HAHN CAPITAL MANAGEMENT, LLC
REGISTERED INVESTMENT ADVISORS

Mid Cap Equity Strategy **1st Quarter 2024 Commentary**

Source: Hedgeye

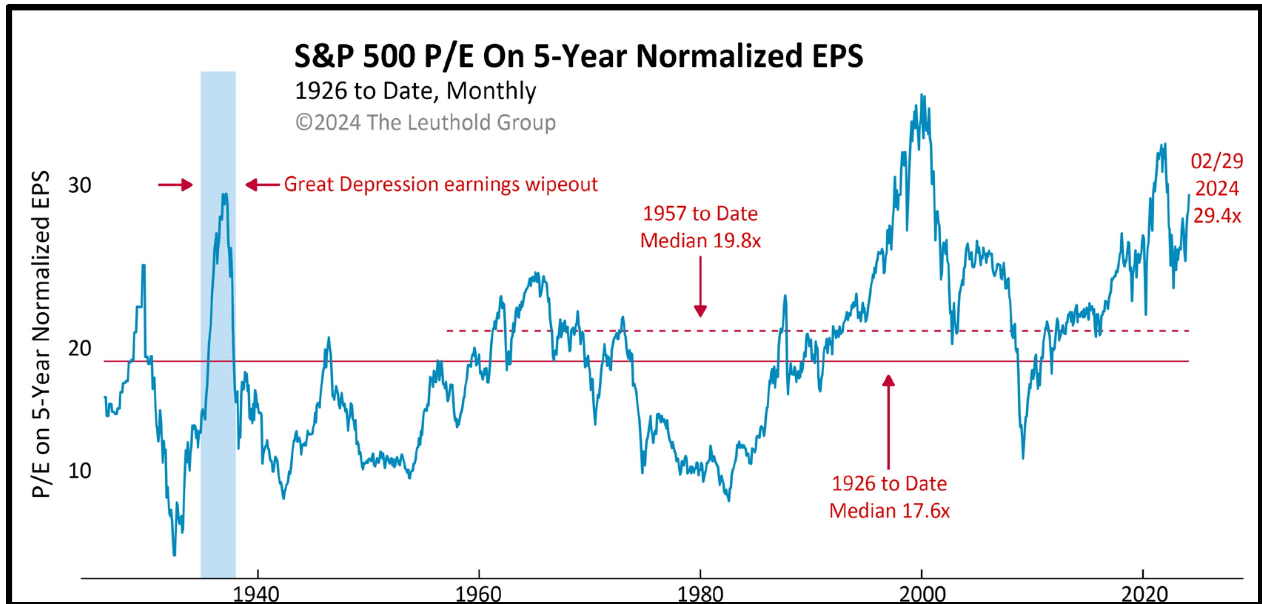
A World of Cognitive Dissonance

It's important to step back and reflect, from time to time, on the difference between the way that financial markets behave and the way that investors think they should behave. The past five years have witnessed the following list of events, each of which might have been expected to impact the stock market in a meaningful way:

A once-in-a-century global pandemic, relegating billions of people to shelter in place, bringing entire industries to a screeching halt; U.S. inflation rising from 1.9% to over 9%, before settling in at 3.2% (68% higher); the U.S. Federal Funds Rate more than doubling, from 2.4% to 5.3%. mortgage rates in the U.S. rising from 3.0% to 7.0%; the U.S. federal debt increasing from $22 trillion to $34 trillion, with ballooning deficits; U.S. productivity trending below historical averages; a regional banking causing the failure of several medium-sized banks; the U.S. economy growing real GDP at a below-average rate of only 2.1%; global GDP growth experiencing its weakest half-decade in 30 years; a cold war with China, a proxy war with Russia (via Ukraine), and the Middle East aflame. And most recently, deepening political dysfunction, creating a massive cultural divide within the U.S.

Over that same 5-year period, the S&P 500 Index is up 102% (vs. 48% for the Russell 2000 and 42% for the MSCI EAFE USD). The S&P 500 component companies grew earnings by ~37% (2.7% annualized) cumulatively, accounting for about a third of the index's total return (with multiple expansion making up the majority). The underlying earnings growth was boosted spectacularly by the Magnificent Seven (Apple, Microsoft, Alphabet, Amazon, Nvidia, Tesla, and

Meta Platforms), as the average company grew earnings at only 0.6%. Normalized valuations in the S&P 500 have increased considerably, as seen in the chart below.

