HAHN CAPITAL MANAGEMENT, LLC

Mid Cap Equity Strategy 2nd Quarter 2019 Commentary

2nd QUARTER MARKET SUMMARY

The Pavlovian Market

In June, the central banks came to the rescue. Confronted by weaker economic data, risks to the trade outlook and still-low inflation, the Federal Reserve (the Fed) and the European Central Bank (ECB) indicated that the cavalry is coming in the form of further monetary stimulus. So, bad economic news was good news for markets. The stock market suffered a slight temper tantrum in May with most equity asset classes experiencing a -7% average pullback on the fears of slowing growth and a significant flattening of the treasury yield curve. The more hawkish tone from the Federal Reserve that was witnessed in the 1st quarter was quickly reigned in; replaced by the Fed Chairman Powell's June 19 policy comments: "Many FOMC participants now see that the case for somewhat more accommodative policy has strengthened." Indeed, Federal Reserve Governor James Bullard (St. Louis) voted in favor of a 0.25% rate cut, the first dissenting vote of Powell's tenure as Fed Chairman and an overt sign of the Fed's overall shift in outlook for monetary policy. As market participants grew tense and volatility increased in May, the Fed's seemingly conditioned response is to deliver what market participants desire: fuel for a continued economic expansion.

The net result of the hand wringing and subsequent change in tone by the Fed was a continuation of the rally in risk assets that began in late December. Equities and credit rallied along with traditional safe-haven assets, such as developed market government bonds, gold and the yen. Reversing the weakness in risk assets in May, June's strong performance made it a good quarter and certainly a good start to the year, almost irrespective of what you were invested in. Midway through the year most stock markets are enjoying double-digit returns. The NASDAQ Composite, S&P 500 and the Dow Jones Industrial Average are up 21.3%, 18.9% and 15.4% respectively. The two key international stock benchmarks, MSCI EAFE and the MSCI Emerging Markets, trailed the U.S. markets but still posted 14.0% and 10.6% year-to-date increases.

To say that the markets are forecasting the possibility of an interest rate cut in July is an understatement. According to recent readings in Fed Funds futures contracts, Wall Street is predicting that the Federal Reserve will trim short-term interest rates in late July. The only question is by how much; the futures market is signaling a 75% probability of a 0.25 percentage point cut. Investors want a rate cut, and a rate cut they will most likely get.

EXHIBIT C: PROBABILITY OF A FED RATE CUT AT JULY MEETING

Source: Bloomberg, Fiduciary Trust Company. Data as of June 27, 2019.

There is ample evidence to suggest that economic growth in the U.S. is slowing. The consensus forecast for S&P 500 profit growth started the year at roughly 9%, and it is currently at 3%. This may be an overly pessimistic assessment of the slowing of profit growth; however, the size of the drop is notable when, at the same time, prices paid for that shrinking profit growth are up roughly 17%. With equities currently trading at 19x trailing earnings and 17x forward profits, there does not seem to be a great deal of room for error. The current market rally seems to indicate that the consensus is too conservative and that the economy will be able to navigate the trade impasse with China and higher short-term interest rates. The less sanguine view is that investors have become habitual in seeking protection via interest rate relief from central bankers. Cheap money is the narcotic equivalent to the investor class. The longer the markets are influenced by cheap money, the greater the dependence becomes. After 20 years of the Fed "put," one cannot help but wonder if markets can successfully operate with a market-determined price of money.

