COMMENTARY

A tale of whipsaws and head-fakes

The best thing we can say about the third quarter of 2022 was that it looked worse than it actually was. However, the market environment was already ugly. We have written in the past about the difficulties facing the Fed, trapped between the mythical Scylla and Charybdis as it attempts to guide the economy through a phase of restrictive monetary policy needed to fight inflation while also trying to avoid creating a recession. Regardless of how successful the Fed ultimately proves to be as it attempts a proverbial soft landing, the financial markets have borne the brunt. This quarter was no exception.

A brief but powerful rally commenced in mid-June, driven by the prospect that both inflation and interest rates were peaking. The rally came to an abrupt halt in mid-August as inflationary data proved more elevated and persistent, which caused interest rates to resume their upward trend. Consequently, the Fed aggressively reiterated its goal of pushing inflation back to its 2% baseline. Hopes of an early reversal of Fed policy were dashed, causing equities to decline through the end of the quarter. As a result, robust gains from early in the quarter reversed into losses:

<table>
<thead>
<tr>
<th>Index</th>
<th>3Q2022</th>
<th>YTD</th>
</tr>
</thead>
<tbody>
<tr>
<td>Russell 2000 Value Index</td>
<td>-4.6%</td>
<td>-21.1%</td>
</tr>
<tr>
<td>Russell 2000 Index</td>
<td>-2.2%</td>
<td>-25.1%</td>
</tr>
<tr>
<td>Russell 2500 Value Index</td>
<td>-4.5%</td>
<td>-20.4%</td>
</tr>
<tr>
<td>Russell 2500 Index</td>
<td>-2.8%</td>
<td>-24.0%</td>
</tr>
</tbody>
</table>

Source: Russell.

Although equity results were negative for the quarter, market leadership was tilted, atypically, toward more cyclical sectors rather than traditionally defensive sectors. That was a result of market practitioners weighing the prospects of positioning for positive fundamental inflection against paying higher multiples for lower cyclical exposure. Energy, Healthcare, Financials, and Consumer Discretionary sectors were the best performers while Communication Services, Real Estate, Consumer Staples, and Utilities were laggards.
Inflation results in August (Figure 3) only served to cement the Fed’s message at its annual meeting at Jackson Hole. Consequently, the outlook for the Fed Funds Rate moved considerably higher, indicating rates will stay higher for longer than expected (Figure 4), which led to the market decline through quarter end (Figure 5).

Core inflation peaked in March at a 30-year high and remains elevated

Rate expectations moved higher as Fed reiterates inflation goals

Recent market direction driven by expectations of Fed moves

Performance based on quality metrics were similarly mixed with no clear leadership in either direction. However, growth-related companies were able to regain some traction relative to value, outperforming during the quarter but still trailing for the year. Performance by quality factors was muddled but tilted toward higher quality attributes. Unprofitable companies outperformed which, similar to sector leadership, is atypical for this environment (Figure 1).

Factors were biased to high quality, though there was not a discernable pattern

No! We really, REALLY mean it this time

While equity market declines were relatively modest for the quarter, the resulting change in sentiment was even more damaging. Most equity indices retreated more than 15% from their mid-August highs, triggering an increased level of doubt that the Fed will be able to slow inflation without damaging the economy. Although markets moved higher based on expectations of easing Fed policy, the message from the Central Bank has been consistent and clear: inflation is the #1 priority and interest rate policy has reflected this throughout the year (Figure 2).

Fed remains aggressive with more implied rate hikes through year end

In Figure 3, we show the evolution of core inflation in the past 30 years. As of August 2022, core inflation was at a 30-year high, remaining elevated due to inflationary pressures.

In Figure 4, we illustrate the implied Fed Funds Rate path over the past few years. The data indicates a higher and more extended rate path, reflecting the Fed’s commitment to combat inflation.

In Figure 5, we present the relationship between real and nominal FOMC Futures, highlighting the anticipated path of Fed rates. As of the end of the quarter, the Fed Funds Futures suggest a path higher than previously anticipated.

