Mesirow

Equity Market Review
Small and SMID Cap Strategies

STRATEGY SUMMARY AS OF MARCH 31, 2023

Equity Management AUM	$951.2M
Portfolio Managers	Kathy Vorisek Leo Harmon, CFA, CAIA Andrew Hadland, CFA
Investment Philosophy	We believe that excess returns can be produced by investing in attractively valued stocks that are poised to appreciate due to catalyst driven earnings and cash flow growth.
Vehicle Offerings	• Separately Managed Account • Collective Investment Trust • Mutual Fund (Mesirow Small Company Fund)
Investment Objectives	• Generate attractive risk-adjusted returns • Consistently outperform the benchmark over a market cycle • Participate in rising markets and protect capital in down markets

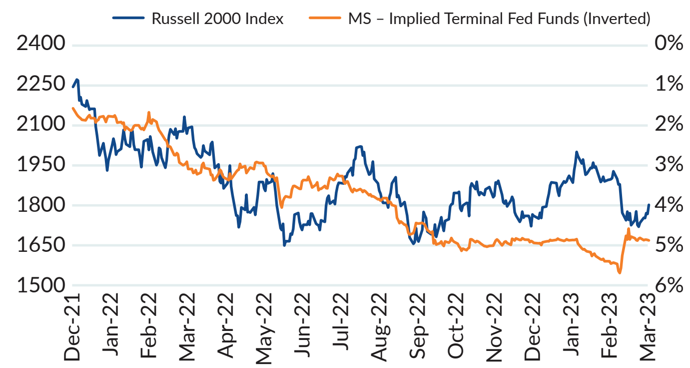
Market commentary

Investing in equity markets sometimes feels like being among the last survivors in a zombie apocalypse movie. You walk carefully knowing that a step in the wrong direction or the slightest disturbance can create a chain reaction of devastating consequences, but you also have several paths of escape and hope no new impediments jump out of the dark to derail you at the last moment.

As we transition from an environment driven by Fed policy and policy expectations (Figure 1) to one more focused on underlying growth trends, investors have expressed hope in a path forward as interest rates and inflation reached their peak.

Equity markets disengaged from rate expectations

FIGURE 1: **RUSSELL 2000 VS. EXPECTED FED FUNDS RATES (INVERTED)**



Data as of 3.31.2023. Source: MEM and Bloomberg. Past performance is not indicative of future results.

However, vestiges of prior concerns, stubbornly high inflation levels and impending recession fears – along with new obstacles embodied in recent bank failures – have acted as a governor for the market. As a result, equity prices have been contained in a fairly consistent range over the past year.

As the quarter commenced, equity markets extended their rally from the prior quarter as investors began to anticipate a change in direction of Fed policy as inflation momentum began to slow. However, intermittent results for inflation data, particularly service-related inflation – a priority for the Fed – proved to be more elevated than expected and placed some pressure on equity prices. Additionally, slower overall economic activity, turmoil from bank failures and downward revisions in earning expectations served to dampen some of the excitement from the initial move in the quarter. As a result of these ebbs and flows, equity performance was inconsistent across our relevant indices:

Index	1Q2023
Russell 2000 Value Index	-0.7%
Russell 2000 Index	2.7%
Russell 2500 Value Index	1.4%
Russell 2500 Index	3.4%

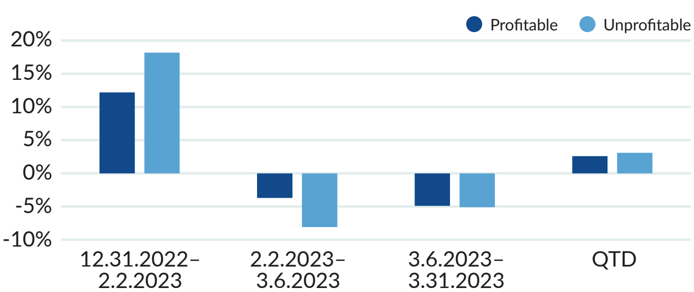
Data as of 3.31.2023. Source: MEM, Bloomberg and FTSE Russell.

