Equity market review

MESIROW EQUITY MANAGEMENT STRATEGIES
AUM: $1.1B as of December 31, 2023

- Small Cap Value
- Small Cap Core
- SMID Cap Value
- SMID Cap Core

"We believe the key to generating consistent investment returns is the selection of investment opportunities that possess attractive valuations and demonstrate identifiable catalysts that are expected to generate accelerating earnings and cash flow growth."

Kathryn A. Vorisek
Head of Equity Management

Leo Harmon, CFA, CAIA
Chief Investment Officer

Andrew Hadland, CFA
Director of Research

INVESTMENT OBJECTIVES

- Generate attractive risk-adjusted returns
- Consistently outperform the benchmark over a market cycle
- Participate in rising markets and protect capital in down market

Good things come to those who wait

Similar to the premise in the Samuel Beckett classic, *Waiting for Godot*, where the protagonists expect the arrival of the title character, equity investors spent most of the year preparing for "the most anticipated recession ever" which, like Godot (spoiler alert), never appeared. What did appear throughout the year was a considerable level of volatility and oscillation. Small cap equities traded in a wide, definable trading range as the debate raged regarding the Federal Reserve's (Fed) ability to slow inflation without crashing the economy. Multiple periods of wide-ranging price movements reflected changes in sentiment as investors wrestled with two possible outcomes. On one hand: the benefits of the end of the Fed's tightening cycle with falling rates and a potential soft landing for the economy. On the other hand: the detriments related to the traditional lagged effects of restrictive monetary policy.

Generally, negative impacts of a Fed tightening cycle happen 12–24 months after significant monetary policy changes have been implemented; 2023 was solidly within this timeframe. The reality of materially higher interest rates, slower marginal growth, and the Fed intimating that rates would remain "higher for longer," plus the panic resulting from the bank liquidity crisis, were all indicative of the Fed's restrictive policy. However, both earnings growth and economic activity in 2023 proved to be more resilient than expected. With fiscal and monetary stimulus producing over $2T in excess savings for the consumer combined with strong employment formation and rising wages, the negative lagged impacts of Fed policy did not materialize.

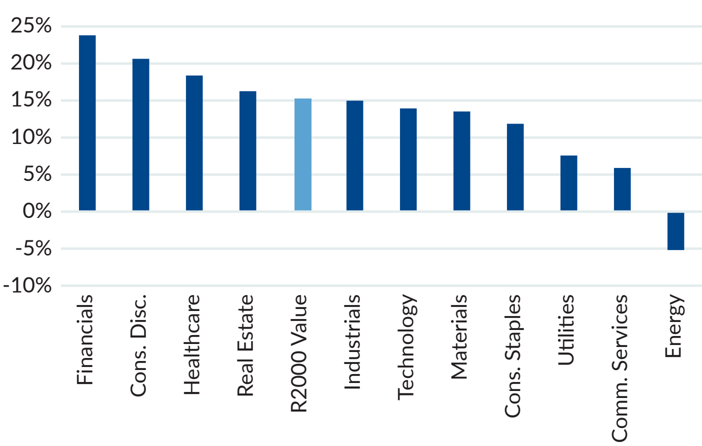
As fourth quarter began, inflation, though declining overall, was still deemed too high for the Fed to pivot to a less restrictive policy. Investors anticipated that they would keep interest rates higher for a longer period, which increased the risk of recession. However, as the quarter progressed, communications from the Fed suggested a potential shift to a more accommodative policy in 2024, leading to a significant surge for small cap equities in the final two months of the year: performance exceeded 20% over this period. The strong performance at year-end helped small cap equities drive impressive results for both the fourth quarter and the year:

Index	4Q2023	YTD 2023
Russell 2000 Value Index	15.3%	14.7%
Russell 2000 Index	14.0%	16.9%
Russell 2500 Value Index	13.8%	16.0%
Russell 2500 Index	13.4%	17.4%

Data as of 12.31.2023. Source: MEM, Bloomberg and FTSE Russell.

For the year, market leadership was decidedly cyclical with Consumer Discretionary, Industrials, Technology and Materials sectors driving market performance while traditional non-cyclical sectors — Utilities, Healthcare and Consumer Staples — were major laggards. However, we did witness some shifts in leadership during the fourth quarter driven by the prospects of lower interest rates. Financials, Consumer Discretionary (particularly housing-related companies) and Real Estate sectors all benefited, as did Healthcare, which had been negatively impacted by the effect of higher rates on its valuation multiples. Conversely, the Energy sector, which had been leading throughout the year, was a considerable underperformer in the quarter (Figure 1).