Quarterly Performance

The return of the Portfolio Composite for the quarter ended June 30, 2019 was 5.61% gross of fees in the second quarter of 2019. For the quarter, we exceeded our primary benchmark, the Russell Mid-Cap Value Index, by 2.42 percentage points. For the quarter, sector allocations to Industrials, Energy, Consumer Staples (no holdings) and Information Technology contributed positively, while those to Consumer Discretionary, Financials and Communications Services (no holdings) somewhat detracted. The most significant positive contributors during the quarter were Euronet Worldwide (EEFT), AirLease (AL) and Equinix (EQIX), while the most significant detractors were PVH Corp (PVH), Albemarle (ALB), and First Republic Bank (FRC). The table below encapsulates the annual results for a Model account (which differs from the Portfolio Composite):

HCM vs. Russell Mid-Cap Value Index - Quarter Ended 06/30/2019										
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	22.05%	12.39%	9.66%	14.34%	8.28%	5.61%	0.47%	1.22%	1.69%	0.01%	1.70%
Real Estate	15.15%	14.31%	0.85%	6.05%	0.24%	5.80%	-0.01%	0.85%	0.84%	-0.01%	0.83%
Information Technology	14.63%	8.91%	5.73%	9.82%	5.47%	4.12%	0.13%	0.60%	0.73%	0.00%	0.73%
Financials	13.80%	17.81%	-4.00%	3.70%	7.47%	-3.51%	-0.15%	-0.47%	-0.62%	0.01%	-0.61%
Consumer Discretionary	12.84%	8.60%	4.24%	-2.47%	-0.58%	-1.90%	-0.17%	-0.22%	-0.39%	0.00%	-0.39%
Health Care	11.72%	6.92%	4.80%	1.97%	2.95%	-0.95%	-0.03%	-0.10%	-0.13%	0.00%	-0.13%
Energy	2.37%	5.69%	-3.32%	1.04%	-8.23%	10.10%	0.39%	0.23%	0.62%	0.00%	0.62%
Materials	1.96%	5.92%	-3.96%	-13.68%	2.76%	-15.99%	0.01%	-0.34%	-0.33%	0.00%	-0.33%
Communication Services	0.00%	3.17%	-3.17%	0.00%	7.75%	-7.19%	-0.14%	0.00%	-0.14%	0.00%	-0.14%
Consumer Staples	0.00%	4.92%	-4.92%	0.00%	-1.53%	1.56%	0.23%	0.00%	0.23%	0.00%	0.23%
Utilities	0.00%	11.37%	-11.37%	0.00%	3.53%	-3.41%	-0.04%	0.00%	-0.04%	0.00%	-0.04%
Cash	5.46%	0.00%	5.46%	0.63%	0.00%	0.63%	-0.11%	0.00%	-0.11%	0.00%	-0.11%
Total Portfolio				5.61%	3.19%	2.35%	0.58%	1.76%	2.34%	0.01%	2.35%

HCM Model Portfolio – Relative Performance by Stock – Quarter Ended June 30, 2019

Attribution Analysis - Notable Performers by Sector & Stock

Notable Performers by Sector

Quarter Ended 06/30/2019 - Portfolio vs Russell Midcap Value Index

	Top Four Holdings Relative Contribution			Bottom Four Holdings Relative Contribution			Top Four Sectors Relative Contribution			Bottom Four Sectors Relative Contribution	
1	EURONET WORLDWIDE INC	2.56%	1	SLM CORP	-0.29%	1	Industrials	4.61%	1	Utilities	-1.60%
2	KEYSIGHT TECHNOLOGIES IN	1.71%	2	ALBEMARLE CORP	-0.13%	2	Information Technology	3.93%	2	Financials	-0.99%
3	HEXCEL CORP	1.48%	3	SNAP-ON INC	0.01%	3	Real Estate	1.76%	3	Materials	-0.97%
4	JACOBS ENGINEERING GROUP INC	1.48%	4	WABTEC CORP	0.04%	4	Consumer Discretionary	0.94%	4	Communication Services	-0.46%

