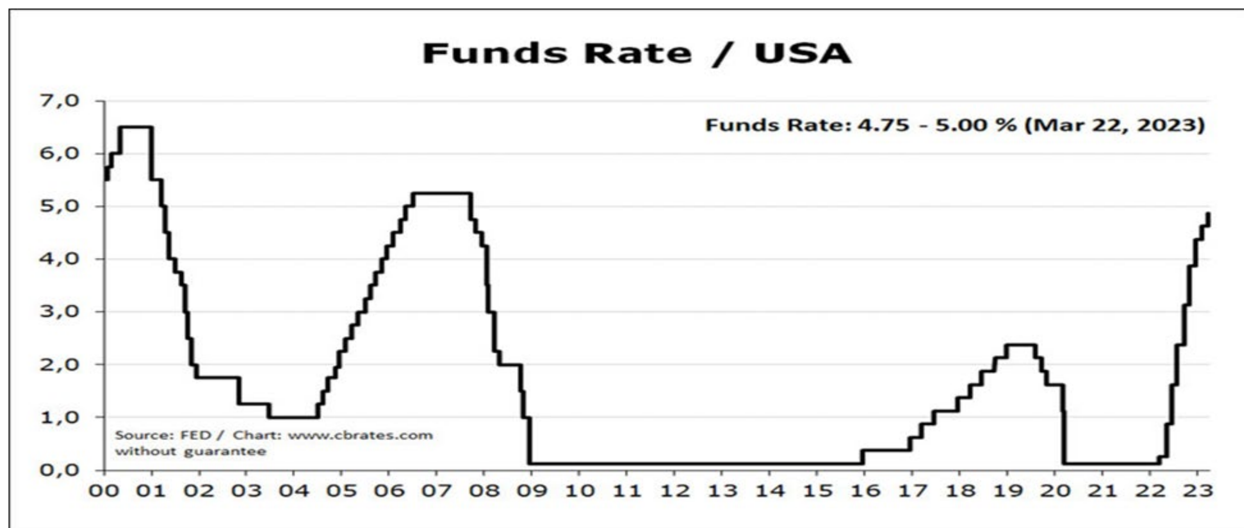
HAHN CAPITAL MANAGEMENT, LLC
REGISTERED INVESTMENT ADVISORS

Mid Cap Equity Strategy **1st Quarter 2023 Commentary**

The Law of Unintended Consequences
(The Fed Finally Broke Something)

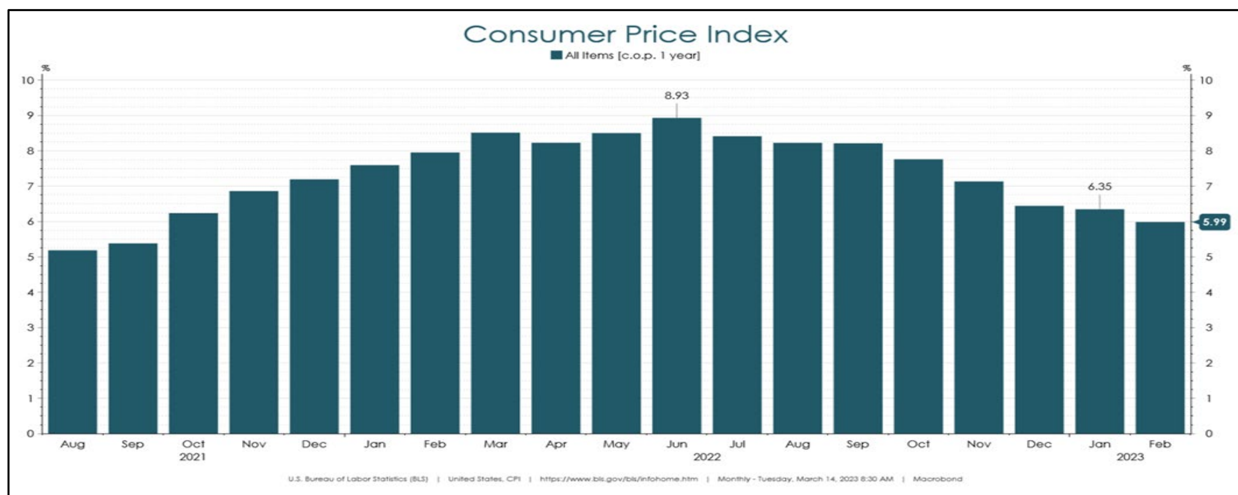
We have lamented in past letters and privately to our clients over the past several years about the outsized impact that the Federal Reserve Bank has had on the economy and real price discovery in financial markets. Our sense for many years has been that due to the hyper-financialization of the broader economy and an overly indulgent Federal Reserve, the real economy had become addicted to cheap money and that there would come a day when this would have an outsized impact on the real economy and could be potentially devastating to the financial economy. In the first quarter of this year, some of our fears were realized in a particularly sinister way.

