PENN CAPITAL

Executive Summary

The Russell 2000 Index, a proxy for small cap equities, increased 6.23% in 4Q22 ("4Q") ending on a positive note from a very difficult calendar year for capital markets. Risk assets rallied early in the quarter in anticipation of peak inflation and a Federal Reserve ("Fed") pivot gave back a portion of those gains late in the quarter on rising recession fears.

Overview

The best performing sectors in the Russell 2000 Index were Energy, Industrials and Basic Materials while Healthcare, Telecom and Information Technology ("IT") underperformed. Small cap value stocks outperformed small cap growth stocks during the quarter while large cap equities outperformed small cap equities. The 10-year US Treasury yield rose only slightly, from 3.67% to 3.88% during 4Q. The spread to worst on the JPM US High Yield Index declined from 575 bps to 511 bps during the quarter.

Micro Cap Equity

Our Micro Cap Equity strategy outperformed its benchmark, the Bloomberg Micro Cap Index, during 4Q as top contributors included the IT, Consumer Discretionary and Utility sectors. Within IT, our focus on suppressed companies due to valuation compression from higher rates and supply chain challenges allowed the strategy to outperform as companies rebounded with stronger outlooks as supply chains eased and companies focused on reducing costs and generating more cash flow. In Consumer Discretionary, our restaurant and apparel exposure outperformed as the consumer proved more resilient than the market had anticipated and our names outperformed as inflation showed signs of peaking. Utilities outperformed during the quarter as interest rates peaked during 3Q22 ("3Q") after inflation peaked and growth prospects in the US started to slow after the Fed's aggressive 2022 rate tightening campaign.

The strategy experienced underperformance in the Real Estate, Energy and Financials sectors. Within Real Estate, our exposure to apartment REITs negatively impacted the strategy as cap rates increased with prospects of a US slowdown combined with the Fed's aggressive tightening posture. Within Energy, our underexposure to the oil exploration and drilling sectors negatively impacted the strategy as this top performing group closed the year on a high note. Within Financials, several of our regional bank holdings suffered as deposits slightly increased in the quarter and their low cost funding bases declined as interest rates moved higher and institutions became more aggressive in pricing short term deposit rates to gain deposit share. The outlook for loan growth also generally softened from previous expectations but still remained strong.

As the year closed the Fed continued its aggressive tightening campaign to rein inflation as the economy remained rather resilient during the quarter. Although inflationary data has likely peaked, the economy remained strong with employment data causing the Fed to remain committed to tightening financial conditions which continues to impact more uncertainty for 2023 economic projections. With the outlook being impacted, market interest rates peaked in 3Q as the yield curve continued to remain inverted signaling a strong possibility of a recession in 2023. Growth stocks were most impacted during the year as IT and healthcare names suffered the most as valuations contracted and the market searched for more resilient cash flow models to reward during the year.

Our focus on free cash flow and balance sheet strength was a key factor of the resiliency of our portfolios throughout the year. Although we expect inflationary costs to abate in 2023, the market faces a more uncertain growth outlook and interest costs for companies have risen dramatically. 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

The Small to Micro Cap strategy outperformed its benchmark, a mix of the Bloomberg 2000 and Bloomberg Micro Cap Indices, during 4Q as top contributors included the Energy, Consumer Discretionary and Industrials sectors. In the Energy sector, a provider of oilfield services and equipment raised FY22 guidance driven by strong demand both domestically and internationally and announced several key contract wins.

Small to Micro Cap Equity (cont.)

A new credit facility improved the company's liquidity and financial flexibility while management used improving free cash flow to pay down debt. Within Consumer Discretionary, a franchisor of value-priced gyms reached a new all-time high for total memberships driven by faster growth from younger consumers. Club usage and new join patterns are normalizing post-pandemic and franchisees are re-accelerating new unit development despite constraints tied to construction delays. Within Industrials, an equipment rental company delivered upside to 3Q Street expectations amid healthy demand trends in non-residential and industrial end markets, constrained equipment supply from OEMs, rising utilization rates and double-digit growth in rental rates.

