare service revenues began to recover as labor became more readily available and limited use of high cost temporary labor began to help profit margins. The sector is also seen as a safe haven during economic stress as health services are less impacted. Within both the Materials and IT space, we benefitted from private equity acquisitions at healthy premiums of our portfolio companies. Our focus on finding undervalued companies continues to be rewarded even as the pace of M&A activity has slowed considerably.

The strategy experienced underperformance in the Financials, Industrials and Utilities sectors. Within Financials, our exposure to regional banks was negatively impacted after the failure of two high profile banks in the market. The shockwaves caused significant downdrafts across the entire space as investors feared which small regional bank may fail next. Within Industrials, our exposure to a landscaping company with snow removal operations was negatively impacted by a seasonally warm winter which resulted in sub-seasonal snow activity in the northeast during 1Q. Within Utilities, our overweighting to a sector that lagged during a rebound in the market negatively impacted performance during the quarter. As interest rates continue to fall, we expect this sector to rebound throughout the balance of 2023.

The first quarter was an eventful start the year, as many downtrodden stocks impacted most dramatically by the Fed's rate hiking campaign in 2022 started the year very strong out of the gate as the yield curve began to signal a peak in inflation and a slowing in the economy. It was a quarter where bad economic news was deemed positive in the market indicating an end to the Fed rate hiking campaign was on the horizon. As the quarter concluded, two bank failures precipitated angst in the fragility of the financial system, which sparked comparisons to the 2008 Global Financial Crisis. Although credit issues have not arisen in the banking system, a modern day run on a bank occurred in record time as Silicon Valley Bank's homogenous client base simultaneously looked to withdraw all corporate cash balances after announcing a significant loss on their asset portfolio.

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Micro Cap Equity (cont.)

The quarter ended on a positive note as deposit outflows from banks abated, and markets began to price in rate cuts as the year progressed. As we move into the balance of the year, we need to be cognizant of the point when bad economic data is actually taken as negative news for the market. A slowing economy is likely to impact revenues and company profit margins and could eventually cause financial credit stress. As the fragility of the banking system has already been seen very early in this cycle, a focus needs to be on companies that can weather a slowdown and have the balance sheets to handle stresses on the business.

Our focus on free cash flow and balance sheet strength continues to be a key factor of the resiliency of our portfolios as we successfully navigated a volatile quarter. Although we expect the rate hiking cycle to end in 2Q23, the market continues to face a more uncertain growth outlook with a severe blow to banking confidence seen in the first quarter. With those headwinds playing out throughout 2023, we expect our focus on strong balance sheets and free cash flow should continue to drive positive alpha in 2023.

Small to Micro Cap Equity

During 1Q, the Small to Micro Cap Equity strategy outperformed its benchmark, a mix of the Bloomberg 2000 and Bloomberg Micro Cap Indices. Top contributors to performance were the Consumer Discretionary, Healthcare and IT sectors. Within Consumer Discretionary, an owner and operator of an all-inclusive resort reported a 4Q beat driven by broad-based leisure travel demand and a recovery in its previously lagging Jamaica-based properties. 2023 bookings are up over 30% driven by both occupancy and room rate increases and the board authorized a new $200 million share repurchase program. In the Healthcare sector, a maker of diagnostic medical imaging agents and products reported a strong 4Q beat and full year guidance increase driven by sequential revenue growth acceleration and increasing market penetration for its flagship product. Within IT, a semiconductor company that provides power and sensing solutions for motion control delivered strong results and guidance as the automotive industry began to recover from an extended period of supply issues.

Top detractors to performance were the Communications Services, Financials and Materials sectors. In the Communications Services sector, an owner of television stations and networks missed Street expectations for 4Q and guided for revenue declines in 1Q amid ongoing softness in advertising demand. Within Financials, a regional bank operating in Washington state and Oregon sold off in the wake of the Silicon Valley Bank failure. In the Materials sector, a maker of specialty thermal insulation products for industrial companies underperformed on liquidity fears related to Silicon Valley Bank deposits which have since been ameliorated as well as investor concerns surrounding product adoption and the timing of a new facility ramp up.