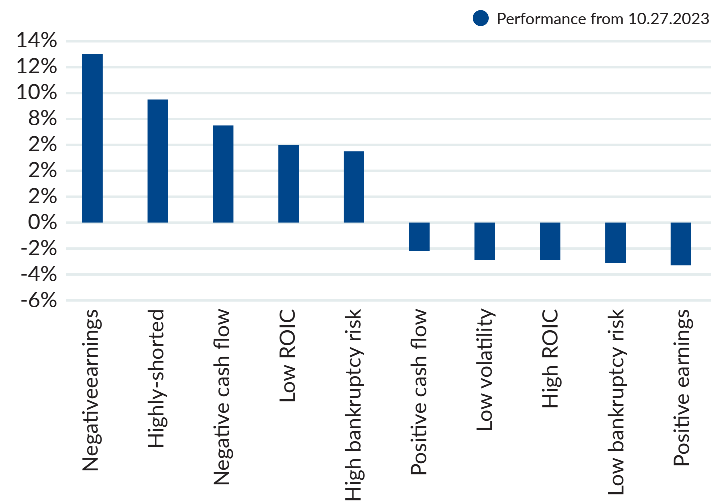
FIGURE 1: **4Q2023 MARKET LEADERSHIP DRIVEN BY LOWER INTEREST RATE OUTLOOK**



Source: MEM using data from Bloomberg, LP. Data as of 12.31.2023.

Performance based on company characteristics also bounced between leadership from high- and low-quality factors throughout the year. In the fourth quarter, equity markets experienced more extreme leadership from lower-quality factors as companies with negative earnings and cash flow, higher beta, lower profitability, higher leverage and higher levels of short-interest dramatically outperformed their higher-quality peers (Figure 2). The dramatic change in leadership was directly related to expectations from investors that the Fed tightening cycle had ended and policymakers would begin to lower interest rates earlier than expected in 2024.

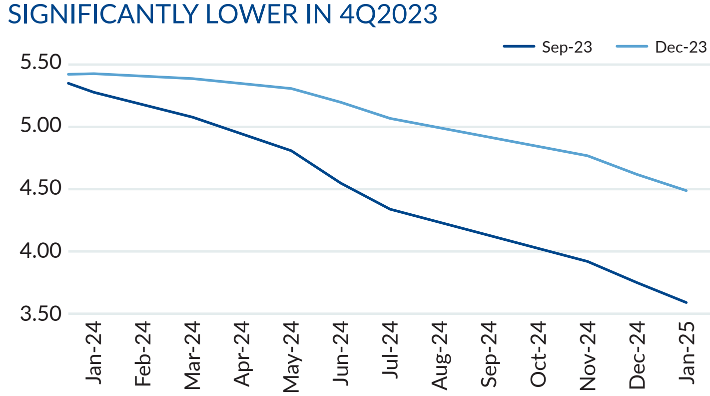
FIGURE 2: **LOW QUALITY FACTORS DOMINATED IN 4Q2023**



Source: MEM using data from Furey Research Partners. Data as of 12.31.2023.

Based on the Fed's more accommodative rhetoric, the implied Fed Funds rate is now anticipating four additional rate cuts, relative to last quarter, over the next year (Figure 3).

FIGURE 3: **INTEREST RATE PROFILE SHIFTS SIGNIFICANTLY LOWER IN 4Q2023**

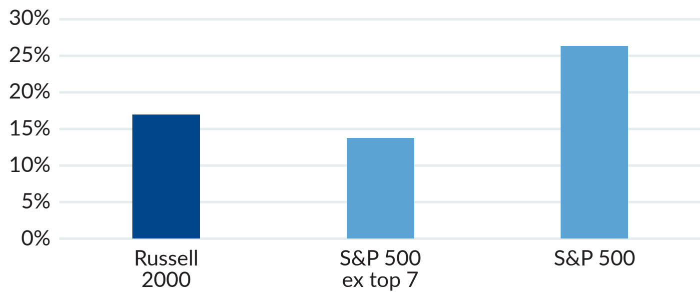


Source: MEM using data from Bloomberg, LP. Data as of 12.31.2023.

Past performance is not indicative of future results.