As of September 2022, sources: Mesirow Equity Management and Bloomberg. Past performance is not indicative of future results.


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In addition, inflation is a global phenomenon and other Central Banks are pursuing restrictive policies at various levels. Fed policy is also being transmitted globally through foreign exchange rates. The result has been a crisis for the British pound, which is now close to an all-time low relative to the USD. That in turn exacerbated global tightening policies, which increased the chances of a worldwide recessionary environment.

The small cap market is sooooo cheap... (How cheap is it?)

It is so cheap that it trades almost two standard deviations below its 20-year average relative to large cap peers (Figure 6). Relative to 10-year Treasuries, small cap equities display similar valuation attributes despite the significant move higher in 10-year yields (Figure 7). Given the relative underperformance of small cap over the last 10 years, many investors are beginning to postulate whether equity markets are positioning for another small cap super cycle. You can probably guess where our bias lies as small cap practitioners, but the odds are improving.

Small cap is relatively attractive vs large cap

But first things first, we need earnings to turn

One of the reasons we've been reticent about taking incremental risk in current market conditions is the outlook for earnings. While revenue growth has been acceptable, it reflects impeded price increases driven by inflation while corresponding unit growth has been more stagnant. Inflationary pressures driven by supply chain disruptions and limited workforce participation has resulted in lower margins from higher wages and other input costs, resulting in the degradation of earnings results. In fact, small cap earnings are down about 15% from peak expectations (Figure 8). As we see more evidence of slowing economic growth and a reduction in companies' ability to pass through prices, we would expect more pressure on earnings over the near term.

Small cap earnings expectations head lower. Now about 15% below peak.
Kissing babies and shaking hands

With mid-term elections just around the corner, market practitioners are left to ponder how political change may drive changes in policy that could impact equity markets. Historically, one of the better periods of performance for small cap investors is directly after the mid-term cycle: Figure 9 shows significant outsized returns on an historical basis after the mid-terms. While there are many cross currents from near-term fundamentals, small cap markets could be poised for success once near-term risks have subsided.

** Election-year headwinds historically abate in November

**FIGURE 9: AVERAGE SMALL CAP RETURNS AROUND ELECTIONS (SINCE 1960)

![Graph showing average small cap returns around elections](image)


Famous last words

We still believe that, absent a recession, much of the expected damage to equities is already embedded in prices. We would become more constructive about intermediate market trends should inflation data allow the Fed to suspend or reverse its current path (Figure 10). However, we have continued to witness deterioration in underlying economic fundamentals. Employment and spending levels remain strong. That said, inflation is masking the shortfall in real unit growth, broader economic data indicators are slowing on the margin, and increased levels of market risk are being transmitted through higher volatility (VIX) and increases in high-yield bond spreads. Furthermore, we would expect earnings reports to be more challenging for the balance of the year as many companies adjust expectations to account for lower growth and profitability and a reduced ability to pass through higher prices.

** FIGURE 10: SMID CAP PERFORMANCE DURING CORRECTIONS

![Graph showing smid cap performance during corrections](image)


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

- An inflection in inflation that would signal the end of the Fed tightening cycle
- Continued improvement / stagnation in economic activity
- Risk factors related to liquidity and credit that could signal more material downside for equities
- Visibility into positive changes for higher unit growth
- Pricing power and margin stability as inflation persists
- Earnings revisions and changes in growth cadence for 2023

We are acutely aware that equity markets are notoriously forward-looking mechanisms, and the bottoming process could reach its conclusion well before a corresponding bottom in economic data. Therefore, we will continue to look for opportunities where market prices have dislocated from reasonable expectations and focus on identifying companies with embedded fundamental strength, increasing pricing power, or natural cost advantages that can weather a potentially more distressed environment.
Benchmark Definition: 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. (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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Performance and Attribution
SMID Cap Value Equity

COMPOSITE ANNUALIZED PERFORMANCE (as of 9.30.2022)

Returns (%)