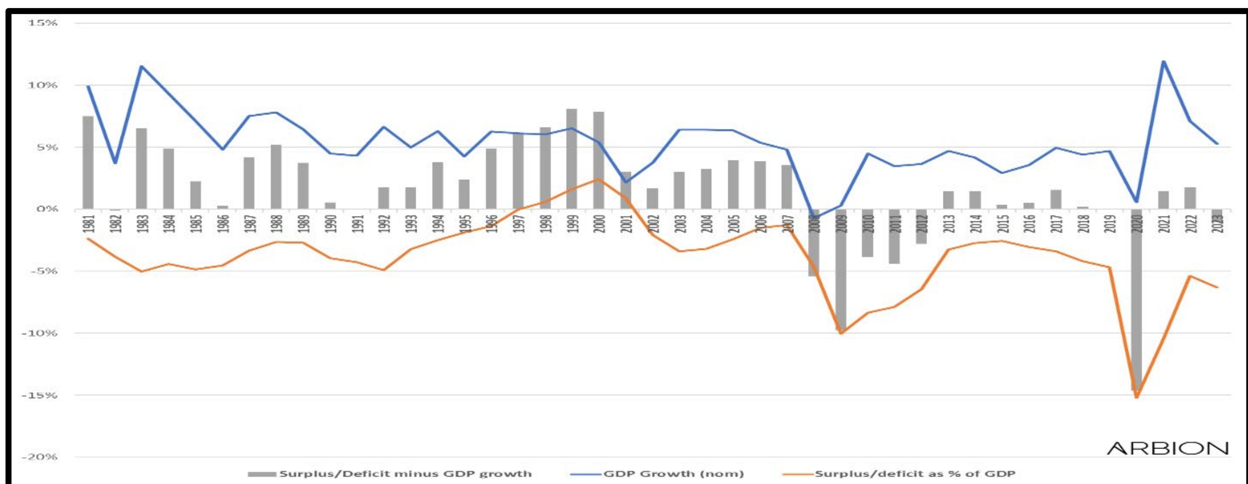


Source: Leuthold Group

Most importantly, the S&P 500 is currently in the 10th decile of historical valuation (on 5-year normalized earnings), one of the most expensive stock markets on record. Since 1926, when starting in the 10th decile of valuation, the forward 10-year returns have averaged only 4.1%. This pales in comparison to the ~15% compound annual return of the last 5 years.

Given the laundry list of factors listed above, and relatively modest earnings growth outside of the Magnificent, why did valuations (the stock market price/earnings ratio) expand so dramatically over the most recent 5-year period? The quick answer is a combination of massive deficit spending and monetary policy, more specifically on-going liquidity support from the Federal Reserve Bank.

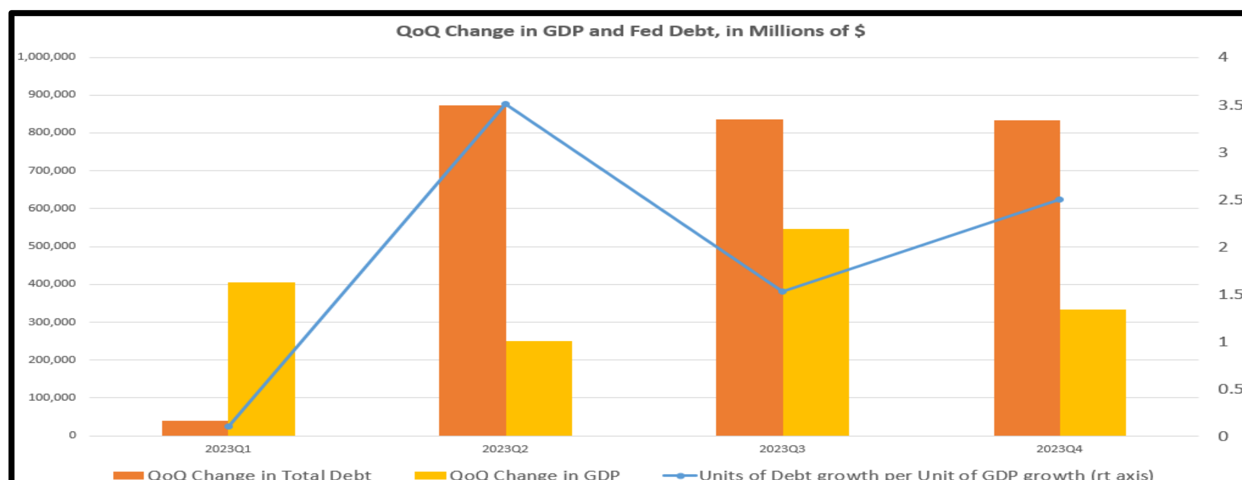
The US is currently running a $1.7 trillion budget deficit, the equivalent of 6.3% of GDP. This outpaces nominal GDP growth of just over 5%. The chart below highlights how important deficit spending has become after the financial crisis to prop up US GDP growth.



