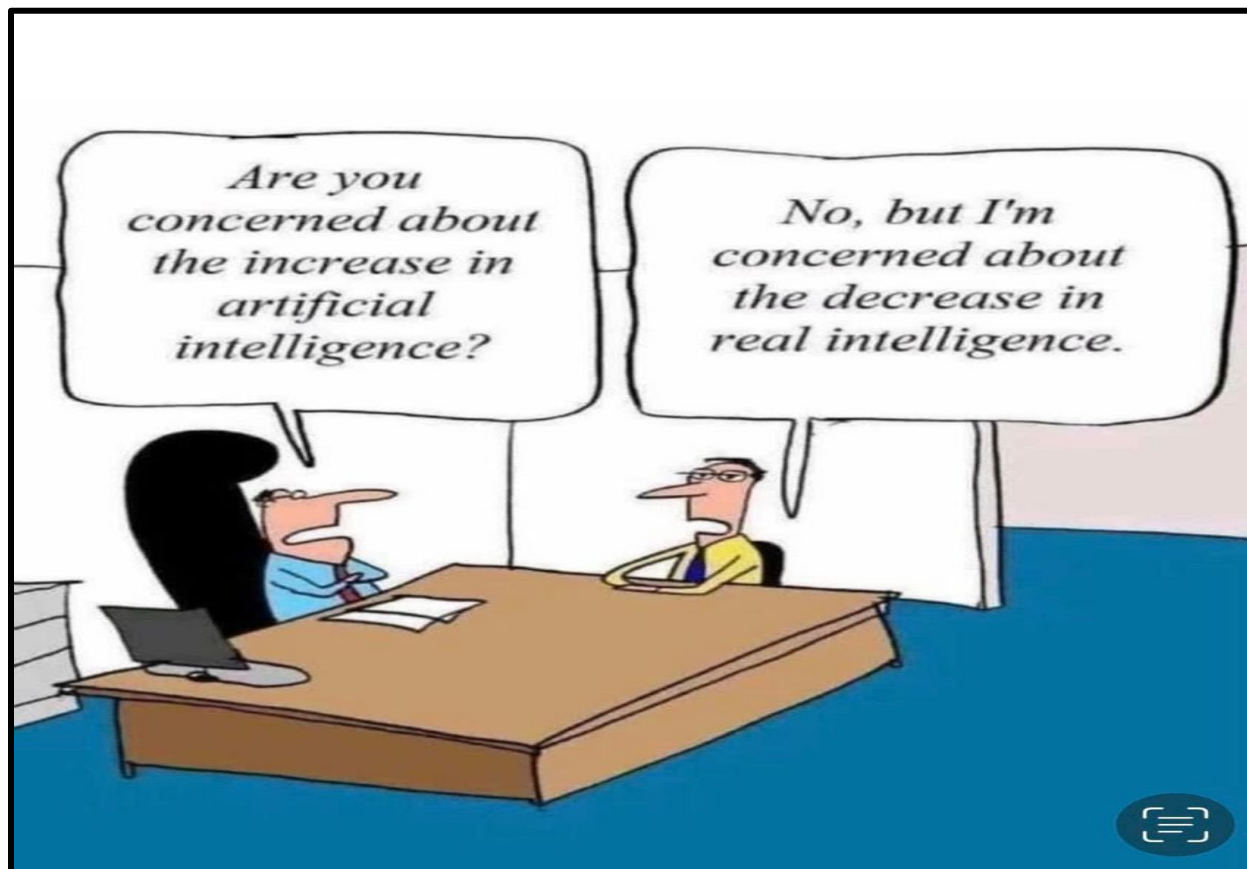


**Mid Cap Equity Strategy**

**2nd Quarter 2023 Commentary**

**Where is the Recession? (It's on the Way!)**



Source: Grant's Interest Rate Observer

The S&P 500 gained over 7% for the third quarter in a row (+9% in the 2<sup>nd</sup> quarter) on advances in AI-related stocks and an eventual pause in Fed rate hikes. The markets started off with benign gains in April and May as investors pondered the structural integrity of banks and politicians' ability to work together on a debt-ceiling resolution. As those issues were resolved, investors turned their focus to supporting big-cap Tech names in June, driving the market to its highest monthly return for the year. Growth-oriented stocks vastly outperformed their value-centric counterparts (13% vs. 4%), while a strong June rally helped small caps nearly catch large caps with a 7% gain. The proliferation of artificial intelligence has been predicted to have as large an impact as the Industrial Revolution. In the 2<sup>nd</sup> quarter, A.I.'s largest impact was propelling tech stocks increasingly further away from their 2022 lows. Unlike the forecasted wide-reaching potential for A.I., the impact on stock returns was not very broad. The seven largest stocks in the S&P 500 averaged 26% returns for the quarter; the other 493 only gained 3%. Alongside Tech, double-digit gains in Consumer Discretionary and Communication Services stocks rounded out the great sector reversal of 2023. The average return for all other sectors was a pedestrian 2%.