We have made no secret about our disdain for the extreme degree of monetary ease that has existed since the Great Financial Crisis (which itself was a creation of easy money from former Fed Chair Alan Greenspan in response to the bursting of the Internet Bubble of the late 1990s). The following chart plots the course of the Effective Federal Funds Rate from 2000-2023. Note that the target rate for the primary monetary tool used by the Federal Reserve to affect the cost of money stayed at zero early 2009 to early 2016, almost 7 years! This zero-rate period was intended to allow the financial sector to rebuild its collective balance sheet that was left in tatters by the impact of excess leverage on credit losses during the Great Financial Crisis. When the Fed attempted to raise rates so that real yields wouldn't remain negative (punishing the savers among us), it was met by a period of severe bond and stock market volatility (popularly referred to in 2019 as the "Taper Tantrum" because the Fed was attempting to shrink its own bloated balance sheet, the result of its massive quantitative easing program). This signaled confirmation to us (at Hahn Capital) that markets faced a cheap money addiction that was perhaps a larger problem than the Fed either could or was willing to deal with. The Fed eased several times during 2019 in response to this market volatility and then in March 2020, the pandemic hit.



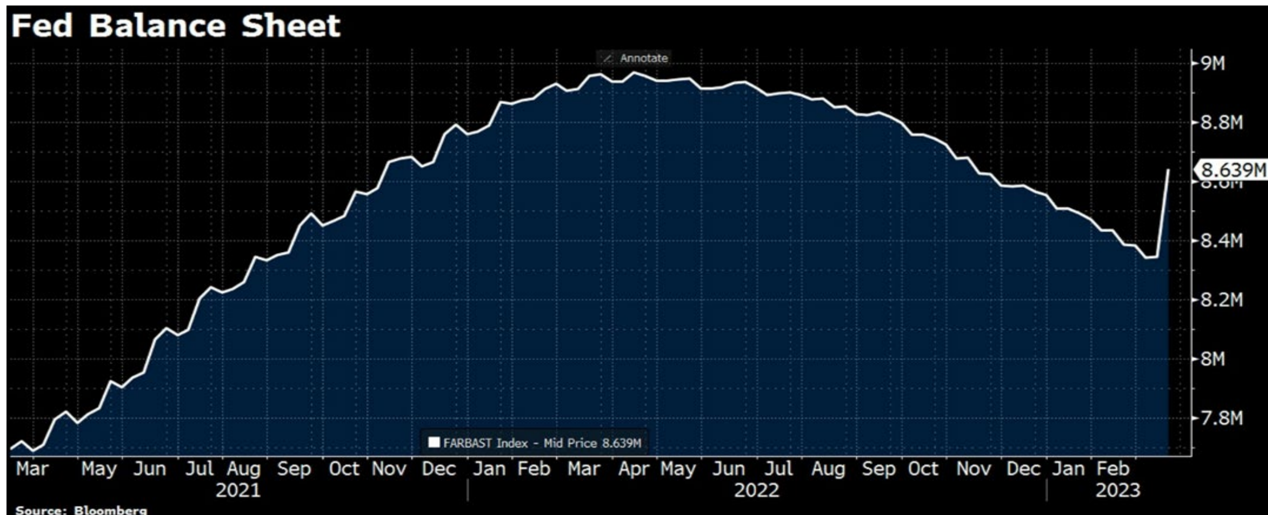
Source: cbrates.com

In response to the effective shutdown of the U.S. economy, the Fed quickly dropped the Fed Funds rate to zero once again and left it there for another two full years. In addition, fiscal policy became ultra-stimulative as well with the U.S. Government spending an extra $5.2 trillion during the pandemic to directly support the U.S. economy. This combination of extraordinary monetary ease and fiscal largesse stoked the fires of the most significant spike in inflation since the 1970's. By early 2022, The Fed realized it had a significant problem on its hands, with headline inflation reaching a peak of 9% by June of that year. The following chart shows the sharp inflation, labeled by the Fed as a "transitory" issue caused primarily by snarled supply chains and other real economy dislocations caused by the interruption of normal business during the pandemic. In fact, the CPI remained well above the Fed's target rate of 2% for over a year before the Fed acknowledged it had a problem on its hands.