Year-to-Date Ended 06/30/2019 - Portfolio vs. Russell Midcap Value Index

	Top Four Holdings Relative Contribution			Bottom Four Holdings Relative Contribution			Top Four Sectors Relative Contribution			Bottom Four Sectors Relative Contribution	
1	EURONET WORLDWIDE INC	0.82%	1	PVH CORP	-0.79%	1	Industrials	2.02%	1	Financials	-0.72%
2	AIR LEASE CORP	0.71%	2	ALBEMARLE CORP	-0.27%	2	Information Technology	0.92%	2	Materials	-0.46%
3	HEXCEL CORP	0.69%	3	AGILENT TECHNOLOGIES INC	-0.24%	3	Real Estate	0.86%	3	Utilities	-0.40%
4	EMCOR GROUP INC	0.53%	4	CARTER'S INC	-0.09%	4	Energy	0.52%	4	Consumer Discretionary	-0.28%

HCM ERFORMANCE HISTORY

% Annualized Returns As of 06/30/2019	2Q 2019	YTD	3 Years	5 Years	7 Years	10 Years	Since Inception 06-30-88
HCM Gross of Fees	5.61%	26.50%	12.67%	7.79%	12.79%	14.31%	14.04%
HCM Net of Fees	5.36%	25.94%	11.65%	6.78%	11.73%	13.23%	12.95%
Russell Mid Cap Value Index	3.19%	18.02%	8.95%	6.72%	12.34%	14.56%	11.38%
Russell Mid Cap Index	4.13%	21.35%	12.16%	8.63%	13.37%	15.16%	11.44%

Link to: HCM Performance Disclosures

PORTFOLIO ACTIVITY

Positions Added

There were no new positions during the quarter.

Positions Increased

EastWest Bancorp (EWBC) – We added to our position in EastWest Bancorp during the quarter. EastWest has very quietly become one of the 20 largest banking companies in the United States, ending its most recent quarter with close to $42 billion in assets. EastWest has what we believe is a unique and highly defensible niche as the consumer and commercial bank of choice for Asian and Asian American customers. It operates very efficiently, with a total expense ratio of around 40% of Net Interest Income, among the very best among its banking peers. In addition, EastWest has become very adept at attracting new customers, as it is growing its deposit and loan base at the very high end of banking peer comparisons. We were able to add to our position at very close to a 20% discount to our estimate of intrinsic value, primarily because of market worries about the impact of trade tariffs with China on EastWest's near-term growth opportunities.

Positions Reduced

There were no positions reduced during the quarter.

Positions Sold

There were no positions sold during the quarter.

Outlook

Heading into the second half of 2019, we remain cautiously positive about global economies and financial markets, but caution that political risks, in particular escalating trade disputes, could trigger renewed volatility and further impede growth. To a certain extent, market behavior in the first half of 2019 seemed to reflect two contradictory perceptions: falling bond yields and an inverted U.S. Treasury yield curve, a situation in which longer-term yields move below short-term interest rates, appear to signal growing economic pessimism. On the other hand, the relatively strong equity gains seen in the U.S. and many emerging markets in the first six months of 2019 seemed to suggest hopes for an earnings reacceleration later in the year.

On the positive side, market expectations for monetary policy shifted dramatically in the first half. Investors now lean toward the view that the U.S. Federal Reserve is more likely to cut interest rates rather than raise them further. On the negative side, hopes for a trade deal between the U.S. and China deteriorated in May, and the Trump administration briefly threatened to impose tariffs on Mexican goods. Trade fears contributed to persistent strength in the U.S. dollar, keeping emerging market (EM) currencies under pressure.

One of the greatest worries about the prevailing market environment is that amidst low bond yields and falling earnings expectations, investors have started to chase GAAP and YAAP: Growth At Any Price and Yield At Any Price, respectively. The former is reflected in astonishing quarterly gains for high (50-100x P/E) or no multiple stocks such as Twilio (+60%), Wayfair (+66%), Shopify (+129%), Splunk (+32%), Alteryx (+93%), and Netflix (+35%).

The chart below partly shows the degree to which investors have become wedded to growth companies. This is obviously reflected in a high dispersion between relative valuations of "growth" and "value" stocks.