To put an exclamation point on how narrow the advance in the index averages have been since the technology-related stock market retreat of 2022, two stocks (Apple and Microsoft) now account for over \$5.5 trillion in market capitalization! Apple and Microsoft also account for almost 15% of the market capitalization of the S&P 500 Index.

The last time that two companies were so highly valued a piece of the index was in 1980, when IBM and AT&T represented a similar proportion. The catch phrase of the moment is A.I. or Artificial Intelligence, which has driven investors into a frenzy, attempting to find leverage to this technological advancement. Setting aside issues about how and where it should be used, A.I. fever has fueled renewed enthusiasm in high tech that rivals both the first Internet Bubble and the easy money-fueled pandemic bubble in related stock prices. Because we keep score of such claims, we have assembled a table of what we refer to as the “Miracle Seven,” the seven largest technology-related stocks that have benefitted from A.I. fever.

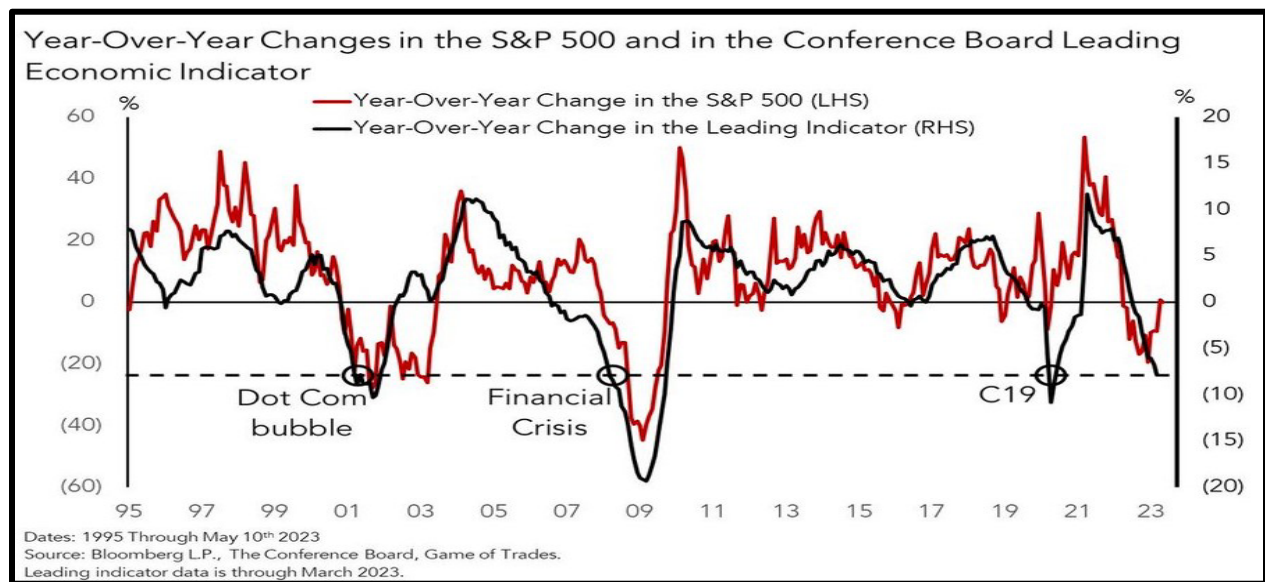
The Miracle Seven Technology Companies		
	Market Cap. (\$B)	TTM P/E
Apple	\$3,027	33
Microsoft	\$2,513	36
Alphabet (Google)	\$1,526	25
Amazon	\$1,336	140
NVIDIA	\$1,048	206
Tesla	\$887	81
Meta (Facebook)	\$733	26
<b>Total</b>	<b>\$11,069</b>	<b>65</b>
<b>Total US Market Cap.</b>	<b>\$11,069</b>	<b>19</b>
<b>(3687 stocks)</b>		
<b>The Miracle Seven share of:</b>		
<b>Valuation</b>	<b>25%</b>	
<b>Earnings</b>	<b>7%</b>	

With a trailing P/E multiple of 65 times trailing 12-month earnings and representing 25% of the total market capitalization of all U.S. stocks (while accounting for only 7% of the underlying earnings), we would submit that if there isn’t a new industrial revolution, that this group of companies is priced for something approximating perfection. Finally, it is important to remember that even if artificial intelligence does evolve into the economic panacea that is currently being extolled, there are no assurances that the “Miracle Seven” will be direct beneficiaries and may, in a few cases, be disrupted by it.