Source: Federal Reserve

Belatedly recognizing its policy mistake, the Fed set about to quell the inflation which it had created by rapidly raising rates throughout 2022 and into 2023. The Fed also attempted to shrink its balance sheet by starting to allow its massive holdings in Treasury securities to run-off (maturing securities were not replaced with new open market bond purchases)–its first attempt since 2019 at allowing the longer-dated securities to find their own price/yield level determined solely by the forces of supply and demand, i.e. real price discovery. Starting very slowly in May of 2022, the Fed started shrinking its holdings of Treasuries, even daring the market to balk by selling some securities directly into the market as the year progressed. The Fed was able to shrink its balance sheet by about $500 billion over the course of the second half of 2002 and the first two months of 2023.



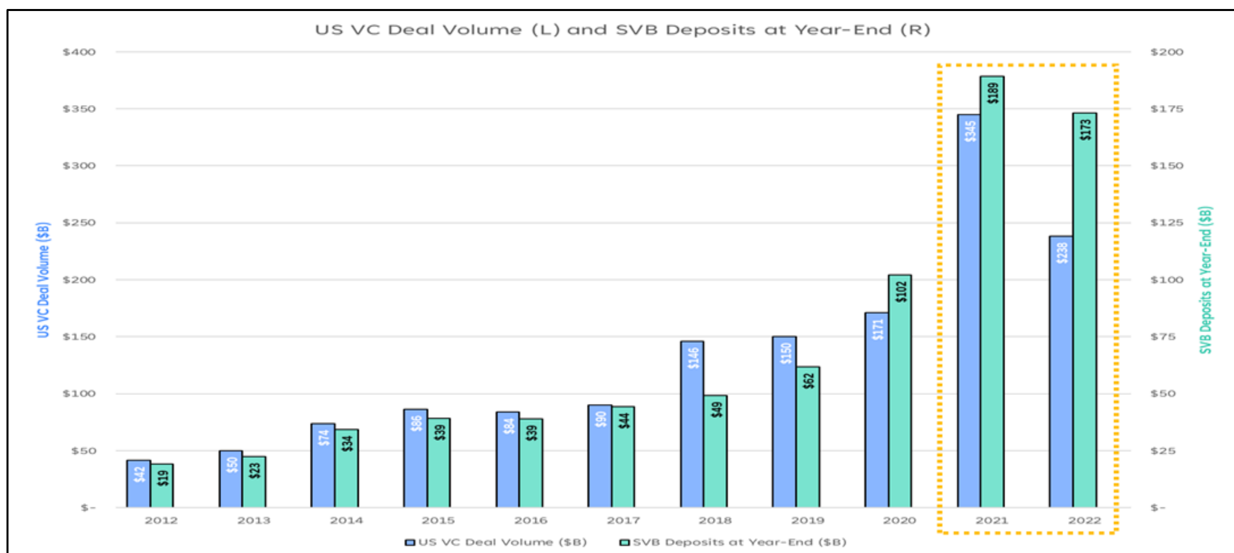
Source: Bloomberg

Insofar as the Fed's goals were reducing inflation and letting bond yields rise to slow end demand in the economy, the strategy was moderately effective with inflation easing to a more moderate (but still far too high) level of 6% by February of this year, while 30-year Treasury rates rose from a pandemic low of approximately 1.5% to a more recent yield of 3.65% after topping 4% in the third quarter of 2022. With employment numbers remaining strong, there was even widespread talk in the financial press of a "soft landing" or even "no landing" whereby the Fed would skirt a painful economic contraction despite engineering monetary conditions much tighter than had been experienced in the post Great Financial Crisis era. Then the Fed finally broke something.

Enter Silicon Valley Bank, ranked the 16th largest bank in the United States, with approximately $209 billion in assets. Founded in 1988, Silicon Valley Bank had become over its 30-year history, the bank of choice for the $2 trillion venture capital industry and an estimated 40-50% market share in this business. As the last several years clearly demonstrated, the venture capital industry had experienced a golden era, with the industry investing $345 billion in 2021 alone, followed by $238 billion in 2022. As the venture capital industry went, so did Silicon Valley Bank, whose deposits skyrocketed to $189 billion in 2021 from $62 billion in 2019. Forced to find a useful place to deploy that amount of liquidity flowing in, Silicon Valley resorted to buying U.S. Treasury and other agency-backed securities, in huge amounts and with very long maturities. At the time of its collapse, Silicon Valley Bank approximately 57% of its assets were invested in Treasuries, mortgage-backed securities, and other "high quality liquid assets." About $29 billion or 14% of that total were classified as "Available for Sale" and another $91 billion were classified as "Held to Maturity." GAAP accounting standards for banks require banks to classify these holdings separately because "Available for Sale" assets are marked-to-market at least quarterly and the gains or losses on these securities run through the equity portion of the balance sheet, while "Held to Maturity" assets are valued at par (as they are assumed to be riskless if in fact they are held until they mature).

