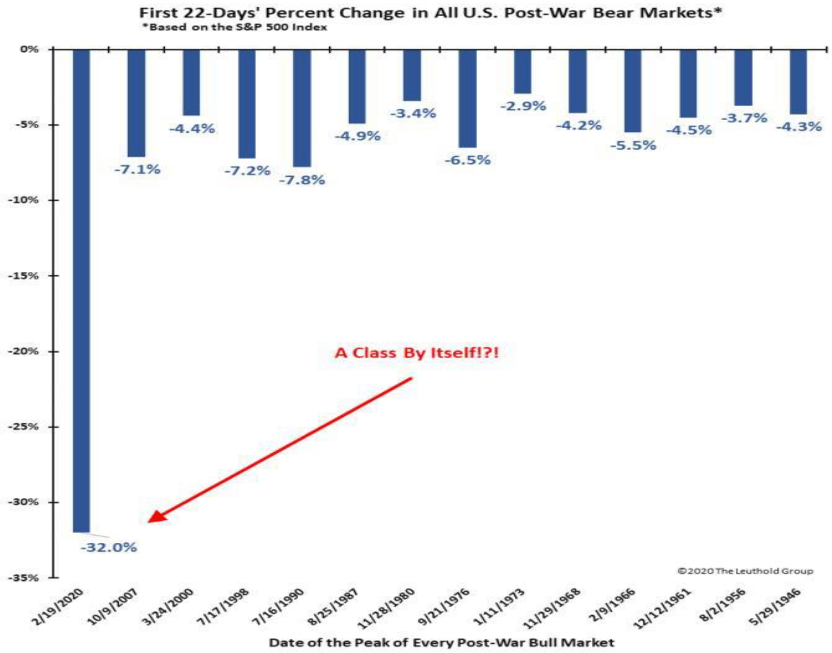
Mid Cap Equity Strategy — 1st Quarter 2020 Commentary

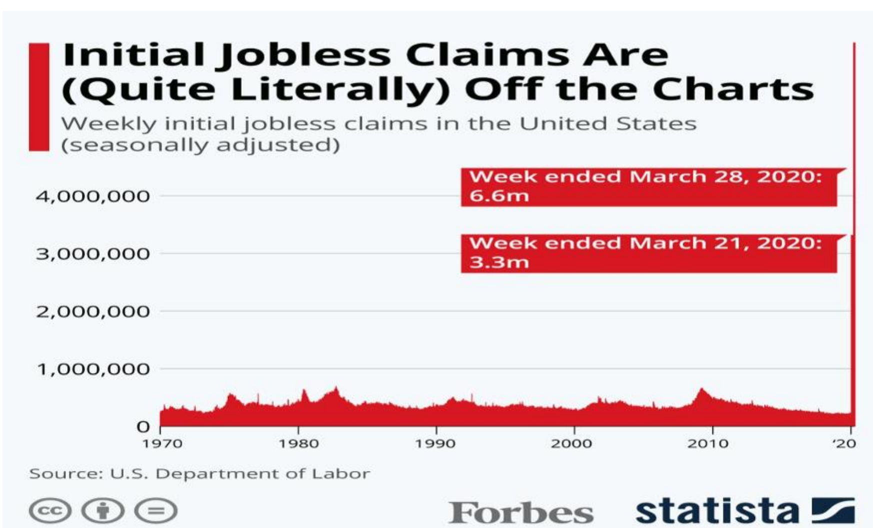
The White Swan

We incorrectly alluded to the Covid-19 Pandemic in our interim communication to clients as a Black Swan, a tail-risk event that can't be foreseen or predicted, with extreme consequences. According to NYU risk engineer and professor Nassim Taleb, however, the Covid-19 pandemic is more aptly described as a "White Swan," an event that while extreme in impact, should have been predictable in terms of both its ultimate likelihood and the world's preparedness for it. Ominously, Bill Gates made a presentation at the 2015 TED Conference, outlining both the risks and many of the steps needed to prevent such an event from becoming as impactful as it has now become. In our view, the failure of our federal government to heed the many warnings about the likelihood and impact of the current crisis is a national shame. It belies a degree of dysfunction at the level of national government that compares unfavorably to the Keystone Cops. The lack of a coherent and competent national strategy for such a contingency has led to greater than necessary spread of the virus, an unprepared and soon to be overwhelmed health care system and profound damage to the economy. We expect that the unfortunate footnote to this crisis will be the needless suffering that has taken place across our society, if only for a lack of a basic level of prevention and contingency planning. As we have stated previously, the Covid-19 pandemic represents a real human tragedy; however, we can't ignore the fact that this tragedy has been amplified by our lack of preparation.