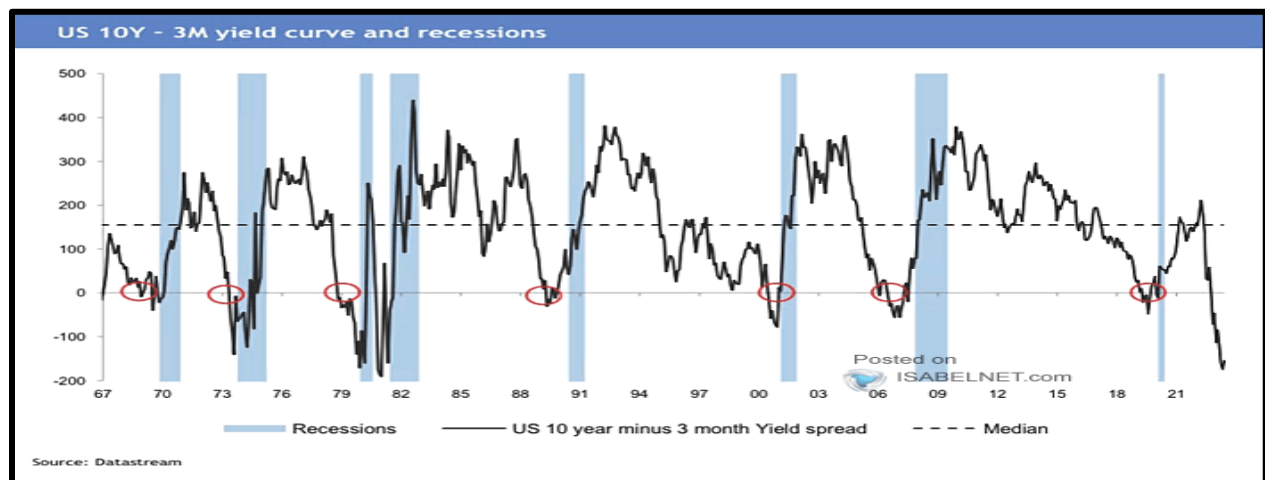
Meanwhile, in the Real Economy....

Despite better-than-expected corporate earnings in the 1<sup>st</sup> quarter, there remain clear signals that the economy is slowing rapidly. Year-over-year earnings rose 0.1% in the first quarter, much better than the forecast for a 5.1% drop at the start of the reporting season. Heading into earnings reporting season, analysts expect earnings for S&P 500 companies to fall 5.6% in the second quarter from a year ago, according to IBES data, with pressure likely across all economic sectors. The Conference Board Index of Leading Indicators remains pointed directly toward a meaningful contraction in the economy, likely emerging over the next 12 months. With the Federal Reserve Bank continuing to signal that it will keep short-term interest rates “higher for longer,” the recent divergence in stock performance (higher) from the index (lower) points to lower equity prices.

In other words, stocks are already pricing in a Fed pivot toward lower rates while the economy is deteriorating rapidly. Either the rally in stocks reverses or the Fed will need to start easing far sooner than is currently priced into the bond market.

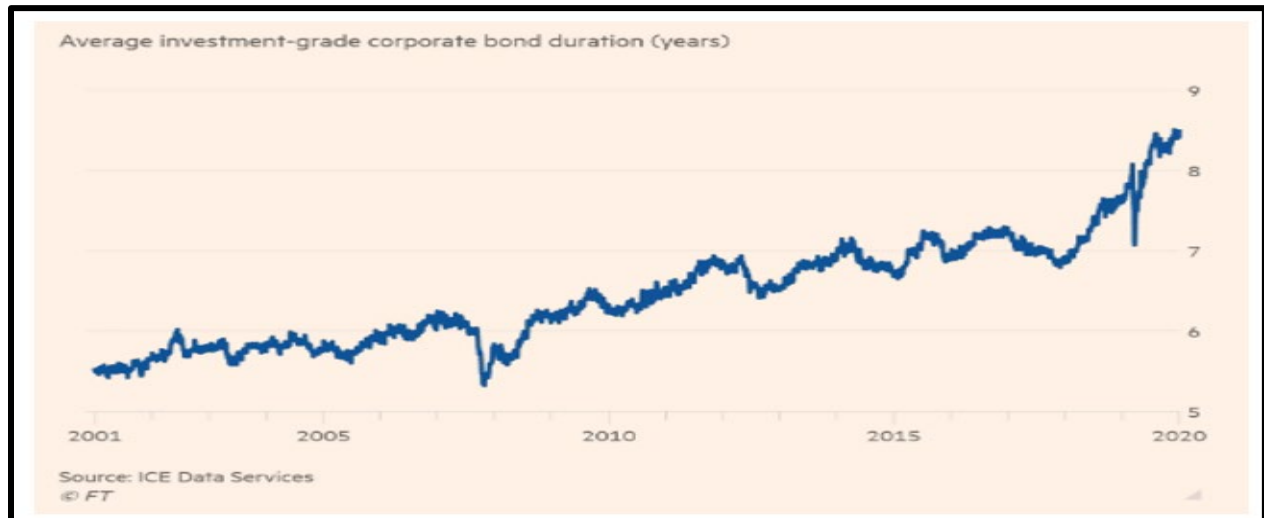


Another indicator of an impending economic slowdown is the inverted yield curve, with short-term interest rates (the Fed Funds Rate) having remained above long-term interest rates (the benchmark 10-year bond) for more than a year.