Something for everyone

For the first quarter, the market was driven higher by the performance of cyclical and cyclical growth sectors: Technology, Consumer Discretionary, Industrials, and Materials were the best performers while Financials and Healthcare lagged the overall market. Market performance was also skewed toward larger growth companies, particular in technology, as the decline in interest rates resulted in some recovery of valuation multiples which had significantly compressed over past 18 months. Market returns were also influenced by outperformance of lower-quality factors, particularly unprofitable companies, which outperformed their profitable counterparts (Figure 2). However, using other measures of quality produced results that were more mixed (Figure 3).

Unprofitable companies faded late but outperformed for the quarter

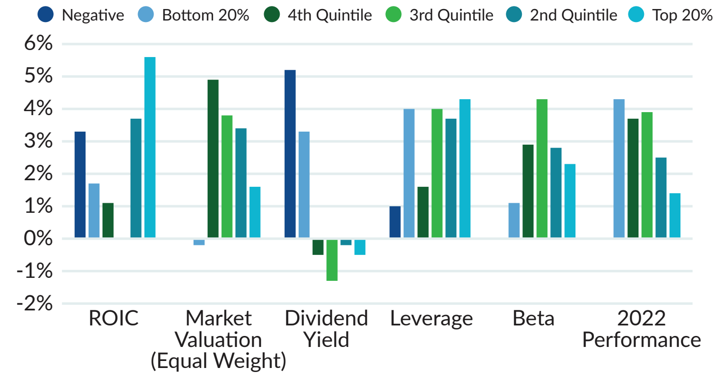
FIGURE 2: **PERFORMANCE BY PROFITABILITY**



Data as of 3.31.2023. Source: MEM and Furey Research Partners.

Factors had no clear pattern, but last year's losers are now leading

FIGURE 3: **PERFORMANCE BY FACTORS**



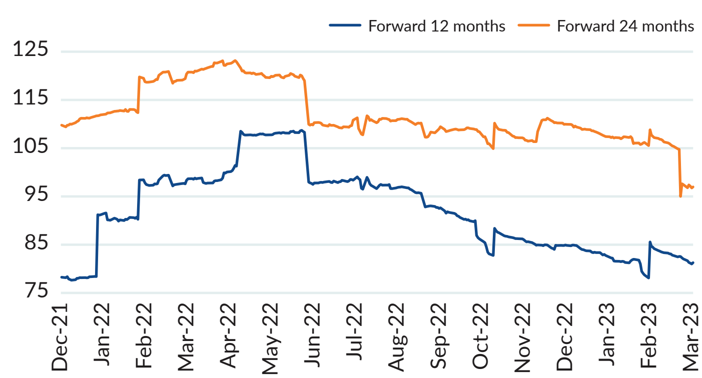
Data as of 3.31.2023. Source: MEM and Furey Research Partners.

Expectations for slowing growth

Despite strong employment formation, elevated consumer spending, and lower interest rates relative to year-end, the lagged effects of tighter monetary policy are weighing more heavily on economic data. Many indicators (money supply, industrial production, LEI, regional surveys, and the yield curve) are signaling either a continued slowdown in economic activity or a recession of some magnitude. The expectation for slowing growth can be illustrated in earnings expectations for small cap companies, which have declined 20-30% from their peak in June 2022 (Figure 4).

Expected earnings for small caps have fallen 20–25%

FIGURE 4: **RUSSELL 2000 EARNING EXPECTATIONS**



Data as of 3.31.2023. Source: MEM and Bloomberg.

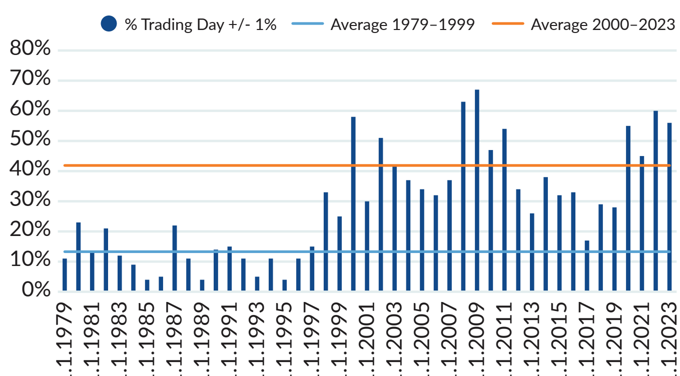
Additionally, shock events, such as OPEC's recently announced supply cuts, could pull forward a recession forecast if consumers are negatively impacted by higher energy prices. As such, the prospect of the Fed engineering a "soft landing" appears to be less probable. Global central banks also remain "behind the curve" on inflation and are still tightening monetary policy. However, equity markets seem to be looking through any recessionary issues: volatility within range-bound prices is indicative of an expectation for a milder recession with uncertain timing. We would expect the market to take a more definitive path once the timing, magnitude, and duration of a potential recession has more certainty.