Despite outperforming in the fourth quarter, small cap indices still trailed large cap for the year. The outperformance for large cap was driven by the largest seven names, without which small cap equities would have outperformed (Figure 4). The concentration within large cap is near a historical high. In the past, peaks in large cap concentration have signaled future outperformance for small cap companies (Figure 5).

FIGURE 4: SMALL CAP UNDERPERFORMANCE ATTRIBUTED TO SEVEN LARGE COMPANIES

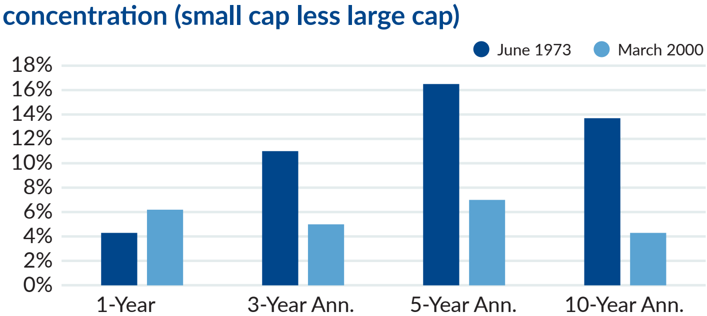


Source: MEM using data from Furey Research Partners. Data as of 12.31.2023.

FIGURE 5: SMALL CAP OUTPERFORMS AFTER PERIODS OF LARGE CAP CONCENTRATION

Weight of top 7 stocks in the S&P 500

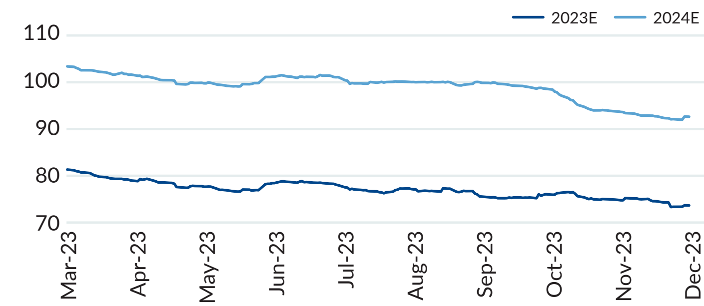
Annualized forward returns after peak in large cap concentration (small cap less large cap)



Source MEM using data from Blomberg, LP. Data as of 12.31.2023.

With the most recent move in prices, small cap equity markets are now at the top-end of a well-defined two-year trading range. Whether this is the start of a new bull market or a continuation of recent volatile patterns depends largely upon avoiding a recessionary outcome and achieving the elusive "soft landing" as a platform for future growth. While markets have responded favorably to lower inflation and the potential for a Fed pivot, both economic activity and earnings expectations (Figure 6) continue to decelerate on the margin. We will need to generate stronger growth on both fronts, over the next few quarters, in order to sustain recent market momentum.

FIGURE 6: REVISIONS FOR RUSSELL 2000 MOVE LOWER; GROWTH EXPECTED FOR 2024



Source: MEM using data from Bloomberg, LP. Data as of 12.31.2023.

In the meantime, we continue to monitor several factors that may influence our tactical portfolio positioning:

- Re-acceleration in baseline inflation
- Earnings revisions and changes in the growth cadence for 2024
- Incremental economic growth, particularly over the next year
- Geopolitical issues and their impact on energy prices and growth expectations
- Timing and duration of a potential recession
- Bank credit costs
- Lagged effects of monetary policy on employment formation

Past performance is not indicative of future results.

Over the last few quarters, there have been many discussions about the lagged effects of monetary policy and whether the Fed could successfully reduce inflation without creating a recession or a material slowdown in economic activity. While there are still impediments to reaching this outcome, the Fed appears willing to tolerate slightly higher inflation in order to lower rates and balance economic growth which makes the soft-landing scenario more achievable. Regardless of the environment, we remain diligent in our quest to identify value-added opportunities to drive excess performance.

About Mesirow

Mesirow is an independent, employee-owned financial services firm founded in 1937. Headquartered in Chicago, with locations around the world, we serve clients through a personal, custom approach to reaching financial goals and acting as a force for social good. With capabilities spanning Global Investment Management, Capital Markets & Investment Banking, and Advisory Services, we invest in what matters: our clients, our communities and our culture. To learn more, visit mesirow.com and follow us on LinkedIn.

Contact us

portfoliospecialist@mesirow.com | 312.595.7300

Benchmark definitions:

The Russell 2000 Index offers investors access to the small-cap segment of the US 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 US 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 US 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 US 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 US 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.