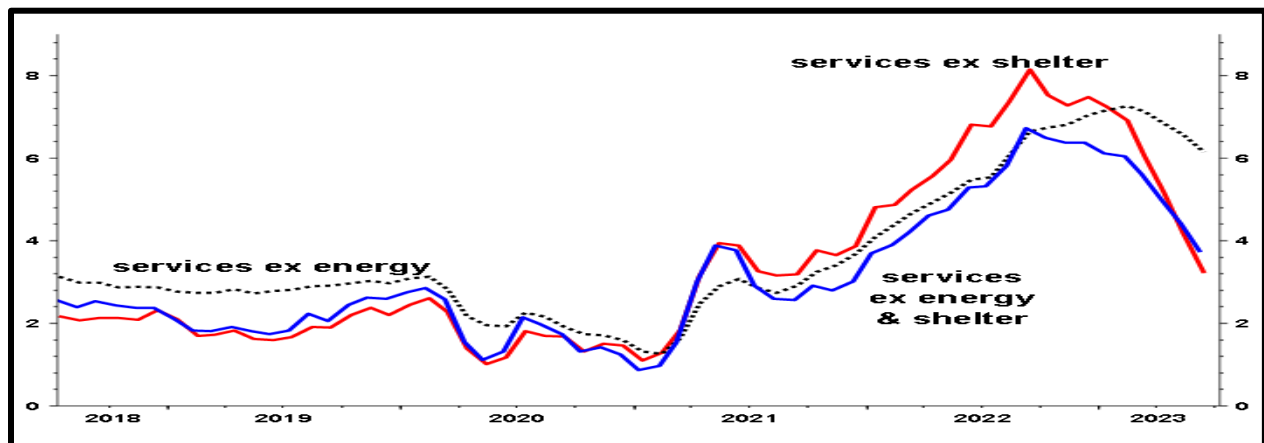
It is interesting to note that an inverted yield curve has a basically perfect record of predicting recession, and the current degree of inversion again suggests a significant economic contraction. It is also true, however, that the lag between the initial inversion of the yield curve and the onset of the economic recession can be long and vary depending on the economic environment that preceded it. In the case of the current environment, it appears that many companies locked in cheap capital at very low rates during the “lower for longer” period of interest rates that the Fed engineered in order to get the U.S. economy through the worst of the Covid-19 pandemic. The following chart shows that corporations dramatically extended maturities when long-term interest rates were at generational lows.

## Bond Durations Skyrocketed Over the Past 5 Years



This phenomenon has served to delay and at least partially mitigate the impact of the Fed's rate raising campaign that started in 2022. The much better news, however, seems to be that the inflation gauges that the Fed has been so intently focused on for the past year are all rolling over rapidly and this theoretically will allow the Fed to pivot toward lower rates. It's not clear though that the Fed is going to become more accommodative until it sees weakness in the labor market as well. We'll see whether energy inflation has genuinely subsided.

## Inflation Appears to be Rolling Over Quickly

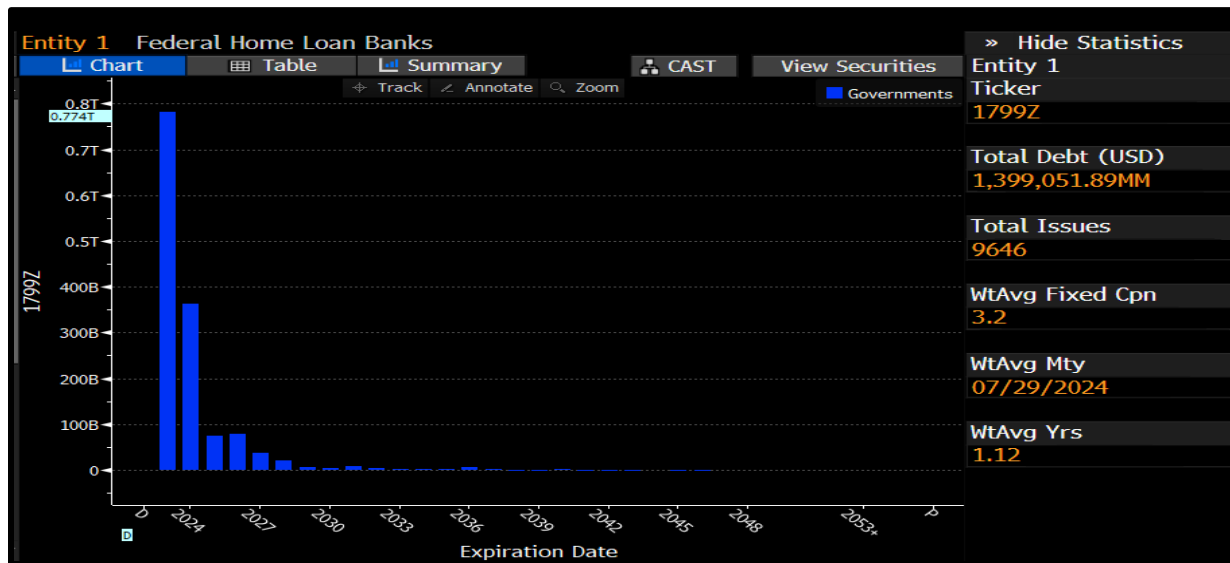


Source: National Bureau of Economic Research

In last quarter's letter, we wrote extensively about the regional banking crisis and its causes. We thought it important to provide an update as the market has shifted its focus to the technology stock rally and away from this on-going crisis that remains brewing just below the surface. Deposits are continuing to flee the regional banks that do not enjoy the Fed's explicit guarantee and high interest rates will continue to add fuel to that deposit flight, such that any spark, whether it be a continued bond market sell-off or significant credit losses, could ignite further bank runs. The following chart shows that bank borrowings from the FHLB (Federal Home Loan Bank) continued to accelerate throughout the quarter and are currently over \$1.4 Trillion. This represents growth in borrowing at the FHLB window of over \$1trillion since the beginning of 2023.