Silicon Valley Bank faced a tricky proposition because of the massive inflows of deposits during the boom years of the pandemic era. At the time these deposits were flowing into the bank, short-term interest rates were effectively zero and the bank couldn't refuse the business of their core customers, so management chose to reach for yield by choosing to buy longer-term Treasuries rather than earning next nothing on incremental deposits, which tripled over a 3-year period. This was a fatal error. Matching the duration of assets and liabilities is Banking 101, and, while it is

never easy, the Fed's decision to keep interest rates so low for so long, made the choice of how to invest those incremental deposits as psychically difficult as possible. Silicon Valley Bank could either crush their own profitability by investing two-thirds of those deposits at effectively no return or take the risk that the deposit base was sticky enough to take the extra liquidity risk (asset/liability duration mismatch) so they could earn a "reasonable" return on those assets. Deposits had not declined materially at the bank since the Great Financial Crisis and the consensus was that the venture capital industry was extremely well capitalized. The following chart shows the tight correlation between the rapid growth of both the U.S. venture capital industry and the deposit base at Silicon Valley Bank.



Source: The Information VC Survey

Fast forward to February 2023 and Silicon Valley Bank knew that they had a major problem on their hands. The venture capital industry was experiencing a downturn, with venture-backed firms burning through cash at an increasing rate. The industry was seizing up as the venture capital firms were asking for onerous (relatively speaking) terms for additional equity investments, and the venture-backed firms were starting to husband their own liquidity situations in a material fashion. Deposits were flowing out of Silicon Valley Bank as these start-ups burned cash, and the bank was getting desperate to raise additional funds to support the demand from its clients. The bank was literally running out of cash. On March 8, the bank made the fateful but necessary decision to sell almost $21.5 billion in Treasury securities to Goldman Sachs but in the process was forced to recognize a $1.8 billion loss as the securities were held on its books for just under $24 billion. This loss left the bank in a very difficult position, as its tangible book value declined by 14% as a result of the transaction. The bank hastily tried to organize a common stock sale of $2.25 billion, but the damage done to the bank's credibility and its extremely poor liquidity situation caused a crisis of confidence among depositors. It has been reported that Silicon Valley Bank's top 10 depositors alone combined for more than $13.3 billion of the bank's deposit base. From the time of the original announcement of the bond sale to Goldman Sachs on March 9 to the bank's seizure by the FDIC on Friday, March 12, the customers of the bank had all tried to get to the exits at once – a classic "run on the bank." An associated but not related event that occurred virtually simultaneously was the federal banking regulators decision to shutter Signature Bank, a New York-based bank that had come under heavy criticism for material violations of numerous federal banking statutes including "know your customer" rules as well as wire fraud and money laundering due to its known involvement as the bank of choice (along with Silvergate, which itself had

announced its decision to liquidate more than a week earlier) for the crypto asset industry. Signature Bank, which itself had $110 billion in assets at the time of its seizure, was at the time, the 29th largest bank in the U.S.

More Collateral Damage Around the Corner

In the space of a day, two of the top 30 banks in the country were seized by federal banking authorities and depositors were terrified. The limit of Federal Insurance is $250,000 per customer and, based on this limit, 93.8% of Silicon Valley Bank's customer deposits were at risk of loss. At Signature Bank, a similarly terrifying 90% of deposits were uninsured. Crucially, the federal regulators were not immediately aware, nor did they actually make the decision to ultimately guarantee the depositors at Silicon Valley Bank and Signature Bank until Sunday, March 14. In fact, due to the Dodd-Frank legislation that came into law during the wake of the Great Financial Crisis, federal regulators did not have the authority to guarantee deposits system wide and banks which had not yet failed. Stoked by fears that were transmitted by social media outlets, a panic started among otherwise healthy banks. This started a cascading run on other, smaller regional banks, particularly those that had a high percentage of uninsured deposits, particularly those located on the West Coast, nearest to the epicenter of the panic. The following table lists the top 10 U.S. banks by percentage of uninsured deposits. Importantly, the largest of the banks on this list, money center giants ranging from BNY Mellon, Citigroup, State Street and Northern Trusts (as well as others not listed here including Wells Fargo, JP Morgan and others enjoy an implicit guarantee of the U.S. Treasury by virtue of their "Too Big To Fail" de facto designation). This is an explicit guarantee of the U.S. government by virtue of their systemic importance to the health of the U.S. financial sector.