Source: Arbion

On February 28th of this year, the federal government's Bureau of Economic Analysis released its revised estimate for GDP growth in the fourth quarter of 2023. According to the report, total GDP

increased $334.5 billion (quarter-over-quarter) during the fourth quarter. That's down from the third quarter's quarter-over-quarter increase of $547.1 billion but is nonetheless an ostensibly robust rate of growth. Yet, if we compare GDP growth during the fourth quarter to growth in the total national debt, we find that the numbers don't look quite so robust after all. While GDP may have grown by $334 billion during the period, the national debt grew by more than twice as much; $834 million. In other words, for every dollar of GDP growth, the national debt grew by $2.70. Moreover, this is the third quarter in a row during which debt growth has substantially outpaced GDP growth. During the third quarter, the federal debt grew $1.50 for every dollar of GDP growth. Even as the budget deficits have continued to rise, the incremental impact of deficit spending on GDP growth has weakened. Nonetheless, GDP growth has been propelled forward by the largest sustained budget deficits since the World War 2 era.



Source: NBER

Of course, the well-publicized rise in inflation that has taken place since starting in 2022 was a direct result of constrained capacity coupled with the above-mentioned deficit spending and easy monetary policy. In response, the Federal Reserve Bank sharply raised short-term interest rates from zero to the current 5.25%, inverted the yield curve and made numerous public statements about the need to raise unemployment and slow aggregate demand growth. Still, as of the recently released first quarter 2024 National Account statements, nominal incomes are growing at 6%, and real GDP is cruising along nicely at around 2%. The labor market is still holding up quite well with the rate hovering around 3.5%, and there are no clear signs of broad economic weakness. How can we square this with one of the most aggressive FEDS hiking cycles in history which brought Fed Funds above 5% for almost a year and counting?

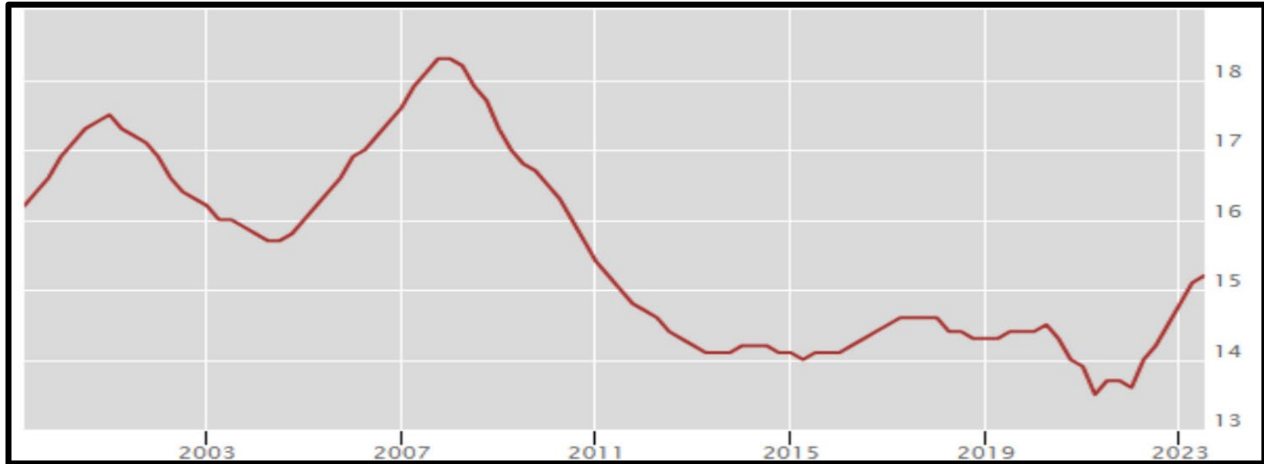
The answer lies in private sector balance sheets and fiscal stimulus. Higher interest rates generally slow down economic activity: corporates and households face higher debt servicing costs and therefore they must cut capex/hiring/spending to allocate more resources to debt servicing, i.e. lower spending = a slowing economy. In other words: higher rates tend to negatively affect the liability side of private sector balance sheets. But this time that's going to take much longer, and in the meantime the opposite is happening.

This is a summary of what is taking place in the economy now.

1. **Continued fiscal stimulus:** checks and lower taxes increased the private sector net worth.
2. **Higher rates provide an additional income boost:** households and corporates can park money at 5% T-Bill yields and harvest the benefits of higher rates.

3. **Higher rates are not affecting debt servicing:** Fed Funds at 5% are less scary if households run on 30-year fixed mortgages and corporates have termed out their debt at lower levels.