These are banks that are borrowing at 3.2% to fund assets that are in many cases, yielding well less than 3%. It's terrible for regional bank profitability and terminal to their business models if left this way for too long.

## Borrowing From the Federal Home Loan Bank Has Exploded



Source: Bloomberg

There are a large number of brand-name regional banks that are on the brink of reporting some truly abysmal earnings numbers as margins get squeezed by the higher cost FHLB borrowings relative to the cost of the former deposits they were replacing. The absolute level of borrowing at many of these institutions should be even more frightening. Neither the Fed nor the regulators appear concerned. This will not end well, in our view.

The following table chronicles the sheer scale of the borrowings and the size of FHLB borrowings relative to their equity capital. Keep in mind that a healthy bank should not need to borrow AT ALL from the FHLB, so a reading above zero represents an incremental sign of stress to the bank's business. The numbers listed below are staggering in their scale. Charles Schwab, for instance, has a huge problem. It has borrowed \$10 billion from the FHLB, presumably to provide liquidity to customers who are pulling their bank deposits. We would not be surprised to see Schwab's profitability get smashed in the 2<sup>nd</sup> half of this year, and, if that causes a loss of confidence, then Schwab could itself face a bank run. With over \$300 billion invested in long-term, low-yielding securities, Schwab will be unwinding its illiquidity position for a decade unless long-term rates plummet again as they did during the 2019-2022 period. In addition to Charles Schwab, KeyBank, PNC and Northern Trust are all perilously close to the same types of liquidity runs that regulator allowed to fell Silicon Valley Bank. It goes without saying that banking regulators will be forced to extend the emergency program that created the lending facility in the first place as none of these institutions will have re-gained sufficient liquidity to allow them to fund their assets with the deposits they have on hand. It remains an existential risk for the entire regional banking industry, though less talked about recently.



## Large Financial Institutions on a Knife's Edge

	A	B	C	D	E	F	G
1	Bank Name	FDIC Cert no.	Total Equity Capital	FHLB advances less than 1 year	FHLB advances 1-3 years	TOTAL SHORT TERM FHLB	FHLB as % of Equity
2	Signature Bank	57053	\$8,013,101	\$11,259,000	\$24,738	\$11,283,738	140.82%
3	Charles Schwab	57450	\$7,664,000	\$10,000,000	\$0	\$10,000,000	130.48%
4	USAA Federal Savings	32188	\$3,009,000	\$3,500,000	\$0	\$3,500,000	116.32%
5	Silicon Valley Bank	24735	\$15,456,000	\$15,000,000	\$0	\$15,000,000	97.05%
6	Keybank	17534	\$13,033,651	\$11,252,256	\$18,764	\$11,271,020	86.48%
7	First Republic	59017	\$17,445,927	\$9,225,000	\$4,375,000	\$13,600,000	77.96%
8	PNC Bank	6384	\$43,894,962	\$32,075,000	\$0	\$32,075,000	73.07%
9	Northern Trust	913	\$10,897,234	\$7,500,000	\$0	\$7,500,000	68.82%
10	Truist Bank	9846	\$59,943,000	\$29,700,000	\$1,000	\$29,701,000	49.55%
11	Ally Bank	57803	\$13,197,000	\$3,302,000	\$3,103,000	\$6,405,000	48.53%
12	First-Citizens Bank	11063	\$9,934,614	\$4,250,000	\$0	\$4,250,000	42.78%
13	U.S. Bank	6548	\$44,715,034	\$19,000,074	\$0	\$19,000,074	42.49%
14	Citizens Bank	57957	\$23,673,882	\$8,500,000	\$13,240	\$8,513,240	35.96%
15	TD Bank	18409	\$42,576,090	\$9,500,588	\$1,472	\$9,502,060	22.32%
16	Fifth Third Bank	6672	\$19,481,117	\$4,308,469	\$4,407	\$4,312,876	22.14%
17	Wells Fargo	3511	\$161,470,000	\$32,000,000	\$0	\$32,000,000	19.82%
18	MUFG UNION BANK	22826	\$15,156,416	\$2,250,000	\$0	\$2,250,000	14.85%
19	BMO Harris	16571	\$18,540,361	\$2,500,000	\$0	\$2,500,000	13.48%
20	Manufacturers & TT	588	\$24,419,791	\$3,200,281	\$1,634	\$3,201,915	13.11%
21	Citibank	7213	\$164,945,000	\$19,250,000	\$0	\$19,250,000	11.67%
22	Huntington Nat'l	6560	\$17,383,683	\$1,700,962	\$200,003	\$1,900,965	10.94%