<table>
<thead>
<tr>
<th></th>
<th>QTD</th>
<th>YTD</th>
<th>1 yr</th>
<th>3 yr</th>
<th>5 yr</th>
<th>10 yr</th>
<th>ITD (5.1.10)</th>
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<tbody>
<tr>
<td>MEM SMID Cap Value Equity (gross)</td>
<td>-1.88</td>
<td>-15.59</td>
<td>-8.57</td>
<td>8.10</td>
<td>6.51</td>
<td>9.64</td>
<td>9.47</td>
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<tr>
<td>MEM SMID Cap Value Equity (net)</td>
<td>-2.05</td>
<td>-16.03</td>
<td>-9.23</td>
<td>7.31</td>
<td>5.72</td>
<td>8.96</td>
<td>8.78</td>
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<tr>
<td>Russell 2500 Value Index</td>
<td>-4.50</td>
<td>-20.41</td>
<td>-15.35</td>
<td>4.52</td>
<td>3.78</td>
<td>8.41</td>
<td>8.23</td>
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<tr>
<td>Relative Performance (gross)</td>
<td>2.62</td>
<td>4.82</td>
<td>6.78</td>
<td>3.58</td>
<td>2.73</td>
<td>1.23</td>
<td>1.24</td>
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<tr>
<td>Relative Performance (net)</td>
<td>2.45</td>
<td>4.38</td>
<td>6.12</td>
<td>2.79</td>
<td>1.94</td>
<td>0.55</td>
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Performance characteristics (gross)

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<th>5 yr</th>
<th>10 yr</th>
<th>ITD (5.1.10)</th>
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<tr>
<td>Alpha</td>
<td>2.63</td>
<td>1.62</td>
<td>1.67</td>
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<tr>
<td>Beta</td>
<td>0.95</td>
<td>0.93</td>
<td>0.94</td>
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<tr>
<td>Information Ratio</td>
<td>0.97</td>
<td>0.48</td>
<td>0.51</td>
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Note: Periods over 1 year are annualized. Source: MEM, eVestment and Bloomberg. | Performance characteristics data based on quarterly observations and gross returns. | Performance results are shown gross and net of fees. Past performance is not necessarily indicative of future results.

ATTRIBUTION ANALYSIS – QTD (BPS)

Returns (%)

<table>
<thead>
<tr>
<th></th>
<th>SMID Cap Value</th>
<th>Russell 2500 Value</th>
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<tbody>
<tr>
<td></td>
<td>1.8</td>
<td>5.8</td>
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<tr>
<td></td>
<td>-7.0</td>
<td>-7.1</td>
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Sector weights (%)

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<thead>
<tr>
<th></th>
<th>SMID Cap Value</th>
<th>Russell 2500 Value</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>9.2</td>
<td>5.0</td>
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<tr>
<td></td>
<td>10.8</td>
<td>3.0</td>
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The information provided above is supplemental. Please see GIPS Reports at the end of this commentary for complete performance information, including benchmark/index definitions.
### Portfolio Characteristics (9.30.2022)

<table>
<thead>
<tr>
<th>Metric</th>
<th>MEM SMID Cap Value</th>
<th>Russell 2500 Value Index</th>
</tr>
</thead>
<tbody>
<tr>
<td>Number of holdings</td>
<td>76</td>
<td>1,830</td>
</tr>
<tr>
<td>Forward price/earnings (median)</td>
<td>12.2x</td>
<td>12.1x</td>
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<tr>
<td>Year 2 EPS growth</td>
<td>13.2%</td>
<td>8.7%</td>
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<tr>
<td>5-year return-on-equity</td>
<td>10.3%</td>
<td>11.4%</td>
</tr>
<tr>
<td>Weighted median market cap</td>
<td>$3.8 B</td>
<td>$4.9 B</td>
</tr>
<tr>
<td>% of portfolio in top 10</td>
<td>17.1%</td>
<td>4.3%</td>
</tr>
</tbody>
</table>

Source: MEM, BNY Mellon, Bloomberg, and FTSE Russell.