There should be little doubt about the economic impact of the near shutdown of the global economy. We appear to be headed for a rather severe recession, highlighted by record levels of unemployment. Almost 10 million newly jobless claims have been filed during the past two weeks. As anticipated, the impact on economic activity has been wide but most severely concentrated in industries such as travel, retail and a broad swath of discretionary categories. Small businesses, especially restaurants but many other service-related businesses as well, face enormous obstacles in the face of the national shutdown. The energy sector is in severe turmoil as Saudi Arabia and Russia have cynically engaged in a supply-driven oil price war during the pandemic, causing oil prices to plummet to levels last seen in 1999. Both Russia and Saudi Arabia are attempting to drive a stake through the heart of the U.S. shale industry, something the industry was doing a good job of on its own. At current oil prices in the $25 per barrel range, 100% of the U.S. shale industry is unprofitable. In terms of the market impact of this global health crisis, the rapid decline in asset prices from the Covid-19 -induced economic paralysis is in rarified territory.



The current economic consensus seems to be coalescing around a decline in economic activity that has never occurred in the modern era for advanced economies. Goldman Sachs is leading the charge in estimated GDP decline with -9% in Q1 and a staggering -34% in Q2 (annualized figures), before recovering in Q3 and Q4. These numbers would imply a trough in US real GDP in the 2nd quarter of 2020 at $17.2T, a level equivalent to December 2014 and suggesting a decline in GDP/capita of nearly 11%. In contrast, the Global Financial Crisis saw real GDP/capita decline by only 5.3% in the U.S. We suspect that the current (early April) rally (up nearly 20%) we are experiencing off the March lows will meet with a bit of a reality check when April quarter economic activity begins to be disseminated.



Things We Know

Both the Federal Reserve and Congress have reacted in historically dramatic fashion. The FED has embarked on its largest quantitative easing program to date, dwarfing the initial measures deployed to counteract the economic impact of the Great Financial Crisis. The FED not only initiated a new $800 billion quantitative easing program but included in its new mandate the ability to make open-market purchases of investment grade corporate debt and municipal bonds. The FED also included $3.2 trillion in new swap capacity while simultaneously lowering the rate on those lines to 0%. Congress has enacted the $2 trillion CARES (Coronavirus Aid, Relief and Economic Security) Act, a package of relief measures for the economy. The act seeks to provide economic support to the business sector, employees, individuals, and families. It also specifically addresses industries that have been impacted the most, including air transportation, health care, and education. The specific aim of both programs is to bridge individual citizens, businesses and the all-important proper functioning of credit markets through this period when our economic system has been placed into a temporary coma.

Congress is already working on the next package of programs including more subsidies and direct aid. The FED can also choose to continue to expand both the scope and size of its quantitative easing program and likely will as state and municipal tax receipts begin to fall well short of previous expectations, which will likely require support from the FED in the municipal issuance market on a significant scale. So far, the all-important credit issuance markets are open for business. Investment grade borrowers can still issue debt at attractive rates and the banking system is well capitalized so financial system integrity remains strong. Even corporations with poor credit ratings have been able to access the capital markets. We note Carnival Cruise lines issuing $4 billion in debt at 11.5%. If that sounds like an extraordinarily high rate, it is; however, for a highly levered business with no current revenues and extraordinarily bad publicity, it represents crucial liquidity. Our takeaway was that if a credit as dubious as Carnival Cruise Lines can issue debt, then the capital markets are still very much open for business.

Things We Don’t Know

We do not have any idea how long the recession will last, nor its ultimate intensity. Do not believe anyone who says they do know as it's quite unknowable. Earnings reports across the market will be an adventure during 2020 as the demand impact across industries will be dramatic initially, then recover as businesses re-start and, in some cases, re-build. We expect to see a surge in bankruptcies. How far do earnings plunge in the second quarter, the third quarter or the fourth quarter this year? We expect that we may see second quarter 2020 S&P 500 earnings growth print a negative aggregate number, only the second time in history (the last time was fourth quarter 2008). Do earnings fully rebound by early 2021, the middle of 2021, or early 2022? What industries and businesses become more dominant post-coronavirus? What industries or businesses become permanently impaired? We will leave you with this thought: through Revolutionary War, Civil War, two world wars, the Spanish Flu pandemic which killed 50 million worldwide and literally dozens of financial crises, our economy has ultimately demonstrated a resilience and adaptability which have carried the day.