Source: FHLB

## Quarterly Performance

The return for the Hahn Capital Management Mid-Cap Value Composite (see table below) was 1.82% gross of fees and 1.57% net of fees in the second quarter of 2023. For the quarter, we underperformed our primary benchmark, the Russell Mid-Cap Value Index, by 2.02 percentage points gross of fees and 2.29 percentage points net of fees. For the quarter, sector allocations to Information Technology, Energy, Materials, Utilities (no holdings), and Consumer Staples (no holdings) (relative to the benchmark) contributed, while those to Industrials, Financials, Real Estate, Consumer Discretionary, and Healthcare detracted. The most significant relative performers during the quarter were Advanced Micro Devices (AMD), CBRE Group (CBRE), Equinix (EQIX), and Becton Dickinson, while the most significant underperformers were Genpact (G), Agilent (A), Alexandria Real Estate (ARE), and Jacobs Solutions (J).

## Hahn Capital Quarterly Performance Attribution – 2Q 2023

LINKED PERFORMANCE BY SECTORS												
BENCHMARK: Russell Midcap Value Index												
PORTFOLIO: Representative Account												
	PORT	BENCH	DIFF	PORT	BENCH	DIFF	SECTOR	STOCK	ACTIVE	PASSIVE	TOTAL	
GICS Sector	Weight	Weight	Weight	Return	Return	Return	SELECT	SELECT	CONTR	CONTR	CONTR	
Financials	14.60%	16.98%	-2.38%	0.76%	2.81%	-2.05%	0.00%	-0.33%	-0.33%	0.00%	-0.33%	
Information Technology	12.94%	8.40%	4.54%	10.75%	2.45%	8.30%	-0.05%	1.05%	1.00%	0.00%	1.00%	
Real Estate	18.42%	10.85%	7.58%	0.99%	3.83%	-2.84%	0.01%	-0.51%	-0.50%	-0.01%	-0.51%	
Industrials	19.71%	16.92%	2.78%	1.74%	11.05%	-9.31%	0.26%	-1.82%	-1.56%	-0.01%	-1.57%	
Health Care	12.33%	7.46%	4.87%	-0.87%	2.04%	-2.91%	-0.08%	-0.38%	-0.46%	0.01%	-0.45%	
Consumer Discretionary	7.13%	10.12%	-2.99%	2.32%	7.89%	-5.56%	-0.12%	-0.38%	-0.50%	0.00%	-0.50%	
Materials	3.00%	7.65%	-4.65%	1.10%	-0.19%	1.29%	0.19%	0.04%	0.23%	0.00%	0.23%	
Communication Services	2.37%	3.25%	-0.87%	0.60%	0.23%	0.37%	0.03%	0.01%	0.04%	0.00%	0.04%	
Energy	4.07%	4.99%	-0.92%	-5.53%	3.09%	-8.62%	0.01%	-0.38%	-0.37%	0.00%	-0.37%	
Consumer Staples	0.00%	4.51%	-4.51%	0.00%	-0.29%	0.29%	0.19%	0.00%	0.19%	0.00%	0.19%	
Utilities	0.00%	8.87%	-8.87%	0.00%	-2.15%	2.15%	0.53%	0.00%	0.53%	0.00%	0.53%	
Cash	5.42%	0.00%	5.42%	1.29%	0.00%	1.29%	-0.19%	0.00%	-0.19%	0.00%	-0.19%	
<b>Total Portfolio - Net of Fees</b>				<b>1.96%</b>	<b>3.87%</b>	<b>-1.91%</b>	<b>0.78%</b>	<b>-2.70%</b>	<b>-1.92%</b>	<b>0.01%</b>	<b>-1.91%</b>	

## Relative Performance by Stock – Quarter Ended June 30, 2023

Quarter Ended 06/30/2023 - Representative Portfolio vs Russell Midcap Value Index											
Top Four Holdings			Bottom Four Holdings			Top Four Sectors			Bottom Four Sectors		
Total Attribution			Total Attribution			Total Attribution			Total Attribution		
1	ADVANCED MICRO DEVICES	0.80%	1	GENPACT LTD	-1.20%	1	Information Technology	1.00%	1	Industrials	-1.57%
2	CBRE GROUP INC - A	0.26%	2	AGILENT TECHNOLOGIES INC	-0.67%	2	Utilities	0.53%	2	Real Estate	-0.51%
3	EQUINIX INC	0.20%	3	ALEXANDRIA REAL ESTATE EQU	-0.39%	3	Materials	0.23%	3	Consumer Discretionary	-0.50%
4	BECTON DICKINSON AND CO	0.18%	4	JACOBS SOLUTIONS INC	-0.38%	4	Consumer Staples	0.19%	4	Health Care	-0.45%

## HCM MID-CAP VALUE COMPOSITE PERFORMANCE HISTORY

% Annualized Returns As of 06/30/2023	2Q 2023	1 Year	3 Years	5 Years	7 Years	10 Years	Since Inception 06-30-88
HCM Gross of Fees	1.82%	4.18%	11.33%	6.16%	8.55%	8.11%	13.04%
HCM Net of Fees	1.57%	3.15%	10.24%	5.11%	7.48%	7.05%	11.94%
Russell Mid Cap Value Index	3.86%	10.50%	15.04%	6.84%	8.20%	9.03%	10.94%
Russell Mid Cap Index	4.76%	14.92%	12.50%	8.46%	10.12%	10.32%	11.12%

