# Mid Cap Equity Strategy 3rd Quarter 2019 Commentary

## 3rd QUARTER MARKET SUMMARY

After a difficult summer for risk assets, investors returned from their holidays in a bullish mood and drove equities higher in September, leaving global equities broadly flat for the quarter. The quarter was marked by a continued slowdown in the global economic data, offset by further monetary easing from the US and Europe. Equity markets ended the quarter in mostly positive territory despite mixed economic data and a continuation of trade tensions. The S&P 500 returned 1.7% in Q3 for a YTD total return of 20.6%. Once again, the US outperformed international equities as the USD strengthened. Investors also sought the safety of long-term bonds with the Bloomberg Barclays US Aggregate 10+ Year rallying 6.6% in Q3 and 20.9% YTD.

The bond market was the big story in 3rd quarter. The Fed embarked on its first rate cut cycle in more than ten years by reducing the overnight fed funds rate 25bps at both the July and September FOMC meetings in an attempt to prolong the economic expansion in the face of a slowdown in the pace of growth and hiring. While the economy continued to add jobs, the pace of growth of aggregate hours worked in the economy has slowed meaningfully. Consumer confidence also declined from elevated levels.

The initial cut in July was proceeded by historic declines in the 10YR and 30YR yields, a temporary inversion of the 10YR – 2YR spread, and a new all-time low for the 30YR yield. The quarter began with key U.S. Treasury yields for the 2-, 10- and 30-year maturities at 1.75%, 2.00%, and 2.52%, respectively. By early September these same benchmark yields resided at 1.47%, 1.47%, and 1.95%, marking the first time the 30-year U.S. Treasury bond yielded less than 2.00%. By quarter end, stocks moved to within 2% of their all-time highs and Treasury yields moved higher. In late August the entire curve was trading below the overnight funds rate.

In early September many short-term funding rates ballooned higher, including the overnight fed funds rate reaching 3%, despite the Fed's then 2% - 2.25% target range. The Fed has since been forced to implement daily repo operations for the first time since emerging from the financial crisis. A more permanent fix to the liquidity crunch could be announced at the October meeting. Some "plumbers" are expecting a permanent repo facility while others see the need for a more impactful QE-like response. Market historians were quick to point out that these money market conditions and the shape of the yield curve were very highly correlated with subsequent contractions in GDP and a signal of oncoming recession. Concerns remain about the strength of the economy as the ISM US Manufacturing PMI Index slipped to its lowest level since 2009.

On September 16th Brent crude spiked a record 20% in one session following coordinated drone and missile strikes against Saudi Arabia's energy infrastructure in what was one of the worst ever disruptions of crude output. While full capacity has yet to be restored, the recovery has gone faster than expected and Brent prices retraced 100% of their gains within two weeks. For the quarter Brent and WTI declined 8.5% and 6.5%, respectively. Signs of weakening global growth also played a part.

The U.S. economy is growing at a moderate pace. The one-time tailwind from last year's tax cuts and reduced regulations turned 1% GDP growth into 3% GDP growth. Now the economy is settling into 2% growth as manufacturing and consumer confidence data are beginning to show signs of slowing. The growth is still impressive in the face of economic weakness from Europe, China and Japan. On the positive side: the U.S. remains at full employment; productivity growth continues to impress; and, low mortgage rates are supporting the housing market. Future corporate earnings estimates have been systematically reduced by Wall Street analysts this year, possibly paving the way for positive earnings surprises down the road. Two percent GDP growth coupled with low inflation can keep long-term expansion fires burning well into 2020.

## Quarterly Performance

Our **return** for the Hahn Capital Management Mid-Cap Value Composite was 0.73% gross of fees in the third quarter of 2019. For the quarter, we underperformed our primary benchmark, the Russell Mid-Cap Value Index, by 0.49 percentage points. For the quarter, sector allocations to Real Estate, Industrials, Healthcare and Communications Services (no holdings) contributed positively, while those to Energy, Financials, Consumer Discretionary, Materials and Utilities (no holdings) somewhat detracted. The most significant contributors during the quarter were Equinix (EQIX), Mid-America Apartments (MAA), Ross Stores (ROST), Keysight Technologies (KEYS), Jacobs Engineering (JEC) and Alexandria Real Estate (ARE), while the most significant detractors were Euronet Worldwide (EEFT), Pioneer Natural Resources (PXD), CIT Group (CIT), EastWest Bancorp (EWBC), and PVH Corp (PVH). During the quarter we exited our position in Carlisle Companies (CSL); initiated a new position in Bank of N.T. Butterfield (NTB); and, reduced positions in Jacobs Engineering and Keysight Technologies.