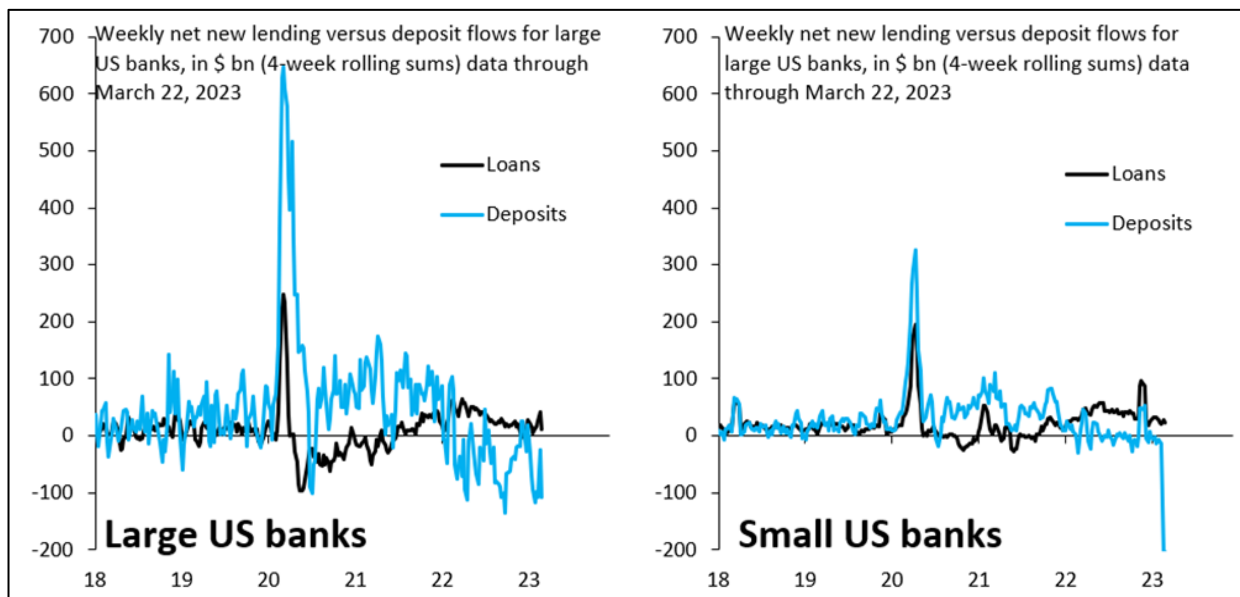
1. BNY Mellon, $BK: 97%
2. SVB, $SIVB: 94%
3. State Street, $STT: 91%
4. Signature, $SBNY: 90%
5. Northern Trust, $NTRS: 83%
6. Citigroup, $C: 77%
7. HSBC Holdings, $HSBA: 73%
8. First Republic Bank, $FRC: 68%
9. East West Bancorp, $EWBC: 66%
10. Comerica, $CMA: 63%

Source: FDIC

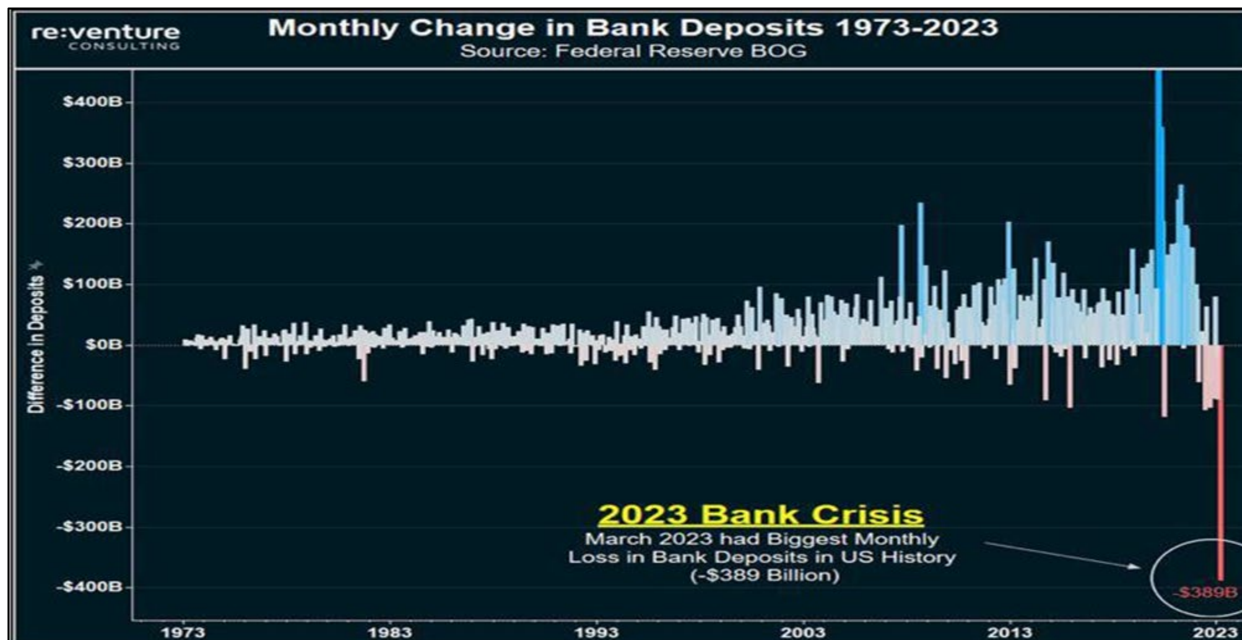
The remaining banks, those that did not enjoy this explicit guarantee faced extreme deposit flight in the ensuing weeks of the crisis, culminating in other extraordinary measures by regulators to try and stem the tide. First Republic Bank, a holding of ours, was one such casualty of the panic. While the entire regional bank group was hit extremely hard during the last several weeks of March, First Republic was devastated, with reports estimating that nearly 40% of First Republic's deposit base fled within a week of the closure of Silicon Valley Bank and Signature Bank. It's worth noting that we held First Republic in the highest regard as a banking institution as did the rest of the banking world. Loved by its customers (generally unheard of in banking), conservative, well-capitalized, meticulous managers of credit risk and with a differentiated approach to banking, First Republic was amongst the best banks in the U.S., in our view. In the end, this did not matter.