[Link to: HCM Performance Disclosures](#)

## PORTFOLIO ACTIVITY

### New Positions

**Intercontinental Exchange (ICE)** - Intercontinental Exchange (ICE) is one of the largest exchange operators in the world. Its exchanges facilitate the trading of everything from equities, commodities, derivatives, credit default swaps, carbon credits, fixed income securities, and mortgages. ICE has been built over the prior two decades through more than twenty acquisitions, all with a similar theme – converting analog trading systems to digital.

ICE was founded in 2000 by Jeff Sprecher (who remains Chairman and CEO to this day) through the creation of an electric power exchange that allowed for the cash settlement of electricity contracts (previously an analog market where contracts were negotiated directly between counterparties). Following the collapse of Enron in the early 2000s, ICE benefitted from the market's desire to trade through an independent third party. Once the success of its initial power exchange was established, ICE diversified its business through acquisition by rolling out its “analog-to-digital” strategy into other trading markets. Most of its acquisition targets were comprised of traditional open outcry markets limited to “members”, which it would subsequently convert to digital markets open to anyone.

In 2016, ICE began its most recent “analog-to-digital” transformation by entering the mortgage industry through its acquisition of MERS (the digital registry for mortgages). ICE subsequently acquired Simplifile (an electronic filing network for county recorders' offices) in 2019, Ellie Mae (loan origination software provider) in 2020, and has entered into an agreement to acquire Black Knight (loan origination, servicing, and trading software provider) with the intent of becoming the clearinghouse and data provider for the mortgage industry.

While exchanges naturally benefit from network effects, the true value of owning an exchange has shifted over time from providing a marketplace for buyers and sellers to operating as an independent clearinghouse and owning the data underlying the exchange itself. Simply operating a marketplace for traders is a relatively commoditized business. Where ICE generates its attractive returns on invested capital is from owning the intellectual property underlying its various derivatives contracts, acting as a clearinghouse, and owning the trading data from its exchanges. These three features account for the majority of ICE's profitability and underly what it is trying to create in the mortgage industry.

While global trading volumes as a whole will likely grow at low-single-digits, ICE should be able to continue to outgrow its markets as its existing and to-be-developed contracts continue to take market share. ICE's highest growth will come from its "Mortgage Technology" segment which comprises ~12% of revenue and is in the process of developing the world's first end-to-end digital trading platform for mortgages.

At our entry price, we were able to purchase a business that earns amongst the highest incremental returns on invested capital of any company in our portfolio, has a conservatively levered balance sheet, and is run by one of the best management teams we have come across, all at a substantial discount to intrinsic value. We expect this combination to lead to very attractive investment results over the long-term.

### **Positions Increased**

**Genpact (G)** – We added to our position in Genpact during the quarter as the stock became increasingly attractive on a valuation basis. Despite outperforming our benchmark over the period of our holding this company in the portfolio, Genpact is now cheaper than it was when originally purchased due to its strong earnings growth over our holding period.

**Virtu Financial (VIRT)** – We added to our position in Virtu during the quarter as the company's stock fell to an all-time low valuation. By our estimates, Virtu trades at only 7 times its current earnings estimate for 2023. Having substantially delivered its balance sheet, Virtu is currently repurchasing its own stock at about 2% of shares outstanding per quarter, while also paying a dividend yielding more than 5%. We currently estimate Virtu's value to be almost twice its current stock price and that value is compounding at double-digit rates annually.

**Wabtec (WAB)** – We increased our position in Wabtec during the quarter as its orders and backlog have increased substantially due to its Tier 1 railroad customers starting to catch up to several years of deferred capital expenditures. We believe that Wabtec is at the front end of a multi-year upgrade cycle by those customers which will lead to increasing levels of revenue and earnings growth in 2023 and beyond.

### **Positions Reduced**

There were no positions reduced during the quarter.

### **Positions Sold**

**East West Bancorp (EWBC)** – We exited our position in East West Bank during the first few days of April, following shortly on the heels of exiting First Republic Bank and SLM Corp near the end of the first quarter – for the reasons previously stated with regard to regional banks.

**Advanced Micro Devices (AMD)** – We exited our AMD position during the quarter as optimism over the impact of A.I. caused the stock to surge during the quarter.



AMD has almost doubled over the course of the last 9 months and was selling at over 40 times forward earnings at the time of our exit. We continue to like the company's positioning for the long-term but much of the intermediate-term upside in the stock was already accounted for at the time of our exit, in our view.

**Embecta (EMBC)** – We exited our very small position in Embecta as this spin-off from Becton Dickinson increased in value by over 25% during the quarter. As a small-cap company, Embecta was not going to be a core holding in the portfolio and was disposed of in opportune fashion.