**QTD HCM vs. Russell Mid-Cap Value Index - Quarter Ended 09/30/2019**

**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 | 22.76% | 11.41% | 11.35% | 1.34% | -0.48% | 1.83% | -0.18% | 0.41% | 0.23% | 0.00% | 0.23% |
| Real Estate | 15.87% | 14.24% | 1.63% | 9.66% | 8.21% | 1.34% | 0.13% | 0.19% | 0.32% | 0.00% | 0.32% |
| Information Technology | 15.12% | 7.38% | 7.74% | -1.24% | -0.51% | -0.74% | -0.12% | -0.10% | -0.22% | -0.01% | -0.23% |
| Financials | 14.68% | 18.91% | -4.23% | -1.88% | 2.33% | -4.11% | -0.06% | -0.64% | -0.70% | 0.00% | -0.70% |
| Consumer Discretionary | 11.71% | 8.84% | 2.86% | -1.60% | 1.05% | -2.63% | 0.00% | -0.33% | -0.33% | -0.01% | -0.34% |
| Health Care | 11.74% | 6.98% | 4.76% | 0.26% | -3.76% | 4.18% | -0.25% | 0.48% | 0.23% | 0.00% | 0.23% |
| Energy | 1.99% | 5.77% | -3.78% | -17.97% | -12.54% | -6.21% | 0.57% | -0.14% | 0.43% | 0.00% | 0.43% |
| Materials | 1.76% | 6.64% | -4.89% | -0.74% | -2.37% | 1.67% | 0.18% | 0.03% | 0.21% | 0.00% | 0.21% |
| Communication Services | 0.00% | 3.93% | -3.93% | 0.00% | -5.09% | 5.36% | 0.25% | 0.00% | 0.25% | 0.00% | 0.25% |
| Consumer Staples | 0.00% | 4.47% | -4.47% | 0.00% | 6.34% | -5.96% | -0.22% | 0.00% | -0.22% | 0.00% | -0.22% |
| Utilities | 0.00% | 11.43% | -11.43% | 0.00% | 7.30% | -6.81% | -0.67% | 0.00% | -0.67% | 0.00% | -0.67% |
| Cash | 4.38% | 0.00% | 4.38% | 0.58% | 0.00% | 0.58% | -0.04% | 0.00% | -0.04% | 0.00% | -0.04% |
| **Total Portfolio** | | | | **0.69%** | **1.22%** | **-0.53%** | **-0.41%** | **-0.11%** | **-0.52%** | **-0.01%** | **-0.53%** |

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

### *MODEL PORTFOLIO REVIEW*

**As of September 30, 2019**

***Attribution Analysis - Notable Performers by Sector & Stock***

**Notable Performers by Sector**

**Quarter Ended 09/30/2019 - Portfolio vs Russell Midcap Value Index**

| Top Four Holdings<br>Relative Contribution | | | Bottom Four Holdings<br>Relative Contribution | | | Top Four Sectors<br>Relative Contribution | | | Bottom Four Sectors<br>Relative Contribution | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| 1 | KEYSIGHT TECHNOLOGIES IN | 2.11% | 1 | SLM CORP | -0.42% | 1 | Industrials | 4.92% | 1 | Utilities | -2.41% |
| 2 | JACOBS ENGINEERING GROUP INC | 1.86% | 2 | ALBEMARLE CORP | -0.16% | 2 | Information Technology | 3.76% | 2 | Financials | -1.76% |
| 3 | EURONET WORLDWIDE INC | 1.84% | 3 | BANK OF N.T. BUTTERFIELD&SON | -0.12% | 3 | Real Estate | 2.09% | 3 | Materials | -0.83% |
| 4 | EQUINIX INC | 1.84% | 4 | PVH CORP | -0.05% | 4 | Health Care | 1.11% | 4 | Consumer Staples | -0.68% |