Because of the Dodd-Frank legislation, the foot-dragging of federal regulators and the social media-stoked panic of terrified depositors, First Republic was wrecked as a financial institution in a matter of days.

Legislation and regulation that guarantees the survival of large banks but not those of the regional bank system has created a two-tier system. Why, as a depositor, would you ever risk keeping uninsured deposits at a regional bank considering this crisis? It may have been unintentional in nature, but the fact remains that if the events of March have proven anything, it's that no regional bank in the nation represents an acceptable risk, either from the perspective of the depositor or of an equity investor. If it (deposit flight) can happen to First Republic, it can happen to any regional bank in the nation. The lesson of First Republic is highlighted in the chart below. In addition, as bank credit losses intensify during the inevitable downturn that the economy is facing, the pressure on regional bank deposit bases will only intensify. We believe we have not witnessed the last chapter of this story. Deposits continue to flee smaller banks, and even to some degree, larger banks, as the Fed has made moving that cash to Money Market Funds, so much more attractive. Funding costs pressure will continue to ramp up for regional banks, something which we had anticipated but as banks start to experience certain credit losses, that deposit flight can intensify catastrophically, with little or no warning. The following charts show the ongoing flight of deposits out of smaller banks during March and the overall flight of deposits out of banks into Treasuries. Both charts should terrify the Fed.



Source: The Federal Reserve



Source: FDIC

Quarterly Performance

The return for the Hahn Capital Management Mid-Cap Value Composite (see table below) was -3.25 gross of fees and -3.50 net of fees in the first quarter of 2023. For the quarter, we underperformed our primary benchmark, the Russell Mid-Cap Value Index, by 4.57 percentage points gross of fees. For the quarter, sector allocations to Information Technology, Energy, Utilities (no holdings), Industrials, and Consumer Staples (no holdings) (relative to the benchmark) contributed, while those to Materials, Financials, Real Estate, Consumer Discretionary, Communication Services, and Healthcare detracted. The most significant relative performers during the quarter were Euronet Worldwide (EEFT), Advanced Micro Devices (AMD), Equinix (EQIX), PVH Corp (PVH) and Liberty Media (FWONK), while the most significant underperformers First Republic Bank (FRC), SLM Corp (SLM), Keysight Technologies (KEYS), Black Knight (BKI) and Ross Stores (ROST).

Hahn Capital Quarterly Performance Attribution – 1Q 2023

LINKED PERFORMANCE BY SECTORS

BENCHMARK: Russell Midcap Value Index
PORTFOLIO: Representative 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
Financials	20.50%	18.54%	1.96%	-16.52%	-7.44%	-9.08%	-0.17%	-1.95%	-2.12%	0.00%	-2.12%
Information Technology	12.57%	8.18%	4.40%	2.47%	12.02%	-9.55%	0.44%	-1.14%	-0.70%	0.00%	-0.70%
Real Estate	17.27%	10.55%	6.72%	-4.16%	0.38%	-4.53%	-0.08%	-0.79%	-0.87%	0.00%	-0.87%
Industrials	17.02%	16.44%	0.58%	2.55%	6.61%	-4.07%	0.02%	-0.66%	-0.64%	0.00%	-0.64%
Health Care	12.15%	7.32%	4.83%	-4.22%	0.38%	-4.60%	-0.05%	-0.57%	-0.62%	0.00%	-0.62%
Consumer Discretionary	7.36%	9.92%	-2.56%	1.68%	6.55%	-4.86%	-0.07%	-0.32%	-0.39%	-0.01%	-0.40%
Materials	3.34%	7.83%	-4.49%	2.12%	4.98%	-2.86%	-0.17%	-0.08%	-0.25%	0.01%	-0.24%
Communication Services	2.08%	3.22%	-1.14%	25.18%	7.33%	17.85%	-0.06%	0.31%	0.25%	0.00%	0.25%
Energy	2.09%	5.10%	-3.01%	-0.59%	-7.06%	6.47%	0.31%	0.16%	0.47%	-0.01%	0.46%
Consumer Staples	0.00%	4.26%	-4.26%	0.00%	1.44%	-1.44%	0.02%	0.00%	0.02%	0.00%	0.02%
Utilities	0.00%	8.64%	-8.64%	0.00%	-1.68%	1.68%	0.31%	0.00%	0.31%	0.00%	0.31%
Cash	5.61%	0.00%	5.61%	1.15%	0.00%	1.15%	-0.06%	0.00%	-0.06%	0.00%	-0.06%
Total Portfolio - Net of Fees				**-3.18%**	**1.43%**	**-4.61%**	**0.43%**	**-5.04%**	**-4.61%**	**0.00%**	**-4.61%**