Quarterly Performance

Our for the Hahn Capital Management Mid-Cap Value Composite was **-29.00%** gross of fees in the first quarter of 2020. For the quarter, we outperformed our primary benchmark, the Russell Mid-Cap Value Index, by 2.71 percentage points. For the quarter, all sectors and holdings declined. Allocations to Cash, Energy, Healthcare, Information Technology, Financials, and Industrials, contributed positively (relative to the benchmark), while those to Utilities (no holdings), Consumer Staples, Consumer Discretionary, Materials, Communication Services (no holdings), and Real Estate detracted. The most significant contributors during the quarter were Equinix (EQIX), Ross Stores (ROST), Jacobs Engineering Group (J – formerly JEC), Alexandria Real Estate (ARE), and Mid-America Apartments (MAA), while the most significant detractors were Air Lease Corp (AL), Euronet Worldwide (EEFT), Hexcel Corp (HXL), PVH Corp (PVH), and Bank of NT Butterfield & Sons (NTB).

Hahn Capital Quarterly Performance Attribution – 1Q20

QTD HCM vs. Russell Mid-Cap Value Index - Quarter Ended 03/31/2020

LINKED PERFORMANCE BY SECTORS

BENCHMARK: Russell Midcap Value Index

PORTFOLIO: Model Account

GICS Sector	PORT Weight	BENCH Weight	DIFF Weight	PORT Return	BENCH Return	DIFF Return	SECTOR SELECT	STOCK SELECT	ACTIVE CONTR	PASSIVE CONTR	TOTAL CONTR
Industrials	18.53%	11.86%	6.68%	-33.75%	-31.21%	-2.54%	0.02%	-0.43%	-0.41%	-0.01%	-0.42%
Real Estate	17.07%	14.31%	2.76%	-17.81%	-31.00%	13.19%	-0.01%	2.17%	2.16%	0.00%	2.16%
Information Technology	13.79%	7.57%	6.22%	-30.45%	-26.79%	-3.66%	0.33%	-0.54%	-0.21%	0.00%	-0.21%
Financials	16.40%	18.07%	-1.68%	-40.15%	-37.59%	-2.56%	0.14%	-0.46%	-0.32%	0.00%	-0.32%
Consumer Discretionary	11.59%	8.63%	2.95%	-40.21%	-43.84%	3.63%	-0.40%	0.49%	0.09%	0.00%	0.09%
Health Care	12.19%	7.36%	4.82%	-18.43%	-17.99%	-0.44%	0.65%	-0.07%	0.58%	0.00%	0.58%
Energy	1.77%	4.68%	-2.91%	-53.27%	-62.75%	9.48%	1.12%	0.23%	1.35%	0.00%	1.35%
Materials	1.99%	6.60%	-4.62%	-22.36%	-28.28%	5.92%	-0.15%	0.09%	-0.06%	0.00%	-0.06%
Communication Services	0.00%	3.91%	-3.91%	0.00%	-29.60%	29.60%	-0.08%	0.00%	-0.08%	0.00%	-0.08%
Consumer Staples	0.00%	4.85%	-4.85%	0.00%	-18.72%	18.72%	-0.61%	0.00%	-0.61%	0.00%	-0.61%
Utilities	0.00%	12.15%	-12.15%	0.00%	-17.55%	17.55%	-1.62%	0.00%	-1.62%	0.00%	-1.62%
Cash	6.67%	0.00%	6.67%	0.40%	0.00%	0.40%	1.90%	0.00%	1.90%	0.00%	1.90%
Total Portfolio				**-28.95%**	**-31.70%**	**2.75%**	**1.27%**	**1.48%**	**2.75%**	**0.00%**	**2.75%**

HCM Model Portfolio – Relative Performance by Stock – Quarter Ended Mar 31, 2020

HAHN CAPITAL MANAGEMENT, LLC

MODEL PORTFOLIO REVIEW

As of March 31, 2020

Attribution Analysis - Notable Performers by Sector & Stock

Notable Performers by Sector

Quarter Ended 03/31/2020 - Portfolio vs Russell Midcap Value Index

#	Top Four Holdings Total Attribution		#	Bottom Four Holdings Total Attribution		#	Top Four Sectors Total Attribution		#	Bottom Four Sectors Total Attribution	
1	EQUINIX INC	1.56%	1	AIR LEASE CORP	-0.89%	1	Real Estate	2.16%	1	Utilities	-1.62%
2	ROSS STORES INC	1.00%	2	EURONET WORLDWIDE INC	-0.81%	2	Not Classified	1.90%	2	Consumer Staples	-0.61%
3	JACOBS ENGINEERING GROUP INC	0.65%	3	HEXCEL CORP	-0.65%	3	Energy	1.35%	3	Industrials	-0.42%
4	ALEXANDRIA REAL ESTATE EQUIT	0.46%	4	PVH CORP	-0.59%	4	Health Care	0.58%	4	Financials	-0.32%