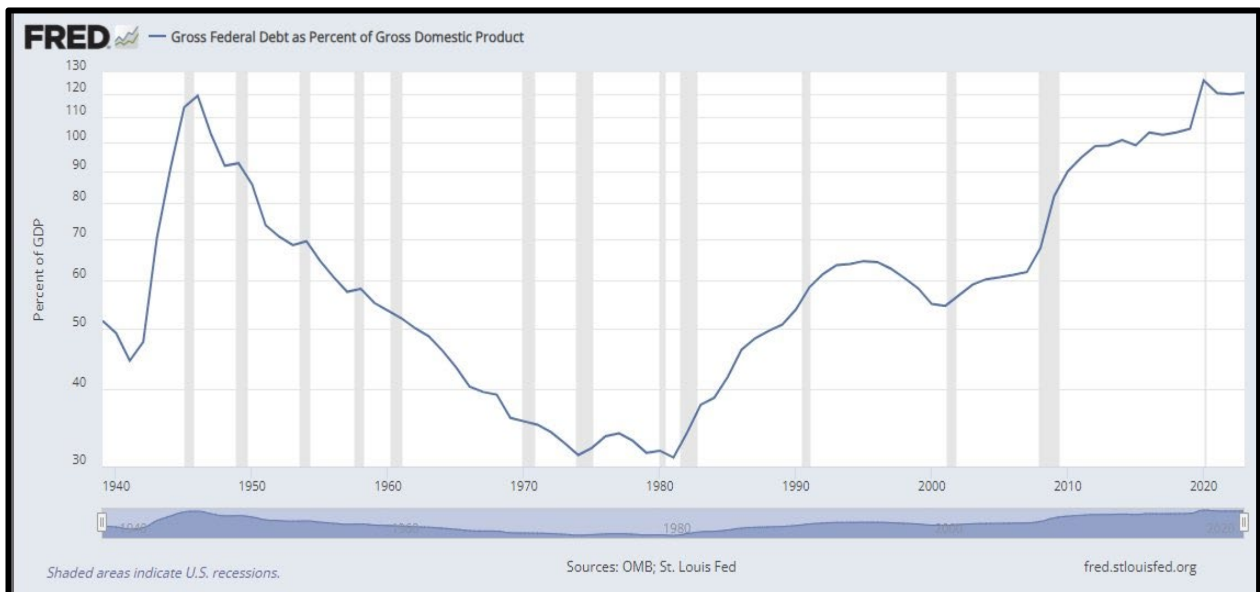
The chart below shows what the **US Private Sector Debt Service Ratio** looks like today: yes, it's rising but slowly if you compare it to the fast and vicious Fed hiking cycle.



Source: NBER

Are We Now Supposed to Believe in Free Lunches?

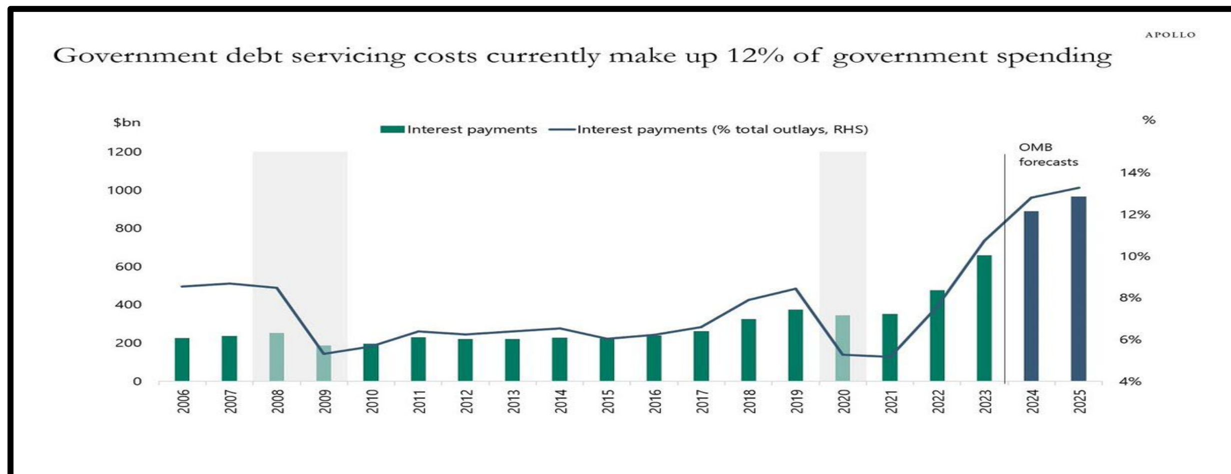
The Federal Reserve and the U.S. Government have both been engaged in an epic version of kick-the-can-down-the-road. With the federal debt rising to the highest levels in the history of the republic and budget deficits averaging 6% annually during a period of robust economic expansion, no less than Federal Reserve Chairman Jay Powell himself commented that fiscal policy was on an unsustainable path.