**Year-to-Date Ended 09/30/2019 - Portfolio vs. Russell Midcap Value Index**

| Top Four Holdings<br>Relative Contribution | | | Bottom Four Holdings<br>Relative Contribution | | | Top Four Sectors<br>Relative Contribution | | | Bottom Four Sectors<br>Relative Contribution | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| 1 | EQUINIX INC | 0.56% | 1 | EURONET WORLDWIDE INC | -0.68% | 1 | Energy | 0.39% | 1 | Utilities | -0.82% |
| 2 | ROSS STORES INC | 0.49% | 2 | PIONEER NATURAL RESOURCES C( | -0.36% | 2 | Industrials | 0.38% | 2 | Financials | -0.78% |
| 3 | MID-AMERICA APARTMENT COMM | 0.43% | 3 | MOHAWK INDUSTRIES INC | -0.29% | 3 | Health Care | 0.32% | 3 | Consumer Discretionary | -0.29% |
| 4 | KEYSIGHT TECHNOLOGIES IN | 0.42% | 4 | CIT GROUP INC | -0.22% | 4 | Real Estate | 0.32% | 4 | Consumer Staples | -0.28% |

## HCM ERFORMANCE HISTORY

| % Annualized Returns As of 09/30/2019 | 3Q 2019 | YTD | 3 Years | 5 Years | 7 Years | 10 Years | Since Inception 06-30-88 |
|---|---|---|---|---|---|---|---|
| HCM Gross of Fees | 0.73% | 27.42% | 11.70% | 8.41% | 11.99% | 13.13% | 13.95% |
| HCM Net of Fees | 0.48% | 26.54% | 10.69% | 7.39% | 10.93% | 12.05% | 12.96% |
| Russell Mid Cap Value Index | 1.22% | 19.47% | 7.82% | 7.55% | 11.63% | 12.29% | 11.32% |
| Russell Mid Cap Index | 1.97% | 21.93% | 10.69% | 9.10% | 12.57% | 13.07% | 11.36% |

*Link to: HCM Performance Disclosures*

## PORTFOLIO ACTIVITY

### Positions Added

**The Bank of N.T. Butterfield & Son Ltd. (NTB)** – N.T. Butterfield & Son is a $11.2B asset, full-service, community bank and trust/wealth manager based in Bermuda. It is the largest bank on the island with ~50% market share and is the largest trust provider in Bermuda, specializing in the offshore trust market. It was the first bank established on the island and is one of only four banks licensed to operate there. NTB received its banking powers in 1858 and it has been a publicly traded bank on the Bermuda stock exchange (BSX) since 1971, recently listing its shares on the NYSE in September 2016 for the first time.

Located ~700 miles off the east coast of the United States, Bermuda is a British Overseas Territory (operating under English Common Law) and is a global hub for the reinsurance industry with ~14% of the global reinsurance market located there, including 15 of the top 40 global players and ~800 captive insurers. Bermuda has no corporate income tax and has the 5$^{th}$ highest GDP per capita in the world; however, it is highly concentrated in the insurance/financial services industries.

NTB is a very simplistic bank: it is funded ~100% with low-cost consumer and business deposits from its three major markets (Bermuda, Cayman Islands, and Channel Islands), it then takes those deposits and invests ~40% into low risk residential and commercial loans within its island communities, and the remaining ~60% into AAA-rated US Treasury securities, resulting in one of the safest and highest liquidity banks in the industry. NTB's loan book is conservatively underwritten with residential mortgages to local Bermudans comprising >60% of total loans. These loans are fully secured (i.e. full-recourse to the borrower) and have an average LTV of <55%. As a result, net charge-offs from its loans have significantly outperformed NTB's US-based peers. In addition, NTB operates with significant liquidity to protect itself in a downturn – NTB has a CET1 ratio of ~20% (almost double its US-based peers) and holds ~20% of its assets in cash (more than 3x its US-based peers).