Top detractors included the Healthcare, Communications Services and Financials sector. In Healthcare, a provider of technology solutions for health care providers reported disappointing 3Q sales and EBITDA results and lowered FY22 guidance citing several operational and customer specific factors while also announcing the exit of its CEO and President. Within Communications Services, a television broadcaster reported lower than expected political advertising revenue as competitive races shifted outside of their markets. Within Financials, a regional bank focused on the attractive Nashville, TN market raised their expense growth forecast as it continues to hire and plan expansion into new markets.

Small Cap Equity

The Small Cap Equity strategy outperformed its benchmark, the Bloomberg 2000 Index, during 4Q as top contributors included the Energy, Consumer Discretionary and Consumer Staples sectors. In the Energy sector, a provider of oilfield services and equipment raised FY22 guidance driven by strong demand both domestically and internationally and announced several key contract wins. A new credit facility improved the company's liquidity and financial flexibility while management used improving free cash flow to pay down debt. Within Consumer Discretionary, a franchisor of value-priced gyms reached a new all-time high for total memberships driven by faster growth from younger consumers. Club usage and new join patterns are normalizing post-pandemic and franchisees are re-accelerating new unit development despite constraints tied to construction delays. In the Consumer Staples sector, a large food distributor is gaining market share with independent restaurant customers and driving margin expansion through favorable customer mix, rising penetration of private label products and lingering benefits from food inflation. Improving earnings and free cash flow have driven balance sheet leverage back within managements' target range for the first time since the onset of the pandemic.

The top detractors in the quarter included the Financials, Materials and Communications Services sectors. Within Financials, a regional bank focused on the attractive Nashville, TN market raised their expense growth forecast as it continues to hire and plan expansion into new markets. In the Materials sector, a producer and distributor of lithium compounds used in batteries and other applications underperformed as weaker sales mix temporarily impacted pricing and investor fears of a global economic slowdown (particularly China) weighed on valuations. Within Communications Services, a television broadcaster reported lower than expected political advertising revenue as competitive races shifted outside of their markets.

Small Cap Value Equity

The Small Cap Value strategy outperformed its benchmark, the Bloomberg 2000 Value Index, during 4Q as top contributors included the IT, Consumer Discretionary and Utility sectors. Within IT, a top holding in the software space reduced its cost structure while still maintaining a strong growth profile as it continued to gain share from competitors that continued to struggle selling legacy solutions that were no longer as relevant in its space. Within Consumer Discretionary, two retail holdings expressed much stronger outlooks as shipping rates and constraints eased and inventory in the retail chain increased improving their respective outlooks relative to their peers. Utilities outperformed during the quarter as interest rates peaked during 3Q after inflation also peaked and growth prospects in the US started to slow after the Fed's aggressive 2022 rate tightening campaign.

Small Cap Value Equity (cont.)

Top detractors included the Real Estate, Energy and Consumer Staples sectors. Within Real Estate, our exposure to apartment REITs negatively impacted the portfolio as cap rates increased with prospects of a US slowdown combined with the Fed's aggressive tightening posture. Within Energy, our underexposure to the oil exploration and drilling sectors negatively impacted the strategy as this top performing group closed the year on a high note. Within Consumer Staples, a top holding experienced lagging inflationary impact after positive hedges rolled off in the quarter and suffered a larger cost impact as a result.

Small to Mid Cap Equity

The Fed continues to raise interest rates which spurred underlying growth concerns that a recession may occur next year. Recession valuations are beginning to be priced into the market providing opportunity if the economy performs better than feared.

Small to mid cap stocks rallied during 4Q after three consecutive quarters of negative performance. Commodity exposure (Energy and Materials) exhibited the strongest returns during the quarter. Consumer Discretionary also outperformed after a rough first nine months of 2022. Growth sectors such as Communication Services, Healthcare and IT, lagged during the quarter.