Source: Federal Reserve Bank of St. Louis

One of the first order impacts of this deficit spending is the rising proportion of overall government spending that goes directly to servicing the debt itself. Including the 50% increase in the level of total debt as well as the impact of higher interest rates, debt service payments now represent 10% of the total federal budget, up from only 6% 10 short years ago. For perspective, the U.S. government now spends substantially more on debt service than it does on national defense. The

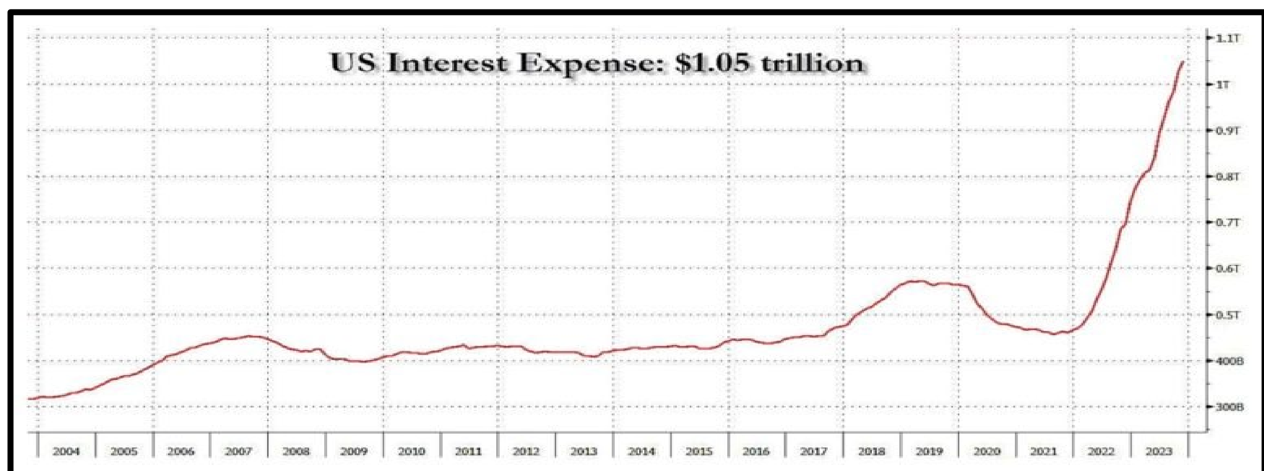
federal deficit is currently $1.2 trillion. It is increasing at a rate of $4.5 million per hour or $109 million per day. Your share of that federal deficit is about $30,920.



Source: NBER

In summary, the analogy of kicking the can down the road was not an accurate one, the better comparison is that we are pushing a barrel up a hill, only the barrel is getting larger and heavier (more difficult to manage safely) as we continue pushing it. That is the long-term danger of structural deficits and higher interest rates. As of now, the economy is chugging along nicely, and profit growth remains relatively strong. There are dangers building up in the system, however, and only a radical change in behavior will adequately address them. The longer we wait, the greater the danger and the more difficult the recovery will become.

U.S. Debt Service Payments – Annual



Source: Bureau of Economic Analysis; NBER

Quarterly Performance

The return for the Hahn Capital Management Mid-Cap Value Composite was ***7.00% gross of fees and 6.75% net of fees in the first quarter of 2024***. For the quarter, we underperformed our primary benchmark, the Russell Mid-Cap Value Index, by 1.23 percentage points gross of fees and underperformed by 1.48 percentage points net of fees.

For the quarter, sector allocations to Industrials, Financials, Consumer Discretionary, Energy, Healthcare contributed, while those to Materials, Communication Services and Real Estate, detracted. Allocations to Information Technology, Consumer Staples, and Utilities were neutral to performance.

The most significant relative performers during the quarter were EMCOR Group (EME), Air Lease (AL), CBRE Group (CBRE), Liberty Media Formula One (FWONK), and PVH Corp. (PVH), while the most significant underperformers were Genpact (G), SBA Communications (SBAC), Virtu Financial (VIRT), Albemarle (ALB), and Keysight Technologies (KEYS).