If a US-based bank were to try to emulate NTB's conservative investment strategy (~60% of earning assets invested in low-yielding US Treasury securities) it would likely not earn its cost of capital as net interest income would be too low to sufficiently offset operating expenses. However, because of NTB's dominance of its niche market (~50% market share in Bermuda, where only three other banks operate), it is able to fund itself at less than 40% of the cost that the average US-based bank funds itself. In addition to zero corporate taxes, this gives NTB a significant competitive advantage vs peers in that it is the low-cost provider in the industry, allowing it to more conservatively invest its earning assets while still generating higher returns (20%+ ROE) vs peers.

However, NTB operates in low growth markets as it is already the dominant bank in its small island economies. This means NTB generates significant excess cash flow, which it has historically returned ~60% of through dividends and share repurchases. Going forward, management has identified the Channel Islands as its most significant growth opportunity. Located in the English Channel, the Channel Islands service mainly European investment funds and trust/wealth management clients, comprising $300+ billion of deposits (>10x the size of Bermuda and the Cayman Islands). With NTB only recently establishing itself in the Channel Islands through its acquisitions of Deutsche Bank's and ABN AMRO's island subsidiaries, it still only has <1%

market share and significant growth opportunities given most multinational banks are looking to exit the market and NTB is the natural acquirer of choice.

At our entry price, we were able to purchase a significantly above average bank that is conservatively run with a sustainable competitive advantage at a below "average bank" price. Given our outlook for NTB's growth prospects and earnings power, we believe this purchase price will result in above market returns over the long-term.

## Positions Increased

There were no positions increased during the quarter.

## Positions Reduced

**Jacobs Engineering (JEC)** – We reduced our position in Jacobs as the company has evidenced excellent traction in its long-term strategy of re-orienting its business toward higher margin, lower risk and less cyclical end markets. Jacobs management has substantially re-fashioned the business and taken advantage of strong end markets to drive excellent earnings growth over the past three years with aggressive growth goals still ahead. Due to the significant price appreciation, we were compelled to take some profits and reduced our position.

**Keysight Technologies (KEYS)** – We reduced our position in Keysight during the quarter as the company's excellent execution has very effectively positioned the company to take advantage of the global roll-out of 5G cellular communication networks. The company has market leading products, software and services across the 5G technology spectrum in test and measurement, just at the time when market demand for those products has started to experience explosive growth. We reduced our position for risk management purposes, as it became greater than 5% of our portfolio during the quarter.