The Small to Mid Cap Equity strategy outperformed its benchmark, the Bloomberg 2500 Index, during 4Q. The strategy outperformed in the Consumer Discretionary, Healthcare and IT sectors while Materials, Real Estate and Energy sectors underperformed.

Discount retailers rebounded during the quarter through a combination of easing gasoline prices and lower costs for products and transportation. Pharmaceutical companies with strong cash flows from core drugs outperformed during the quarter. In IT, an automobile semiconductor company continues to witness solid demand as underlying car production improves.

In the Materials sector, a lithium producer sold off due to declining spot prices although their production is heavily contracted. An apartment REIT pushed rental rates higher which sacrificed occupancy more than anticipated. A natural gas producer declined as warm weather weighed on underlying commodity demand for heating.

Higher rates and monetary tightening have impacted financial markets but have not fully flowed through to the broader economy. Expect to see companies and consumers adjust spending plans over the coming quarters.

Tightening lending standards has eliminated speculation in the market challenging cryptocurrencies, meme stocks and money losing companies that are not focused on generating free cash flow in the intermediate term. Companies that can internally generate capital will be better positioned to grow in this environment. The strategy is invested in companies that can generate strong cash flows in an inflationary environment. While looking for opportunity, strong balance sheets and improving cash flow generation are key indicators for inclusion.

We continue to utilize credit spreads to guide overall portfolio positioning, sector exposures and security inclusion through a volatile market environment. This is a critical indicator that differentiates between stock market sell offs and an adverse turn in the business cycle.

Mid Cap Equity

The Mid Cap Equity strategy underperformed its benchmark, the Bloomberg Mid Cap Index, during 4Q as top contributors included the Consumer Discretionary, Consumer Staples and Energy sectors. Discount retailers rebounded during 4Q through a combination of easing gasoline prices for their customers and lower cost for products and transportation. In Consumer Staples, a food distributor experienced improving profitability due to price raising. An energy producer saw a strong production path in their offshore Guyana project over the next three years.

Mid Cap Equity (cont.)

Top detractors included the Industrials, Financials and Healthcare sectors. An industrial equipment manufacturer announced a large debt funded acquisition that will require a strong integration and execution over the next three years. Regional banks saw rising costs of deposits during the quarter reducing their expected net interest income outlook into 2023. In Healthcare, a drug manufacturer is seeing slowing demand due to customer product issues and reduced drug development spending during the year.

Outlook

Headline inflation appears to have finally peaked as both the October and November Consumer Price Index reports came in below Street expectations and demonstrated a year-over-year deceleration. This welcome slowdown has been driven by lower prices for goods as supply chains normalized, consumer demand shifted to services and retailers resumed widespread discounting to clear excess inventories. Unfortunately, two-thirds of the US economy is services, the primary cost of services is labor and wage inflation is inherently stickier compared to goods inflation.

Nonetheless we do expect inflation to continue to decelerate in 2023 as we lap easier prior year comparisons and the economy feels the effects of more restrictive Fed policies. At their December meeting, the Fed pivoted to smaller rate increases, though talked tough on inflation and the updated dot plot indicated a higher terminal rate for this cycle versus the prior forecast.

A hawkish tone was somewhat expected as the Fed endured criticism for getting inflation wrong on the way up (“transient”) and it was likely concerned that a rally in risk assets and loosening of financial conditions could counteract some of its inflation-fighting medicine. It is still an open question whether the Fed will engineer a soft landing or whether the economy will dip into recession. Our base case would be that any downturn is likely to be mild as both consumers and businesses are in fundamentally good shape. While we expect some erosion around the edges, consumer balance sheets are healthy, unemployment should remain low and the acute pinch from inflation experienced in the spring/summer of 2022 has begun to subside.