Hahn Capital Quarterly Performance Attribution – 4Q 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	19.06%	17.94%	1.12%	6.59%	12.01%	-5.42%	0.06%	-1.03%	-0.97%	0.00%	-0.97%
Information Technology	6.86%	9.43%	-2.57%	0.11%	4.32%	-4.21%	0.11%	-0.31%	-0.20%	0.00%	-0.20%
Real Estate	17.96%	10.17%	7.79%	0.02%	-0.59%	0.61%	-0.76%	0.16%	-0.60%	0.00%	-0.60%
Industrials	21.81%	19.87%	1.94%	23.63%	14.85%	8.78%	0.15%	1.72%	1.87%	0.00%	1.87%
Health Care	11.55%	6.71%	4.85%	1.94%	3.28%	-1.34%	-0.24%	-0.17%	-0.41%	0.00%	-0.41%
Consumer Discretionary	7.52%	9.27%	-1.75%	9.57%	8.35%	1.22%	0.01%	0.07%	0.08%	0.00%	0.08%
Materials	1.61%	7.53%	-5.92%	-8.51%	8.71%	-17.22%	-0.04%	-0.30%	-0.34%	0.00%	-0.34%
Communication Services	4.46%	3.08%	1.38%	-1.21%	-5.09%	3.88%	-0.21%	0.07%	-0.14%	-0.01%	-0.15%
Energy	3.59%	5.26%	-1.67%	9.23%	13.96%	-4.72%	-0.09%	-0.17%	-0.26%	0.00%	-0.26%
Consumer Staples	0.00%	3.70%	-3.70%	0.00%	6.25%	-6.25%	0.08%	0.00%	0.08%	0.00%	0.08%
Utilities	0.00%	7.04%	-7.04%	0.00%	6.29%	-6.29%	0.14%	0.00%	0.14%	0.00%	0.14%
Cash	5.58%	0.00%	5.58%	1.38%	0.00%	1.38%	-0.42%	0.00%	-0.42%	0.00%	-0.42%
Total Portfolio - Net of Fees				**7.03%**	**8.22%**	**-1.20%**	**-1.22%**	**0.03%**	**-1.19%**	**-0.01%**	**-1.20%**

Relative Performance by Stock – Quarter Ended March 31, 2024

Quarter Ended 03/29/2024 - 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	EMCOR GROUP INC	1.98%	1	GENPACT LTD	-0.68%	1	Industrials	1.87%	1	Financials	-0.97%
2	AIR LEASE CORP	0.26%	2	SBA COMMUNICATIONS CORP	-0.31%	2	Utilities	0.14%	2	Real Estate	-0.60%
3	CBRE GROUP INC - A	0.19%	3	VIRTU FINANCIAL INC-CLASS A	-0.30%	3	Consumer Discretionary	0.08%	3	Cash	-0.42%
4	LIBERTY MEDIA CORP-LIB-NEW-C	0.18%	4	ALBEMARLE CORP	-0.29%	4	Consumer Staples	0.08%	4	Health Care	-0.41%

HCM MID-CAP VALUE COMPOSITE PERFORMANCE HISTORY

% Annualized Returns As of 03/31/2024	1Q 2024	1 Year	3 Years	5 Years	7 Years	10 Years	Since Inception 06-30-88
HCM Gross of Fees	7.00%	17.97%	3.75%	8.72%	8.97%	8.09%	13.21%
HCM Net of Fees	6.75%	16.85%	2.72%	7.66%	7.90%	7.03%	12.12%
Russell Mid Cap Value Index	8.23%	20.40%	6.80%	9.94%	8.41%	8.57%	11.16%
Russell Mid Cap Index	8.60%	22.35%	6.07%	11.10%	10.58%	9.95%	11.35%

Link to: HCM Performance Disclosures

PORTFOLIO ACTIVITY

New Positions

Bio-Techne (TECH) – We initiated a position in TECH in Q1 24. Bio-Techne (TECH) develops, manufactures and sells life science proteins, reagents, instruments and services to aid drug discovery and enable accurate clinical tests and diagnoses. Management has successfully

accelerated the growth profile from MSD to HSD-LDD through strategic acquisitions, product extensions and market expansion.

TECH operates in two segments: Proteins Sciences and Diagnostics and Genomics.

Proteins and Sciences: Bio-Techne is the world leader in proteins due to its intellectual property (IP) and trade secrets in manufacturing high-quality, complex proteins to the customer's specifications. TECH offers the industry's largest catalogs of roughly 6,000 proteins, 425,000 antibodies and other research lab essentials. TECH's competitive advantage is creating proteins with optimal bioactivity assay: high quality and consistency. TECH's proteins are used in all aspects of life science research and cell and gene therapy workflow. TECH also offers reagents and immunoassays, which are analytical tools typically used with its proteins in the research workflow.