**F&G Financial (FG)** – We exited our position in F&G during the quarter as this spin-off of Fidelity National Financial (FNF) was not going to be a core position in the portfolio. It has less compelling economics and returns than its parent company and represented a tiny proportion of the portfolio (<0.1%) at the time of our exit.

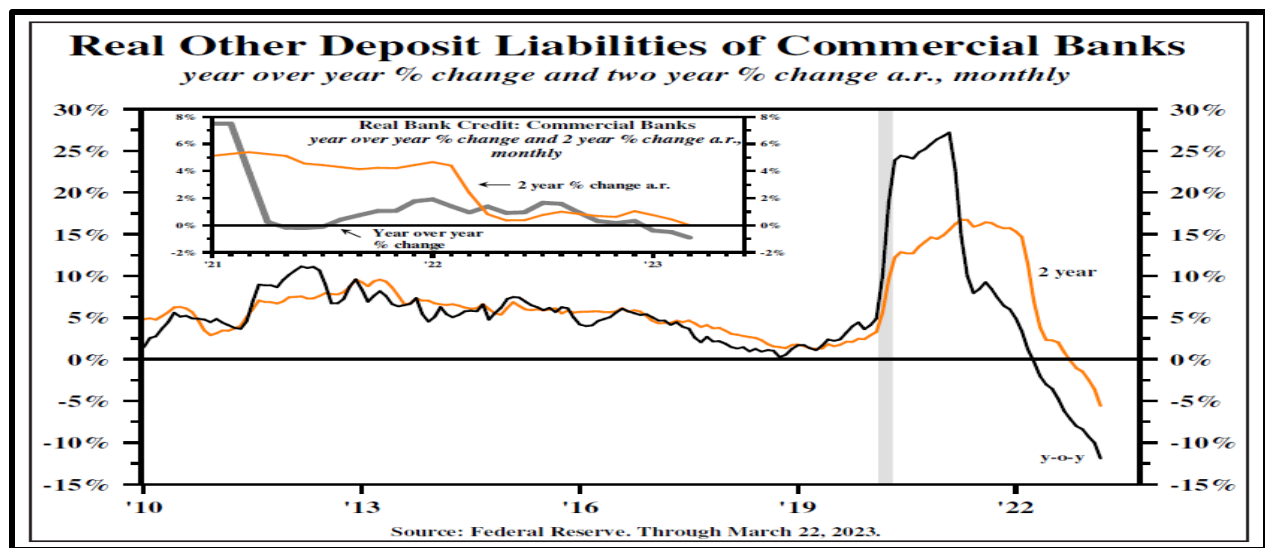
## **Outlook**

### **Economic & Market Outlook**

In our view, recession is generally NOT discounted into current equity fundamentals, with the exception of lower- and mid-capitalization stocks. Domestic large-cap stock valuations remain near cycle highs, with the expansionary cycle extended by excitement around AI and machine learning. We remain cautious regarding large cap exposure as concentration remains at historic highs. For example, the top 10 names in the S&P 500 accounted for roughly 30% of that index at quarter end. We believe small and mid-capitalization stock valuations remain attractive, while fundamental earnings power remains healthy. Mid-cap stocks, specifically, remain at historically wide valuation discounts to large cap stocks. We view the sustainability of earnings growth as more attractive in equities categorized as value and the fundamental valuation multiples are modest compared to historical data. In addition, value style has a lower exposure to sectors that we view as overpriced. Although growth has vastly outperformed value year-to-date, we anticipate that we are in the early stages of a value outperformance cycle.

On inflation, clearly there's been progress in bringing it down, as year-over-year CPI has fallen from over 9% in 2022 to 4% in less than a year's time. However, even at 4%, CPI remains far above the Fed's 2% target. If inflation bounces back, or fails to continue to decline, then the Fed could easily hike rates further, like the Bank of Canada and Reserve Bank of Australia did in the second quarter. Those higher rates would weigh further on economic growth.

The risk of a recession continues to rise, even though the economy grew in the first quarter. The Fed has neutralized the inflationary impact of the fastest modern era money growth in 2020-2021. Other deposit liabilities (ODL), in real terms, have registered a double-digit decline in the 12 months ended March, with the 24-month change at a negative 5% (see chart below). Over the past 12 months, real bank credit had declined even before the recent, and highly visible, bank failures and is now unchanged for the past 24 months. Although monthly data is not available before World War II, the latest 12 month decline in M2 is undoubtedly the sharpest since 1934. For a highly levered U.S. economy which is so sensitive to the availability of bank credit, this is an ominous sign indeed.



We are strategizing for a more volatile and riskier 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

As represented by our new investment in Intercontinental Exchange, we continue to favor companies that are positioned to benefit from continued volatility in global markets. The same can be said for our decision to add to our position in Virtu Financial, whose profitability increases dramatically with higher volatility and trading volume in equities.

We continue to favor companies such as Wabtec and Jacobs, which are correlated to an increase in productive capacity of real goods, a trend which we expect to accelerate in the coming years. Finally, we can't remember a time in our investment careers where the combination of macroeconomic headwinds, geopolitical risks and shifting consumption patterns were so at odds with high valuations for broad stock market averages.

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