Year-to-Date Ended 03/31/2020 - Portfolio vs. Russell Midcap Value Index

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HCM MID-CAP VALUE COMPOSITE PERFORMANCE HISTORY

% Annualized Returns As of 03/31/2020	1Q 2020	1 Year	3 Years	5 Years	7 Years	10 Years	Since Inception 06-30-88
HCM Gross of Fees	-29.00%	-19.26%	-1.03%	1.08%	5.03%	8.84%	12.73%
HCM Net of Fees	-29.25%	-20.12%	-2.03%	0.07%	3.99%	7.77%	11.64%
Russell Mid Cap Value Index	-31.71%	-24.13%	-5.97%	-0.76%	4.07%	7.22%	10.02%
Russell Mid Cap Index	-27.07%	-18.13%	-0.81%	1.85%	6.35%	8.27%	10.31%

Link to: HCM Performance Disclosures

PORTFOLIO ACTIVITY

The nature of the shock to our economy experienced during the Covid-19 pandemic is unique in our time. The depth and length of the accompanying recession is unknowable and the impact across industries is only starting to be ferreted out. As such, we chose not to actively adjust the portfolio during the quarter, instead opting to re-underwrite each of our current positions for strength of liquidity and solvency in the face of this unprecedented period. On that basis, we certainly like what we already own, even though we are aware that some of our portfolio companies will be more affected by the economic shutdown than others. We are always very deliberate and analytical about our current investments and of the potential opportunity cost of doing nothing. For the short term we are content to closely analyze the evolving environment for risk assets and wait for the extraordinary opportunities that we believe lie ahead. For now, we are taking a hard look at what we own in this context and would expect to be significantly more active in the weeks and months ahead. We have a plan; we are simply being patient.

A good example is retailer Ross Stores, which as we speak, has shuttered each of its more than 2000 stores across two brands. Despite having ZERO revenues at present, Ross has over $2 billion in liquidity compared to annual rent expense of approximately $500 million. Its credit rating was reaffirmed by Moodys on April 2nd at A2, with Moodys citing its strong balance sheet, liquidity profile and flexibility in its cost structure. We have absolutely no idea what Ross will earn in 2020, we hope it will be a positive number but that really depends on how long the economy will be locked down. What we do have a high degree of confidence in is Ross' ability to weather the current conditions and to take substantial additional market share in the years ahead. We suspect that much of this market share will come at the expense of the dying mall-based department store business model but also from the many independent retailers and less well-capitalized chains against whom Ross competes. Ross took stunning amounts of market share during the Great Financial Crisis of 2008, demonstrating the consumer appeal, flexibility and profitability of its business model.

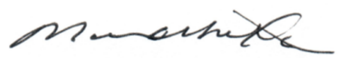
Outlook

Only during extraordinarily difficult markets are extraordinary returns available for a properly diversified, risk-managed portfolio of equity assets. We are on the precipice of such an opportunity. Our first goal has and always will be to own assets that dramatically lower the risk of permanent impairment of capital during periods such as this. Time will tell whether we have been successful, but we are no less confident today than any time in our history. In the short term we have experienced a significant drawdown while still outperforming our benchmark. We expect as the market slowly sorts through the ultimate winners and losers, our risk management-first approach will again shine through. In the meantime, we would like to leave you with the thoughts of Jeremy Grantham, whose investment career spans six decades and whose thoughts from his analysis of the opportunity presented by the Great Financial Crisis of 2008 echoes with us again today. This excerpt was first published on March 10, 2009, within just a few days of the ultimate market low, with the S&P 500 down 60% from its highs and the market in a pure panic:

> "It was psychologically painful in 1999 to give up making money on the way up and to expose yourself to the career risk that comes with looking like an old fuddy duddy. Similarly, today, it is both painful and career risky to part with your increasingly beloved cash, particularly since cash has been so hard to raise in this market of unprecedented illiquidity. Every decline will enhance the beauty of cash until, as some of us experienced in 1974, 'terminal paralysis' sets in.

“There is only one cure for terminal paralysis: you absolutely must have a battle plan for reinvestment and stick to it. I recommend a few large steps, not many small ones. A single giant step at the low would be nice, but without holding a signed contract with the devil, several big moves would be safer. It is particularly important to have a clear definition of what it will take for you to be fully invested. Without a similar program, be prepared for your committee’s enthusiasm to invest (and your own for that matter) to fall with the market. You must get them to agree now – quickly before rigor mortis sets in. Remember that you will never catch the low. Sensible value-based investors will always sell too early in bubbles and buy too early in busts. But in return, you may make some important extra money on the roundtrip as well as lowering the average risk exposure.”

Sincerely,



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