Proteins Sciences enjoys strong operating margins due to TECH's multi-decade leadership position in high quality, tailored proteins. At roughly 75% of TECH's revenues, Proteins Sciences provides a steady, high margin revenue stream for the company.

Diagnostics and Genomics: Over the past 11 years, Bio-Techne has built the Diagnostics and Genomics segment through a series of niche acquisitions. TECH targets products that enable expansion into higher growth end markets. Strategically, diagnostics are designed to use its assay and protein portfolio. Instruments avoid direct competition with large medical technology companies like Thermo Fisher (TMO) and Danaher (DHR). Instead, TECH's instruments focus on low-cost instruments that leverage existing platforms in a specialized niche, increase productivity, and scale well to support lab expansion. TECH offers specialized products in spatial biology, liquid biopsy, and molecular products (genetics and oncology).
In addition, management continues to build out TECH's cell culture and gene therapy portfolio. At roughly 25% of TECH's revenues, Diagnostics and Genomics products have typically generated low to high double digit revenue growth and expanded the TAM from $6 billion to $27 billion.

Hahn Capital had the opportunity to take a position in TECH due to industry weakness caused by the biotech funding slowdown in 2023 and spending cuts in the Chinese healthcare system. However, we have many data points indicating a 2024 recovery in biotech funding as well as a bottoming in lower Chinese healthcare spending. TECH is a durable business with unique IP, a strong balance sheet with almost no leverage, and a strong management team with consistent execution. As TECH continues to execute on innovation, commercialization and M&A, we expect continued market share gains to create long-term value.

Positions Increased

Waner Music Group (WMG) – We added to WMG this quarter as we were pleased with results that they posted in their first quarter following our original purchase. The music industry is experiencing a significant expansion, with streaming revenues boosted by continued international expansion of subscriber bases for companies like Spotify and Apple Music. In addition, Warner appears to be gaining market share, and its margins are expanding at a healthy clip along with its sustained revenue growth. WMG continues to expand its offerings internationally and acquire additional music catalogs at attractive economics.

Positions Reduced

EMCOR, Inc. (EME) – We reduced our position in EMCOR during the quarter as the position exceeded our 5% limit due to its explosive earnings growth and associated stock appreciation.

EMCOR has been the single largest contributor to returns in the Hahn portfolio over the past five years and remains a core holding in the portfolio.

Positions Sold

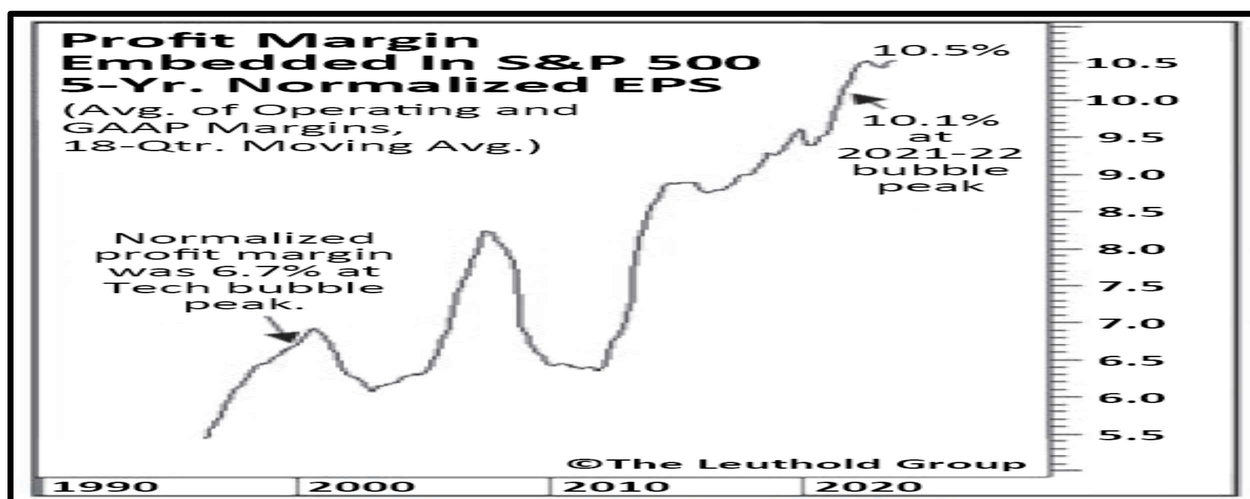
Equinix (EQIX) – We sold our position in Equinix as risk mitigation measure. During the quarter, a "short" report on the company (the second in as many years) again raised questions about the company's accounting of its maintenance and growth capital expenditures. Soon after that report's publication, the company's Board of Directors announced an independent accounting review. In addition, the company announced a surprise transition of the CEO. While the two may not be related, the coincidental timing raised our concern regarding risk of an adverse outcome to the accounting review to level that we exited the position.