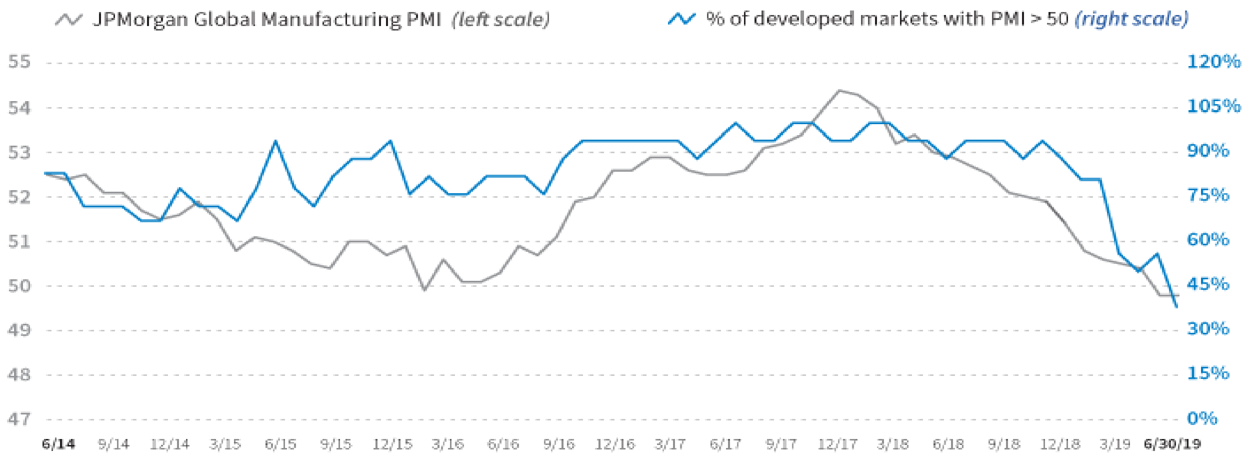
## Positions Sold

**Carlisle Companies (CSL)** – We exited the remaining position in Carlisle during the quarter as a combination of excellent price appreciation, associated valuation expansion and a lack of long-term earnings power drivers compelled us to take profits and move on. Carlisle provided a very satisfactory return during our 3+ year holding period, during which time the company made several very significant acquisitions, re-purchased a significant amount of stock and organically increased its revenues and earnings. The longer-term issue we had with the company's prospects was a lack of conviction around the prospective impact of those acquisitions and a long standing and persistent dependence on one very profitable operating segment to drive results. The company has also added significant financial leverage in the pursuit of diversification without much success in driving further earnings power growth.

## Outlook

Overall, the global economy faces several binary and highly unpredictable risks. Will the trade war escalate? Will the UK face a "no-deal" Brexit? Will the recent tension in the Middle East escalate and cause another spike in the oil price? And will companies respond to slowing growth and profits by cutting jobs? We would argue that the impact of some of those risks have already started to impact global (and U.S. economic activity). The following chart adds some visual perspective to those concerns:

**Figure 2: Global manufacturing has entered a slump**




Source: Putnam.

The effect on the real economy is compounded by the fact that year-on-year comparisons were already going to be difficult because the 2017 Tax Cuts and Jobs Act (TCJA), as mentioned, had pulled forward industrial demand. In addition, technology export restrictions imposed by the U.S. Department of Commerce have also caused companies to question the practicality of their global supply chains. These supply chains and systems of just-in-time inventory have taken the better part of two decades to implement and are not easily disentangled.

The subject of interest rates will remain crucial in the comings quarters. The Fed shifted from merely acknowledging the global economic slowdown and the escalating trade wars, to practicing “risk management” by only cutting 0.25% in July and not appearing too aggressive, to its second rate cut on weakening business investment and the trade wars. Throughout, the Fed assured markets that it will act as appropriate to sustain expansion. The Fed will end two months early its program to reduce its balance sheet by not reinvesting the proceeds of maturing bonds and will now reinvest those proceeds in Treasury bonds, so mortgage holdings will still be going down.

Government spending is continuing unabated, with Congress reaching a deal with the administration that suspends the debt limit for two years and avoids any government shutdowns. Spending will increase $50 billion in the next year and will be $320 billion over the previous, suspended limit over the next two years. There will be no action taken to reduce the deficit during the suspension and total Treasury borrowing for fiscal 2019 will be over $1.2 trillion, up from $546 billion in 2017.

Add to the drama the new drumbeat that negative interest rates in the US are a real possibility. Negative rates (depositors lose money by keeping money in banks and borrowers “make money” because their loan payments reduce the loan by more than the payment amount) have spread across the developed economies, with nearly $20 trillion of foreign government debt at negative rates. The European Central Bank signaled its first rate cut since 2016 and its rates are already at -0.4%. Negative rates would be uncharted territory for the US and the biggest problem is that the normal tool for managing the economy – interest rates – would no longer be available. Central banks have essentially thrown in the towel when rates go negative.

The Fed also intervened in the market for overnight borrowing among banks and short-term investment funds, including money market funds. High issuance of corporate debt and tax payments by corporations sucked up cash and dried up the liquidity in what is known as the repo market (for repurchase agreements) and overnight rates spiked to over 6%. The Fed injected $75 billion a day for over a week to support the market, all the while insisting it was a temporary structural problem and not an ongoing collapse.

All this activity amounts to credit markets making a significant bet on the rapidly rising probability for significantly slower growth ahead, if not recession. While we are almost always in favor of further growth, we also recognize that a significant slow-down, a receding tide if you will, can provide extraordinary opportunities for future returns. There might not be a free lunch in life but there can be a heavily discounted one.

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

Sincerely,

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