

Overview

The Bloomberg U.S. 2000 Total Return Index decreased 3.2% in 2Q24. Small caps churned lower despite benign readings on core inflation that increase the odds of a near-term interest rate cut. Large cap stocks outperformed significantly (S&P 500 Index +3.9%) propelled by Nvidia (+37%) and the “Magnificent 7” (+17%) while the equal-weight S&P 500 Index declined approximately 3%. Ten out of eleven sectors in the Bloomberg 2000 index posted negative returns in 2Q24, with only Consumer Staples up slightly.

On a relative basis, the best performing sectors in the Bloomberg 2000 were Consumer Staples, Financials, and Technology while Consumer Discretionary, Communications Services, and Health Care were the worst. The 10-year U.S. Treasury yield increased from 4.2% at the end of March to nearly 4.7% at the end of April but ended the quarter at 4.4% as the inflation outlook improved. Corporate credit markets were stable with the spread-to-worst on the JPM U.S. High Yield index increasing modestly from 331 bp at the end of 1Q24 to 351 bp. The high yield index has returned 3.3% year-to-date.

Micro Cap Equity

Our Micro Cap Equity strategy outperformed its benchmark, the Bloomberg Micro Cap Index, during 2Q as top contributors included the Healthcare, Industrials, and Utilities sectors. Within Healthcare, our underweight to the biotechnology sector aided performance as the group suffered with uncertain funding outlooks in a capital constrained environment due to higher costs of capital. Within Industrials, an unsolicited bid for one of our commercial aerospace companies helped to drive strong performance during the quarter. Within utilities, performance was strong from our holdings as interest rates started to decline with softer economic data. We continue to like the sector as the economy begins to show a deceleration and companies suffer more as pricing power begins to ebb with a more benign growth outlook for the economy.

Top detractors to performance were the Financials, Materials, and Consumer Discretionary sectors. Within Financials, our underweight to the insurance sector was negative as pricing power for insurance companies was very strong as inflationary pressures were finally passed on to consumers within the sector. Within Materials, an agricultural chemicals company suffered as the safety of one its brands was questioned by the FDA causing them to downgrade its sales outlook for the year. Within Consumer Discretionary, an auto service repair company suffered as demand for tire replacement waned during a period of

tighter consumer spend causing a negative impact to its sales outlook for the year. We view this trend as temporary, given tire replacement tends to be less discretionary as consumers will likely hold cars for longer periods as financing costs have increased dramatically for the purchase of new vehicles. As the economic acceleration continues to moderate, we expect our exposure to more durable parts of the economy to perform well throughout the course of the year. Although we believe interest rates have peaked, companies with less durable spend characteristics could struggle as financing costs remain high without a fed being more aggressive to its rate cut outlook for the remainder of the year.

Small to Micro Cap Equity

The Small to Micro Cap strategy outperformed its benchmark, a mix of the Bloomberg U.S. 2000 and Bloomberg U.S. Microcap Indices, during Q2 2024. The top contributors to performance were the Health Care, Energy, and Technology sectors. Within Health Care, a leading operator of outpatient diagnostic imaging centers reported a 1Q beat, raised guidance, and continues to complete accretive tuck-in acquisitions of imaging centers across the US. In the Energy sector, a shipping company that transports petroleum liquids on medium range tankers is benefiting from tight market conditions with a fleet that earns a premium over traditional tankers due to their eco-friendly vessels and scrubber fitted technology. Within Technology, a builder and operator of next-gen data centers that provide computing power to blockchain infrastructure and CPUs is seeing strong interest for power supply projects with large hyperscalers that could contribute up to \$400m in EBITDA by 2025. The top detractors to performance were the Real Estate and Utilities sectors. In the Real Estate sector, a REIT that specializes in group-oriented and destination hotel assets in urban and resort markets had a weaker-than-seasonal 1Q due to inclement weather though we expect positive rate and volume growth in 2024. Within Utilities, underperformance was driven by the allocation effect as the strategy was underweight the sector and it outperformed the benchmark.

Small Cap Equity

The Small Cap strategy outperformed its benchmark, the Bloomberg U.S. 2000 Total Return Index during Q2 2024. The top contributors to performance were the Materials, Energy, and Technology sectors. In the Materials sector, a fabricator and distributor of steel and metal alloy outperformed driven by strong earnings growth in its Aerospace division where lead times and pricing remain extended. Within Energy, a provider

Small Cap Equity, cont.

of oilfield services and equipment, is benefiting from an increase in offshore spending which is expected to drive improved EBITDA margins over the next few years. In the Technology sector, a lidar technology company that produces sensors and software for industrial and infrastructure clients continues to post strong sequential and year-over-year revenue growth across all end markets. The top detractors to performance in the quarter were the Consumer Discretionary, Financial, and Real Estate sectors. Within Consumer Discretionary, an owner and operator of casual dining restaurants underperformed due to weaker industry traffic trends and increased price promotions. In the Financial sector, a digital financial platform offering banking, investing, loans, and rewards succumbed to profit-taking after a strong run and fell further following the news of a \$50 million shelf registration. Within Real Estate, a REIT that specializes in group-oriented and destination hotel assets in urban and resort markets had a weaker-than-seasonal 1Q due to inclement weather though we expect positive rate and volume growth in 2024.