### Sector Weights (9.30.2022)

- Financials
- Industrials
- Real Estate
- Healthcare
- Consumer Discretionary
- Information Technology
- Utilities
- Energy
- Consumer Staples
- Materials
- Cash / Other
- Communication Services

Source: MEM, Bloomberg, and FTSE Russell. Sector weights and portfolio characteristics are calculated from a representative account invested in the MEM Small Cap Value Equity strategy.

### Positive Contribution (BPS)

- TA
- CCJ
- FTI
- DECK
- BJ


### Negative Contribution (BPS)

- SAFE
- NI
- PRFT
- WOOF
- MAXR


Past performance is not indicative of future results. Please see disclosures at the end for additional, important information.
Mesicrow Financial Equity Management ("MEM") claims compliance with the Global Investment Performance Standards (GIPS®) and has prepared and presented this report in compliance with the GIPS standards. MEM has been independently verified for the periods 01.01.1996 – 12.31.2021. A firm that claims compliance with the GIPS standards must establish policies and procedures for complying with all the applicable requirements of the GIPS standards. Verification provides assurance on whether the firm’s policies and procedures related to composite and pooled fund maintenance, as well as the calculation, presentation, and distribution of performance, have been designed in compliance with the GIPS standards and have been implemented on a firm-wide basis. The SMD Cap Value Equity Composite has had a performance examination for the period 01.01.2016 – 12.31.2021. The verification and performance examination reports are available upon request.

Benchmark returns are not covered by the report of independent verifiers.

Effective 07.01.2022, MEM transferred its assets and associated composites to Mesicrow Institutional Investment Management, Inc. ("MIIM"), a registered investment advisor (RIA) registered with the Securities and Exchange Commission under the Investment Advisors Act of 1940. Prior to 07.01.2022, MEM’s assets and associated composites were part of Mesicrow Financial Investment Management, Inc. ("MFIN"). The historical performance presented prior to the creation of MFIN was managed by MFIN or its predecessor firms prior to 01.01.2005. For purposes of claiming GIPS compliance, as of 01.01.2010 the “firm” was further defined as the US Value Equity business unit, now defined as MEM which manages portfolios primarily for institutional investors adhering to an investment process incorporating fundamental analysis of security valuation factors and drivers. The composites within this unit vary primarily by the capitalization range of the equity securities held. MEM is comprised of the Legacy entities of Mesicrow Financial Investment Management - US Value Equity (the surviving entity) and fiduciary management associates, LLC (the acquired entity), with each prior to this effective date being legacy entities of Mesirow Financial Investment Management - US Value Equity (the surviving entity) and Mesirow Financial Equity Management ("MEM") claims compliance with the Global Investment Performance Standards (GIPS®) and has prepared and presented this report in compliance with the GIPS standards. MEM has been independently verified for the periods 01.01.1996 – 12.31.2021. A firm that claims compliance with the GIPS standards must establish policies and procedures for complying with all the applicable requirements of the GIPS standards. Verification provides assurance on whether the firm’s policies and procedures related to composite and pooled fund maintenance, as well as the calculation, presentation, and distribution of performance, have been designed in compliance with the GIPS standards and have been implemented on a firm-wide basis. The SMD Cap Value Equity Composite has had a performance examination for the period 01.01.2016 – 12.31.2021. The verification and performance examination reports are available upon request.

Performance / Net of Fee Disclosure

Effective 04.01.2016 the firm was redefined and renamed for GIPS purposes to include both the legacy Mesicrow Financial Investment Management – US Value Equity division and the legacy fiduciary management associates, LLC division as one combined entity.

In 2016, MFIN acquired the asset management rights for all managed portfolios from an independent investment advisory firm and retained all of the principals and employees related to such portfolios. Performance results of the SMD Cap Value Equity Composite at the prior firm are the performance record of the firm.

(1) Total Firm Assets are not presented for periods prior to 2016 because the Composite was not part of the Firm.

(2) Performance and composite inception and creation date is 05.01.2010.