Relative Performance by Stock – Quarter Ended March 31, 2023

Quarter Ended 03/31/2023 - 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	EURONET WORLDWIDE INC	0.87%	1	FIRST REPUBLIC BANK/CA	-1.56%	1	Energy	0.46%	1	Financials	-2.12%
2	ADVANCED MICRO DEVICES	0.58%	2	SLM CORP	-0.82%	2	Utilities	0.31%	2	Real Estate	-0.87%
3	EQUINIX INC	0.34%	3	KEYSIGHT TECHNOLOGIES IN	-0.81%	3	Communication Services	0.25%	3	Information Technology	-0.70%
4	PVH CORP	0.32%	4	BLACK KNIGHT INC	-0.64%	4	Consumer Staples	0.02%	4	Industrials	-0.64%

HCM MID-CAP VALUE COMPOSITE PERFORMANCE HISTORY

% Annualized Returns As of 03/31/2023	1Q 2023	1 Year	3 Years	5 Years	7 Years	10 Years	Since Inception 06-30-88
HCM Gross of Fees	-3.25%	-11.73%	16.84%	6.37%	8.42%	8.44%	13.08%
HCM Net of Fees	-3.50%	-12.64%	15.71%	5.32%	7.36%	7.38%	11.98%
Russell Mid Cap Value Index	1.32%	-9.22%	20.69%	6.54%	8.33%	8.80%	10.91%
Russell Mid Cap Index	4.06%	-8.78%	19.20%	8.05%	9.88%	10.05%	11.05%

Link to: HCM Performance Disclosures

PORTFOLIO ACTIVITY

New Positions

There were no new positions during the quarter.

Positions Increased

Alexandria Real Estate (ARE) – We added to our position in Alexandria during the quarter. We view Alexandria as perhaps the best-run, most strategically-advantaged real estate owner in the country. The company services the world's largest and best-capitalized Pharmaceutical and Bio-Pharmaceutical companies by providing them with cutting edge office/lab campus environments, Alexandria has an incredible pipeline of projects, soaring demand for its real estate and is extremely well capitalized to continue taking advantage of its leadership position. It should serve as an excellent hedge against inflation but should also benefit if the Fed is forced to aggressively cut rates at some point later in 2023.

Occidental Petroleum (OXY) – We added to our position in Occidental Petroleum during the quarter as we became increasingly comfortable with both management execution of its business strategy as well as underlying fundamentals in the oil market globally. For the past 15 years, the global energy market has invested in additional energy production assets at about 1/3 of the rate of the previous 50 years.

Despite the pandemic, slowing growth in developed markets and the sale of a substantial portion of the U.S. Strategic Petroleum Reserve, oil prices have remained stubbornly high. With China gradually emerging from three years of Covid-related lockdowns and rising geo-political tensions globally, we expect that this will remain the case for the foreseeable future.

SBA Communications (SBAC) – We increased our position in SBA Communications during the quarter as this dominant provider of wireless infrastructure continues to see strong demand for its real estate as carriers continue to deploy 5G services for in the U.S. and abroad. While all REITs have suffered due to rising interest rates, SBA is among the best-capitalized companies in the industry and very well situated to take advantage of dislocations that may arise from the rising pressure of those rates on the capital structures of competitors.

Positions Reduced

There were no positions reduced during the quarter.

Positions Sold

First Republic Bank (FRC) – We exited our position in First Republic Bank for the reasons stated in the main body of the newsletter. Congress, federal regulators and the Treasury Department have made the regional banking model untenable in the U.S. until such time as deposits are guaranteed on a nationwide basis, which would effectively end the possibility of bank runs on healthy, well-capitalized banks that don't currently enjoy the same protection that is provided to SIFI-designated banking companies. Watching a healthy, proud, extremely well-run bank like First Republic get destroyed in less than two weeks has more than amply demonstrated the two-tier system that legislators, regulators and bureaucrats have inadvertently created in the financial sector.