Corporate credit fundamentals remain robust and high yield credit spreads are benign. We expect default rates to rise somewhat in 2023, though should remain at or below historical averages. Even in a recession scenario, we would make the case that defaults could be much lower than prior cycles as overall leverage is low, interest coverage is high, companies have refinanced and extended maturities, energy sector fundamentals are healthy (larger weighting in high yield vs equities) and there was somewhat of a pull forward effect as distressed issuers defaulted in the early stages of the pandemic. If there is a recession, the current level of the Fed funds rate gives them room to cut rates and stimulate the economy (assuming that inflation is under control).

Finally, with the Russell 2000 Index down -20.4% in 2022 (even worse ex-Energy) we would argue that a considerable amount of negativity is priced in at current levels. Beyond the intermediate term 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. This has pushed the relative valuation discount of small cap equities versus large cap equities to historic extremes on many metrics.

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.

The views and opinions expressed are for informational and educational purposes only as of the date appearing in this material only and may change without notice at any time based on numerous factors, such as market or other conditions, legal and regulatory developments, additional risks and uncertainties and may not come to pass. These views are subject to change at any time and they do not guarantee future performance of the markets.

Indices are unmanaged and not available for direct investment. Index comparisons have limitations as volatility and other characteristics may differ from a particular investment.

All information has been obtained from sources believed to be reliable, but its accuracy is not guaranteed. There is no representation or warranty as to the current accuracy, reliability or completeness of, nor liability for, decisions based on such information and it should not be relied on as such.

This material is not intended to be relied upon as investment advice or recommendations, does not constitute a solicitation to buy or sell securities and should not be considered specific legal, investment or tax advice. It does not take into account the specific objectives, financial situation, or particular needs of any specific person. You should not assume that any discussion or information provided here serves as the receipt of, or as a substitute for, personalized investment advice. Investment decisions should be made based on an investor's objectives and circumstances and in consultation with his or her financial professionals. Investing in the stock market involves gains and losses and may not be suitable for all investors. Investors have the opportunity for losses as well as profits.

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.

Past performance is not indicative of future results. Different types of investments involve varying degrees of risk, and there can be no assurance that the future performance of any specific investment, investment strategy, or product (including the investments and/or investment strategies recommended or undertaken by Penn Capital), or any non-investment related content, made reference to directly or indirectly contained within this commentary be suitable for your portfolio or individual situation, or prove successful. Comparisons to indices are inherently unreliable indicators of future performance. The strategies used to generate the performance vary from those used to generate the returns depicted in the benchmarks. Penn Capital makes no representation as to the methodology used to generate the benchmark returns. Portfolio holdings are subject change and may or may not be held by one or more Penn Capital portfolios from time to time. Please note that comparing the performance to a different index might have materially different results than those shown. The Bloomberg Micro Cap Index is a float market cap weighted benchmark of those securities in the Bloomberg Aggregate Equity Index with a market capitalization ranking of lower than 2,500. The Bloomberg US 2000 Index is a float market-cap-weighted benchmark of the lower 2000 in capitalization of the Bloomberg US 3000 Index. The Bloomberg US 2000 Value Index is screened from the Bloomberg US 2000 Index (B2000) and is constructed based on a linear combination of risk factors. The four factors are: 1) Earnings Yield, 2) Valuation, 3) Dividend Yield and 4) Growth. The factors are equally weighted when forming a composite signal where Growth is considered to be a negative indicator and thus flipped to be a negative. The Indices are market-capitalization-weighted. The current price is used to calculate the price-based ratios. The Bloomberg US 2500 Index is a float market-cap-weighted benchmark of the lower 2500 in capitalization of the Bloomberg US 3000 Index. The Bloomberg US Midcap Index is a float market-cap-weighted benchmark of those securities in the Bloomberg US 1000 Index ranked 201 to 1000 by market capitalization. Investors cannot directly invest in an index.

A copy of Penn Capital's current written disclosure statement discussing our advisory services and fees is available upon request.
PC-EQTYCOM_01112023