Small Cap Equity

The Small Cap Equity strategy evenly matched the performance of its benchmark, the Bloomberg 2000 Index during 1Q. Top contributors included the Healthcare, Real Estate and IT sectors. In Healthcare, a maker of diagnostic medical imaging agents and products reported a strong 4Q beat and full year guidance increase driven by sequential revenue growth acceleration and increasing market penetration for its flagship product. Within Real Estate, a hotel REIT with unique assets in attractive markets continued to benefit from the robust recovery in group and leisure travel. In IT, a semiconductor company that provides power and sensing solutions for motion control solutions delivered strong results and guidance as the automotive industry began to recover from an extended period of supply issues.

The top detractors in the quarter included the Communications Services, Industrials and Consumer Staples sectors. Within Communications Services, an owner of television stations and networks missed Street expectations for 4Q and guided for revenue declines in 1Q amid ongoing softness in advertising demand. In Industrials, a global distributor of oil drilling equipment traded lower driven by commodity price declines and broader macro concerns despite reporting solid 4Q results and guiding to revenue growth with improved margins and operating cash flow in 2023. Within Consumer Staples, a food distributor hit all-time highs in early February, though succumbed to profit taking due to broader concerns about discretionary restaurant demand and ebbing benefits from the pass through of food inflation.

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Small Cap Value Equity

The Small Cap Value Equity strategy outperformed its benchmark, the Bloomberg 2000 Value Index, during 1Q as top contributors included the Healthcare, Materials and IT sectors. Within Healthcare, our exposure to healthcare services was pivotal as it was one of the better performing subgroups in the quarter. After being hampered by Covid and aggressive wage inflation leading to staffing shortages, healthcare service revenues began to recover as labor became more readily available and limited use of high cost temporary labor began to help profit margins. The sector is also seen as a safe haven during economic stress as health services are less impacted. Within both Materials and IT, we benefitted from private equity acquisitions at healthy premiums. Our focus on finding undervalued companies continues to be rewarded even as the pace of M&A activity has slowed considerably.

The strategy experienced underperformance in the Consumer Staples, Consumer Discretionary and Industrial sectors. Within Consumer Staples, our exposure to a coffee distributor was affected by a drop in prices which negatively impacted earnings due to higher inventory costs. Within the Consumer Discretionary sector, our exposure to a large pizza chain in the U.S. began to experience slower sales and lower margins as revenue growth was impacted. Ultimately, we see this reasonably priced food service performing well during tough economic environments. Within Industrials, our exposure to a landscaping company with snow removal operations was negatively impacted by a seasonally warm winter which resulted in sub-seasonal snow activity in the northeast.

Small to Mid Cap Equity

The Small to Mid Cap Equity strategy outperformed its benchmark, the Bloomberg 2500 Index during 1Q as top contributors included the Healthcare, IT and Real Estate sectors. In the Healthcare sector, a maker of diagnostic medical imaging agents and products reported a strong 4Q beat and full year guidance increase driven by sequential revenue growth acceleration and increasing market penetration for its flagship product. Within IT, a semiconductor company that provides power and sensing solutions for motion control delivered strong results and guidance as the automotive industry began to recover from an extended period of supply issues. In the Real Estate sector, a hotel REIT with unique assets in attractive markets continued to benefit from the robust recovery in group and leisure travel.

Top detractors in the quarter included the Communications Services, Financials and Consumer Discretionary sectors. Within Communications Services, a media company underperformed after its majority-owned satellite radio business offered a difficult outlook amid choppy advertising trends, lower than expected subscribers and higher capital expenditures. In the Financial sector, a Western-U.S. focused regional bank underperformed sharply in the immediate aftermath of the Silicon Valley Bank failure. Following an initial wave of withdrawals, deposits have subsequently stabilized, and shares have partially recovered. Within Consumer Discretionary, a franchisor of low-priced gyms was a modest relative underperformer despite reporting better than expected top and bottom line results in 4Q and guiding 2023 above consensus; likely reflecting negative investor sentiment towards levered equities in an uncertain economy.