Sallie Mae (SLM) – For similar reasons, we have exited our position in Sallie Mae, which in addition to being vulnerable to the same pressures that caused First Republic to succumb has additional political liability as the nation's top private student lender.

East West Bancorp (EWBC) – We exited our position in East West Bank during the first few days of April. While this transaction technically took place shortly after the end of the quarter, we have made the decision to disclose it in this report as it represents our other remaining exposure to regional banks and this transaction was consistent with the other actions that also took place during the quarter.

Carters, Inc. (CRI) – We exited our position in Carters during the quarter after a 11-year holding period marked by excellent returns but ultimately somewhat disappointing execution by its senior leadership. Carters was one of those investments that was successful in terms of long-term performance but left us wanting so much more. The company still enjoys an impressive advantage as one of the largest clothing brands in the world; dominating the industry of children's clothing manufacturing. The company has built a significant direct-to-consumer business and has industry leading margins. It has, however, failed to execute a coherent (or profitable) strategy for international expansion, has been a poor acquiror of businesses and it's retail strategy has suffered from poor execution, flagging profitability and a seeming lack of focus. Ultimately, we made the decision that, given the opportunities we were seeing in our own portfolio for better returns, that the capital allocated to Carters should be withdrawn.

Outlook

Economic & Market Outlook

We have the highest bond volatility in history, the war in Ukraine looks to have no end, and monetary authorities have moved the interest dial into a position which was finally able to "break something." This is partly their strategy, partly a fall-out from a singular focus on fighting inflation without addressing what else might be at risk. The jarring market events in March also mean that Fed Chair Powell may ease again after all. As we look forward to the end of this year, we don't know whether the Fed will deliver another 75-100 bps hikes to fight inflation or cut by 75 bps to protect the fragile bank system and the taxed economic system behind it.

Since Long Term Credit Management (LTCM) went bust in 1998, the world's central bankers have used low interest rates and ever larger liquidity injections to induce more and more risk-taking without ever forcing too-leveraged banks and risk takers to take a loss, with the Lehman bankruptcy the exception that really proved the rule on the enormous ensuing bailout during the Great Financial Crisis. Fast forward to today and we see the March intervention in the wake of the Silicon Valley Bank (SVB) collapse and then the Credit Suisse takeover by UBS arranged and subsidized heavily by the Swiss National Bank. There is even sudden talk of insuring all deposits to prevent bank runs. Are all financial institutions now moved into the "systemic" category? We would argue that unless the Fed and regulators want to witness multiple bank runs during the next downturn, they should seriously consider exactly that. This banking crisis so far is not about the solvency of banks, but whether the banks can continue to operate profitably if funding costs rise and funds actually "go elsewhere". How about a US 6-month Treasury yielding 4.50%, for example? Big banks can only run with enough liabilities, deposits, to fund their assets. For whatever reason, but especially in a panic, if clients withdraw money, it forces banks to liquidate assets. That's what this crisis is about.

We are strategizing for a more volatile and risky world, a world in which there is an acute need for global companies to secure access to energy, other vital resources, supply chains and computer power (mostly in the shape of semiconductors). The dominant trend appears to be toward deglobalization, but while the world is still global in its trade, it's just fragmenting more into blocs. Navigating these fragments will be key in investing not only this year but for the coming decades. Being both strategic and tactical has never been more important, as a fragmenting and partially deglobalizing world brings new production capacities where none existed before to secure supply chains, which will bring huge investments, as will the ongoing green transformation. Other fragments, on the other hand, may have excess capacity.

Portfolio Strategy & Positioning

We remain focused on infrastructure of all types, real estate, construction, associated services (consulting, leasing), computing power (semiconductors, 5G, process improvement). These are extremely long tailed investment themes where we own dominant companies that are well capitalized to take advantage of these market opportunities. We remain incrementally positive on many different markets for hard assets including energy, materials and industrial capacity and believe that these markets will thrive despite the underlying fragility of the current financial system. Finally, we are very positive on the outlook for those companies that are able to navigate risky markets and take advantage of volatility to deliver value for customers, especially exchanges and fee based trading companies.

We remain focused for the long-term, on process and risk, with the goal of sustainable wealth creation. Without your understanding and support in this effort, it would truly be a fruitless enterprise, particularly considering the more volatile markets we are now experiencing. We wish you the best in the remainder of 2023.

Sincerely,

John Schaeffer
President and CIO

Michael Whitfield
Dir. of Research and Co-Portfolio Manager