Small Cap Value Equity

The Small Cap Value Equity strategy underperformed its benchmark, the Bloomberg 2000 Value Index, during 2Q as top contributor to performance were the Real Estate, Consumer Discretionary, and Industrials sectors. Within the Real Estate, a REIT exposed to government facilities performed well in the quarter as 100% of its rents are collected from US government agencies which is seen as a healthy payor during a more uncertain times for commercial real estate valuations. Within consumer discretionary, a manufacturer of biking accessories performed strongly with an anticipated recovery of biking sales after significant declines during a post covid demand collapse. Within Industrials, a lawn servicing company performed well due to operational improvements from initiatives implemented from its new management.

Top detractors to performance were the Materials, Financials, and Healthcare sectors. Within Materials, a glass packaging manufacturer suffered as demand for spirits bottling waned during the period leading to a more uncertain earnings outlook. Within Financials, a small regional bank suffered underperformance due to concerns around the health of commercial real estate companies. Given our underweight in the sector, we expect the thematic around commercial real estate lending to be a negative catalyst for banks and remain underweight companies with this exposure on its balance sheets. Within Healthcare, our exposure to a company that is incurring high costs to launch an over the counter contraceptive suffered during the quarter as the success of its new product has come into question. Ultimately, we expect the launch to yield positive results in the market which will ultimately lead to gains.

Small to Mid Cap Equity

The Small-to-Mid Cap strategy modestly underperformed its benchmark, the Bloomberg U.S. 2500 Total Return Index during Q2 2024. The top detractors to performance were the Consumer Discretionary, Health Care, and Real Estate sectors. In the Consumer Discretionary sector, a specialty retailer of extreme value items reported a disappointing 2Q and lowered FY guidance as lower income consumers sharply reduced spending on discretionary products. Within Health Care, a manager of clinical trials for biotech and pharma companies underperformed as the company missed its target book-to-bill ratio in 1Q24 and the slow exit of a costly transition services agreement delayed margin improvement goals. In the Real Estate sector, a REIT that specializes in group-oriented and destination hotel assets in urban and resort markets had a weaker-than-seasonal 1Q due to inclement weather though we expect positive rate and volume growth in 2024.

The top contributors to performance in the quarter were the Technology, Materials, and Industrials sectors. Within Technology, a global maker of semiconductor test products and services is experiencing strong customer demand across all end markets- targeting high growth in its robotics segment and mid-teens growth in testing markets through 2026. In the Materials sector, a fabricator and distributor of steel and metal alloy outperformed driven by strong earnings growth in its Aerospace division where lead times and pricing remain extended. Within Industrials, a leading aviation engine leasing and maintenance aftermarket provider for airlines and air lessors acquired a large engine maintenance facility and is expanding their product offering of maintenance for Pratt & Whitney and GE engines, adding incremental profitability in a tight aftermarket.

Outlook

As noted above, 2Q24 offered decisive evidence that core inflation is on a glidepath lower despite investor fears of “higher for longer” earlier this year. Recent data points demonstrate a cooling in the labor market (higher unemployment, fewer job openings, lower wage increases) and high interest rates are clearly taking a toll on demand for housing and autos. The balance of risks for the Fed has shifted from inflation to growth and we expect a near-to-medium term interest rate cut, which should be a positive catalyst for stocks.

The high yield credit market remains remarkably solid. In early May, high yield credit spreads briefly matched the 2021 cycle low. Corporate credit fundamentals are healthy, underpinned by low overall balance sheet leverage, few defaults, ample liquidity, and healthy interest coverage. The new issue market is active- allowing companies to refinance debt, fund acquisitions, and extend maturities (thereby reducing credit risk). There are few signs of froth in

public credit. Use of proceeds on new issuance has been largely focused on refinancing. Investors are thoroughly scrutinizing lower credit quality transactions- often extracting better terms and additional credit protections to get these dealdone.

Favorable debt market conditions and clarity on interest rate policy has contributed to a pick-up in mergers and acquisitions after a two-year lull. Historically, PENN's equity strategies have been outsized beneficiaries of M&A as the fundamental characteristics we seek in an investment (positive free cash flow, improving capital structure, attractive valuation) also make our portfolio companies attractive acquisition targets. We believe the M&A environment is particularly attractive for large cap, publicly traded "strategic" acquirers of small cap companies versus financial buyers (LBO's) given premium large cap equity valuations, a need to drive growth, and an attractive cost of debt.

The elephant in the room is the continued dramatic outperformance of large caps over small. On virtually every conceivable measure the rally in large caps appears stretched. Relative valuation, performance differentials, cycle duration, asset flows, and measures of large cap concentration are all at or near historic extremes. While we struggle to predict the tipping point for small cap equities, we believe the case for ownership and the long-term risk-reward remains compelling.

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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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