The SMD Cap Value Equity Composite includes all institutional portfolios that invest in the SMD capitalization strategy subject to a $1,000,000 minimum account size. Prior to 06.01.2019 the SMD Cap Value Equity Composite was named the Small-Mid Cap Value Equity Composite, and materials referencing the composite did so by that name. Between 03.31.2016 – 10.01.2014 there was no stated minimum account size threshold for inclusion. Prior to 10.01.2014 the minimum account size required for composite membership was $1,000,000. The strategy allows for investments in equity securities of companies with market capitalizations in a range representative of constituents in the Russell 2000 Index. The strategy aims to deliver a total return primarily through long-term capital appreciation. The benchmarks for the strategy are the Russell 2500 Index and the Russell 2500 Value Index. The performance presented herein represents past performance and is no guarantee of future results. Gross returns presented are net of any witholding taxes incurred. MEM and benchmark performance reflect the reinvestment of dividends and interest income, expressed in U.S. dollars. Results are based on fully discretionary accounts under management, including those accounts no longer with the firm. The firm maintains a complete list of composite descriptions, a list of pooled fund descriptions for limited distributions pooled funds and a list of broad distributions pooled funds, which is available upon request. Policies for valuing investments, calculating performance, and preparing GIPS Reports are available upon request.

Calculation of Risk Measures: Annual / 3 Years Dispersion

Composite internal dispersion is calculated using the asset-weighted standard deviation of annual gross returns of those portfolios that were included in the composite for the entire year. Because it is not statistically meaningful, MEM does not calculate the dispersion of annual returns for the year the composite held five or fewer accounts. Inclusion of the three-year annualized ex-post standard deviation of the composite and benchmark was added as a requirement effective 12.31.2011.

(3) Data are not presented for periods containing less than 36 monthly returns for the composite.

Performance / Net of Fee Disclosure

Effective 04.01.2016 the composite excludes bundled fee accounts. Between 03.31.2016 – 10.01.2015 the Composite included bundled fee accounts and accounts that did not pay management fees to MEM. The bundled fees included a combination of trading, custody and other administrative fees. Those bundled fee accounts and non-management-fee paying accounts represented less than 1% of Composite assets. For bundled fee assets, gross of fee performance is reduced by the entire bundled fee since trading expenses cannot be isolated.

Net of fee performance is calculated using the actual monthly fee accrued to each account in the composite. In presentations shown prior to 06.30.2014, net of fee performance was calculated using the highest actual management fee charged to a member of the composite during the calendar year, applied monthly. Performance information that is provided gross of fees does not reflect the deduction of advisory fees. Client returns will be reduced by such fees and other expenses that may be incurred in the management of the account. Advisory fees are described in Part 2 of Form ADV of MIIM.

Investment Fee Disclosure

MEM requests that any third party, including investment management consultants, provide our performance data only on a one-on-one basis. Performance results are presented before management and custodial fees.

Vehicle Fee Schedule

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<thead>
<tr>
<th>Composite Cap Value Strategy</th>
<th>(described in MEM's Form ADV, Part 2)</th>
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</thead>
<tbody>
<tr>
<td>0.85% on the first $25 million</td>
<td></td>
</tr>
<tr>
<td>0.70% on the next $25 million</td>
<td></td>
</tr>
<tr>
<td>0.60% on the next $50 million</td>
<td></td>
</tr>
<tr>
<td>0.50% on the balance</td>
<td></td>
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</tbody>
</table>

SMID Cap Value Equity Composite (described in MEM’s Form ADV, Part 2)

0.45% on all assets – Founder Class (First $100 million)

0.75% on all assets – Class A

An actual fee charged to an individual portfolio may vary by size and type of portfolio. Fees are collected quarterly, which produces a compounding effect on the total rate of return net of management fees. As an example, the effect of investment management fees on the total value of a client’s portfolio assuming (a) $1,000,000 investment, (b) portfolio return of 8% a year, and (c) 0.85% annual investment advisory fee would reduce the portfolio's value by $8,892 in the first year, by $51,223 over five years and $123,351 over 10 years. Actual investment advisory fees incurred by clients will vary.
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)

These indexes have been displayed as comparisons to the performance of the SMID Cap Value Equity Composite.

(2) Additional Information.

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