Mid Cap Equity

The Mid Cap Equity strategy underperformed its benchmark, the Bloomberg Mid Cap Index during 1Q. Top detractors in the quarter were the Communications Services, Healthcare and Financials sectors. Within Communications Services, a media company underperformed after its majority-owned satellite radio business offered a difficult outlook amid choppy advertising trends, lower than expected subscribers and higher capital expenditures. Within Healthcare, a drug development company saw its shares come under pressure after announcing a strategic collaboration with another company to advance multiple gene therapies for the treatment of neurological diseases. Central nervous system gene therapy is viewed as higher risk and the deal entails an upfront payment along with potential future milestone payments. In the Financial sector, a Western-U.S. focused regional bank underperformed sharply in the immediate aftermath of the Silicon Valley Bank failure. Following an initial wave of withdrawals, deposits have subsequently stabilized, and shares have partially recovered.

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Mid Cap Equity (cont.)

Top contributors were the Real Estate, Consumer Discretionary and IT sectors. In the Real Estate sector, outperformance stemmed from both an allocation effect (the strategy was under weight and the sector underperformed) and favorable stock selection. A REIT focused on single-tenant industrial properties continues to experience healthy leasing demand and favorable pricing.

Within Consumer Discretionary, a diversified gaming company is benefitting from robust growth on the Las Vegas strip, stable demand with margins above pre-pandemic levels at its regional properties, nascent recovery in Macau and an improved line of sight to digital profitability. In the IT sector, a semiconductor company that provides power and sensing solutions for motion control solutions delivered strong results and guidance as the automotive industry began to recover from an extended period of supply issues.

Outlook

Due to the extraordinary actions taken by the U.S. Treasury and Fed to backstop uninsured deposits and extend massive amounts of liquidity to banks, the most acute systemic risks associated with the regional banking crisis appear to be receding. Nonetheless, we expect lasting headwinds to bank earnings due to higher deposit costs, lower loan growth and potentially increased regulatory burdens. More broadly, we expect lending standards to tighten which will further restrict economic growth.

The silver lining is this will also dampen inflation, thereby allowing the Fed to slow or pause its campaign of rate increases. While certain elements of inflation have proven sticky (labor, housing) we believe overall inflation has peaked and the year-over-year increases will continue to moderate towards acceptable levels, particularly as we begin to lap easier comparisons later this year. Historically, stocks have performed well in the period following the Fed's last rate hike.

The economy had strong momentum heading into the regional banking crisis, with nominal GDP tracking up high single digits in 1Q; a meaningful shock absorber. We believe consumers and businesses alike are financially healthy enough to tolerate the Fed's inflation-fighting medicine. Importantly, the HY market has remained remarkably firm in the face of negative headlines and equity market volatility. At their first quarter peak, HY spreads were still below the highs of last summer/fall and approximated long-term averages. Overall, financial leverage is low, interest coverage is high and the percentage of the HY market rated BB is at or near all-time highs, all of which should keep credit spreads and default rates low relative to previous downturns.

We believe our companies have ample liquidity and maturity runway to weather a near term slowdown. Investor sentiment remains disproportionately negative with equity valuations trading at a significant discount to long term averages and small cap equities remain historically cheap relative to large caps. Beyond the intermediate term macro uncertainties, we see a compelling long-term set-up for small cap stocks. Equity performance for the past decade-plus has been dominated by large cap growth shares, underpinned by a backdrop of easy monetary policy, low inflation and a steady decline in long term interest rates. We believe that a normalization of inflation and interest rates will ultimately favor shorter duration, attractively valued small cap companies that are generating positive earnings and free cash flow. We will continue to use our differentiated, fully integrated credit and equity research process to identify companies that are improving their capital structures for the benefit of shareholders.

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Specialists in Capital Structure Investing®

At Penn Capital, we believe that understanding a company's entire capital structure is the best way to identify investment opportunities with the most value. In fact, we've found that managing bond portfolios makes us better equity managers, and vice versa.

Employing a fully integrated credit and equity research process, we focus on non-investment grade companies in the micro to mid-capitalization range, where we can take advantage of inefficient security pricing.

We are a boutique investment management firm based in Philadelphia, PA. We forge our own ideas, we respect hard work, and we are committed to our clients, our staff and our community.

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A copy of Penn Capital's current written disclosure statement discussing our advisory services and fees is available upon request.
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