The persistence of volatility

With developments in technology over the last few decades, markets incorporate information much faster than in the past, which can lead to more volatile swings in prices on incremental news flow. This can be clearly assessed when looking at the number of trading days that have risen or fallen more than 1% during a year: the average over the last two decades is much higher than the previous two. Given the level of market uncertainty as investors try to balance changes in FED policy against falling growth rates, we would expect volatility to remain elevated over the near term (Figure 5).

Markets are more volatile now than in recent history

FIGURE 5: **PERCENT OF TRADING DAYS RISING OR FALLING MORE THAN +/- 1%**



Data as of 1.1.2023. Source: MEM and Furey Research Partners.

In the interim, we continue to monitor several factors with respect to tactical portfolio positioning:

- A pause and/or pivot in the Fed tightening cycle
- Duration of economic stagnation and timing of recovery
- The impact of the removal of zero-COVID policies in China
- Risk factors related to liquidity and credit that could signal more material downside for equities
- Pricing power and margin stability as inflation persists
- Impact of higher energy prices on consumer spending
- Pace of employment formation
- Level and changes of nominal and real interest rates
- Earnings revisions and changes in the growth cadence for 2023 and 2024

Expectations defined

Until there is some resolution on the direction of economic growth, we believe equity prices will remain in a trading range (Figure 6).

Equity markets remain in a definable range

FIGURE 6: **RUSSELL 2000 INDEX**

Data as of 3.31.2023. Source: MEM and Bloomberg.

We continue to expect inflation trends will decline as we move through 2023. However, levels of inflation will remain higher than the Fed's baseline goal and may remain sticky, resulting in a higher-than-expected FED funds rate for a longer period than previously imagined. Finally, we expect earnings reports will remain sluggish for the first half of the year as companies lower growth and profitability expectations. Although a recessionary environment for the economy and markets may be well anticipated, the bottoming process for equity markets could still take several more quarters and we continue to assess both opportunities and challenges within this environment.

Past performance is not necessarily indicative of future results.

Benchmark definitions: The Russell 3000 Index measures the performance of the 3,000 largest U.S. companies based on total market capitalization, which represents approximately 98% of the investable U.S. equity market. The Russell 2000 Index offers investors access to the small-cap segment of the U.S. equity universe. The Russell 2000 is constructed to provide a comprehensive and unbiased small-cap barometer and is completely reconstituted annually to ensure larger stocks do not distort the performance and characteristics of the true small-cap opportunity set. The Russell 2000 includes the smallest 2000 securities in the Russell 3000.

The Russell 2000 Value Index offers investors access to the small-cap value segment of the U.S. equity universe. The Russell 2000 Value is constructed to provide a comprehensive and unbiased barometer of the small-cap value market. Based on ongoing empirical research of investment manager behavior, the methodology used to determine value probability approximates the aggregate small-cap value manager's opportunity set.

The Russell 2500 Index measures the performance of the small to mid-cap segment of the U.S. equity universe, commonly referred to as "smid" cap. The Russell 2500 Index is a subset of the Russell 3000® Index. It includes approximately 2500 of the smallest securities based on a combination of their market cap and current index membership. The Russell 2500 Value Index measures the performance of the small to mid-cap value segment of the U.S. equity universe. It includes those Russell 2500 companies with lower price-to-book ratios and lower forecasted growth values. The Russell 2500 Index is constructed to provide a comprehensive and unbiased barometer for the small to mid-cap segment. Both indices are completely reconstituted annually to ensure large stocks do not distort the performance and characteristics of the true small to mid-cap opportunity set and that the represented companies continue to reflect value characteristics. (Source: Russell).

The S&P 500 is widely regarded as the best single gauge of large-cap U.S. equities. There is over USD 9.9 trillion indexed or benchmarked to the index, with indexed assets comprising approximately USD 3.4 trillion of this total. The index includes 500 leading companies and covers approximately 80% of available market capitalization. Please see the following GIPS disclosure for additional benchmark definitions.

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