Outlook

Economic & Market Outlook

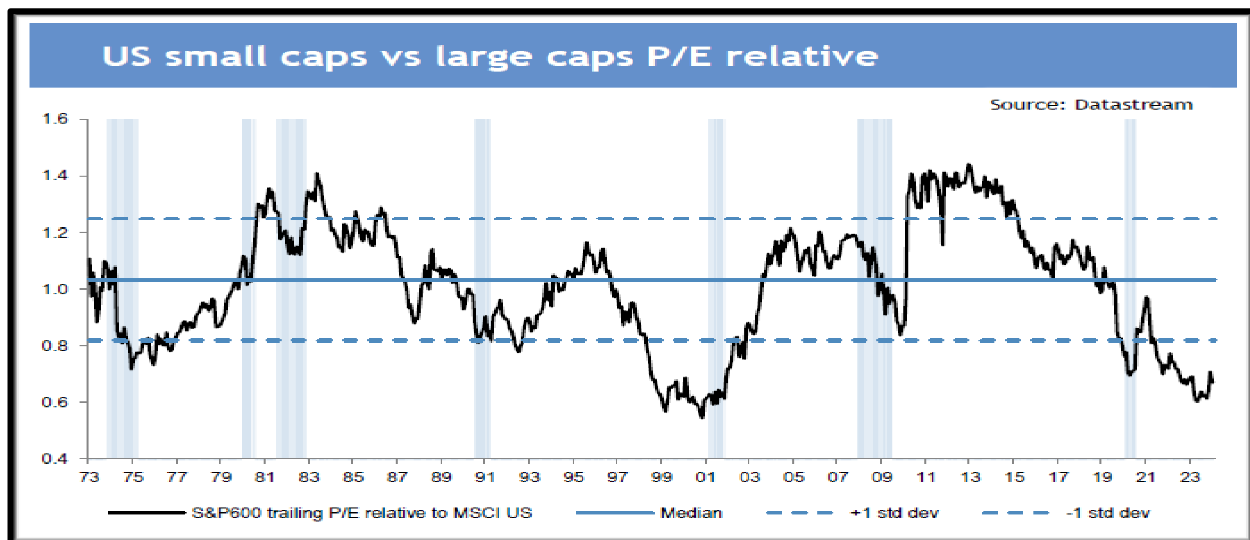
The market turned a blind eye to numerous negative macro developments, which is not all that uncommon when looking back over a 100-year history. Stocks don't always follow earnings or macro conditions over 5-year periods. During long periods of time, however, they do eventually track earnings and fundamentals. Periods of excess returns relative to the fundamentals are often followed by periods of subpar returns relative to the fundamentals, and vice versa.

To make matters worse, normalized profit margins in the S&P 500 are currently at a 40-year high, and 56% above where they peaked in the late 1990s Tech Bubble (see left of chart below). With both margins and valuations running hot at the same time, we're left with a potentially unattractive combination. Ultra-low interest rates helped boost valuations (low discount rates) and profit margins (low borrowing costs) in recent years, but the rate environment is much less accommodative today. Should there be any reversion to the mean in terms of valuations or profit margins (or both), the downside risk could be substantial. Furthermore, it doesn't help that companies have been facing higher inflation, in both rising input costs and wage growth, which may weigh on profitability over the long-term. The sustainability of the S&P 500's spectacular run remains an open question, but, in our view, seems improbable.



Source: Leuthold Group

What is the good news you might be asking, in this world full of risk that we have described? The following chart shows the relative valuations of small-cap stocks compared to their large cap brethren. While we are primarily invested in Mid-Cap stocks, the degree of underperformance from our primary hunting grounds is quite analogous to what has happened in the small-cap space. And the news is quite good with both small- and mid-cap stocks trading at valuations that signal the prospect for much more attractive returns looking forward relative to their large cap peers. We have been relatively active over the past few quarters, adding new holdings such as Intercontinental Exchange (ICE), Warner Music Group (WMG) and most recently, Bio-Techne (TECH). We are excited about the long-term prospects for each of these holdings and believe that their businesses should thrive for many years into the future.



Source: Datastream

Our float is the capital you have entrusted to us, and we expend all our energies, protecting that capital first and expanding it. Compounding sits logically alongside the Hahn Capital Management Mid-Cap Strategy since we are long-term owners of these businesses.

We wish you much health and happiness in 2024 and thank you for your support.

John Schaeffer
President and CIO

Michael Whitfield
Dir. of Research and Co-Portfolio Manager