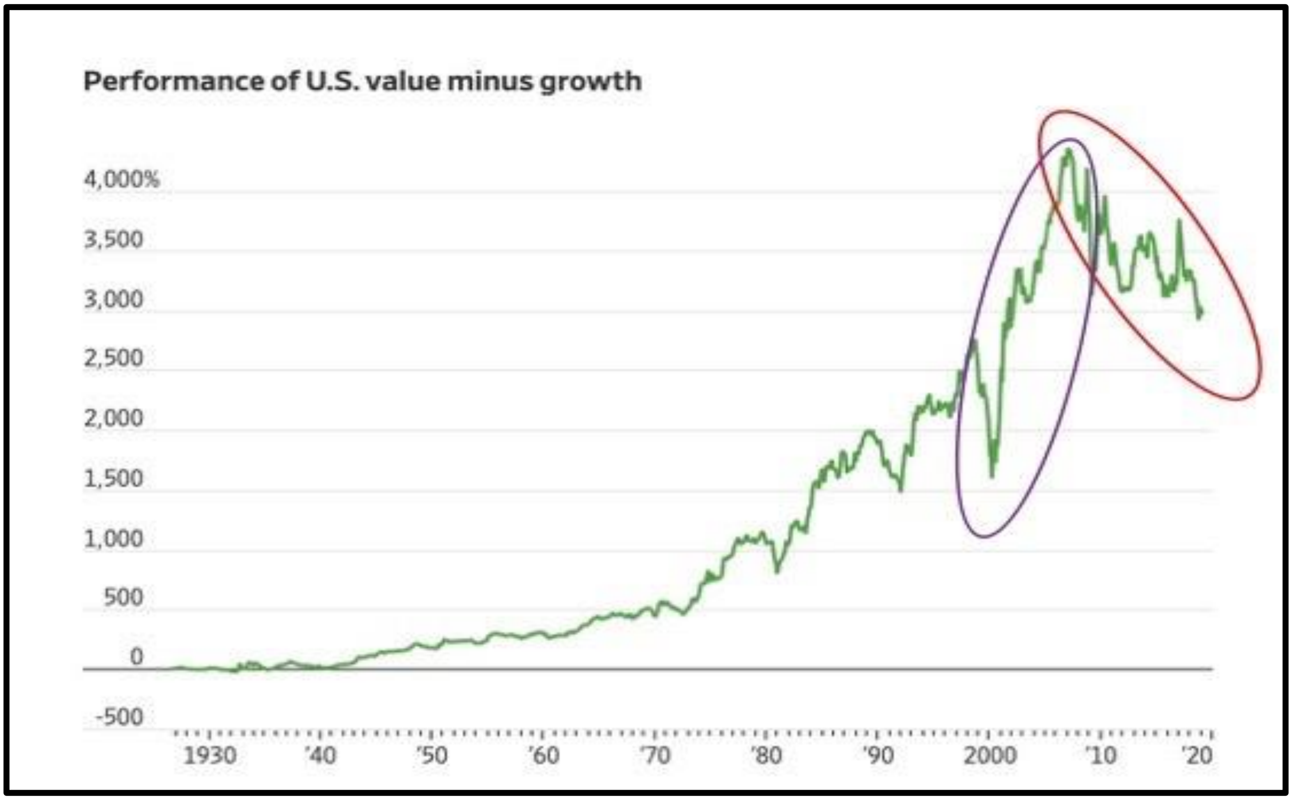

Chart courtesy of Factset Data Systems

Chasing growth tends to happen in these slowing growth environments and typically ends in tears. The current set-up has about it elements of 1999, in terms of the extreme outperformance of growth relative to value. Older readers may remember the period when the dot.com stocks trounced their traditional counterparts, prior to a seven-year period of aggressive reversal (purple loop on chart). Since the Great Financial Crisis, "growth", largely the mega-cap technology stocks but also the mid-cap cloud computing and internet services stocks – have comprehensively trounced "value" (red loop), with the occasional blip – like 2016.

A "corporate zombie" is a company producing sufficient cash flow to pay interest on a high debt load, but incapable of repaying any meaningful part of the obligation.

A number of very highly priced technology companies might now be considered "growth zombie" companies: corporates with seemingly no visible ability to provide free cash flow to investors other than through the use of share based compensation payments to employees, and no great insight as to when this may change. However, they are unlikely to go out of business in the near-term due to past accumulated high cash piles from share issuance and customer cash paid up front.

Many of these companies are very highly valued enterprise software businesses. They all talk in a similar language - "transforming the way people use data to solve problems" and "opportunities for human advancement"[6] – so long as you are paid by them one might suggest.

These companies have particular attributes. Extra-ordinarily high gross margins (well over 80%), hefty R&D and almighty sales/marketing costs. Since they are subscription type models, they all generate significant quantum of deferred revenue[7], which in many cases accounts for a significant proportion of on balance sheet cash. Investors love subscription models with high margins and afford them extraordinary valuations – think the big-daddy of them all, Salesforce (CRM) with a market value of $123 billion trading on 58x forward earnings. At least it makes a net profit after tax and doesn't have its operating cash flow more than 100% comprised of stock-based compensation and/or deferred revenue. Here's a selection of "new-age" listed enterprise software businesses:

ticker[8]	BOX	DATA	DBX	DOCU	WDAY	SPLK[9]	ZEN
Operating cash flow (A)	55	155	425	76	606	296	79
Share based pay (B)	119	239	650	411	652	442	119
Net deferred revenue impact (C)	26	56	66	39	344	153	43
Adjusted (A-B-C)	**(90)**	**(140)**	**(291)**	**(374)**	**(390)**	**(299)**	**(83)**
After tax profit	(135)	(77)	(485)	(426)	(418)	(276)	(131)
Cash & securities (D)	217	1,048	1,089	932	1,779	2,868	820
Debt – including converts (E)	140	-	245	463	1,204	1,635	458
Net carry value deferred revenue (F)	278	394	485	267	1,868	608	198
Adjusted cash (D-E-F)	**(201)**	**654**	**359**	**202**	**(1,293)**	**625**	**164**
Equity market value (G)	2,735	10,945	9,032	8,881	42,766	18,366	9,122
Share price Δ% 12months	-7%	+57%	-30%	+85%[10]	+52%	+26%	+76%
Sales (H)	608	1,155	1,392	701	2,822	1803	599
EMV/sales (G/H)	4.5x	9.5x	6.5x	12.7x	15.2x	10.2x	15.2x

6 Tableau Software Annual Report CEO's letter (stock ticker: DATA)
7 Revenue for a period paid up front, so cash is on balance sheet but significant liability for services yet to be provided
8 All figures US$ million for latest 12 months to December 2018/January 2019
9 Splunk's marketing motto is "we take the sh out of IT" (but perhaps not their accounting) Splunk 2019 Annual Report
10 versus IPO price April 2018

These "human advancement" companies are not as lucky as Salesforce in making a profit; or maybe they are, since investors, by and large, don't worry about such minor details, focusing exclusively on the "business model." God forbid some of these companies' "spinning wheels" slow down, since the deferred revenue would slide, reducing available cash, and bringing on a situation not envisaged when equity values average out at over 10x trailing sales.

It will be most interesting to revisit these folks in a less buoyant environment – perhaps when the echo-chamber around them stops reverberating.

As we look back on the performance of value versus growth during the past several years we are reminded of the reason that we are value investors to begin with: we only buy high-quality assets when they are on sale (trading at a substantial discount to readily ascertainable, risk-adjusted intrinsic value) because our primary goal is the preservation of your capital.

We know and understand from years of experience in similar markets that we will see a significant reversal of the current trend and when this happens, we will have the opportunity to achieve excess returns over the benchmark.

We thank you for your continued support and look forward to serving your best interests for many years into the future.

Sincerely,

John Schaeffer	Michael Whitfield
President and CIO	Dir. of Research and Co-Portfolio Manager