Mid Cap Equity Strategy **3rd Quarter 2021 Commentary**

So, What's Next?

Scanning the financial news headlines during the slightly more volatile, much less fruitful 3rd quarter gives ample reason for pessimism: a critical ongoing struggle over raising the national debt ceiling, a likely tapering of Federal Reserve support for the bond market, a possible hike in corporate taxes, and a threatened financial collapse in China all loom over the markets to trouble investors. If you add in the geopolitical risks associated with a rapidly nuclearizing Iran, a tangibly more aggressive and expansionist Russia and China and a fragile global supply chain, there really is ample reason for concern though we would argue that none of the risks needs to be further priced into the market than they currently are and that the likelihood of any of them manifesting to a worst-case scenario is quite low. Ultimately, they obfuscate, at least temporarily, the underlying story for the stock market, which is a continuing broad-based economic recovery, rising levels of employment, powerfully rising corporate earnings and an accelerating rate of innovation across the economy. These risks also belie the risk of not being invested, particularly in equities, as the following table demonstrates rather powerfully.

MARKET INDEX RETURNS AS OF SEPTEMBER 30, 2021

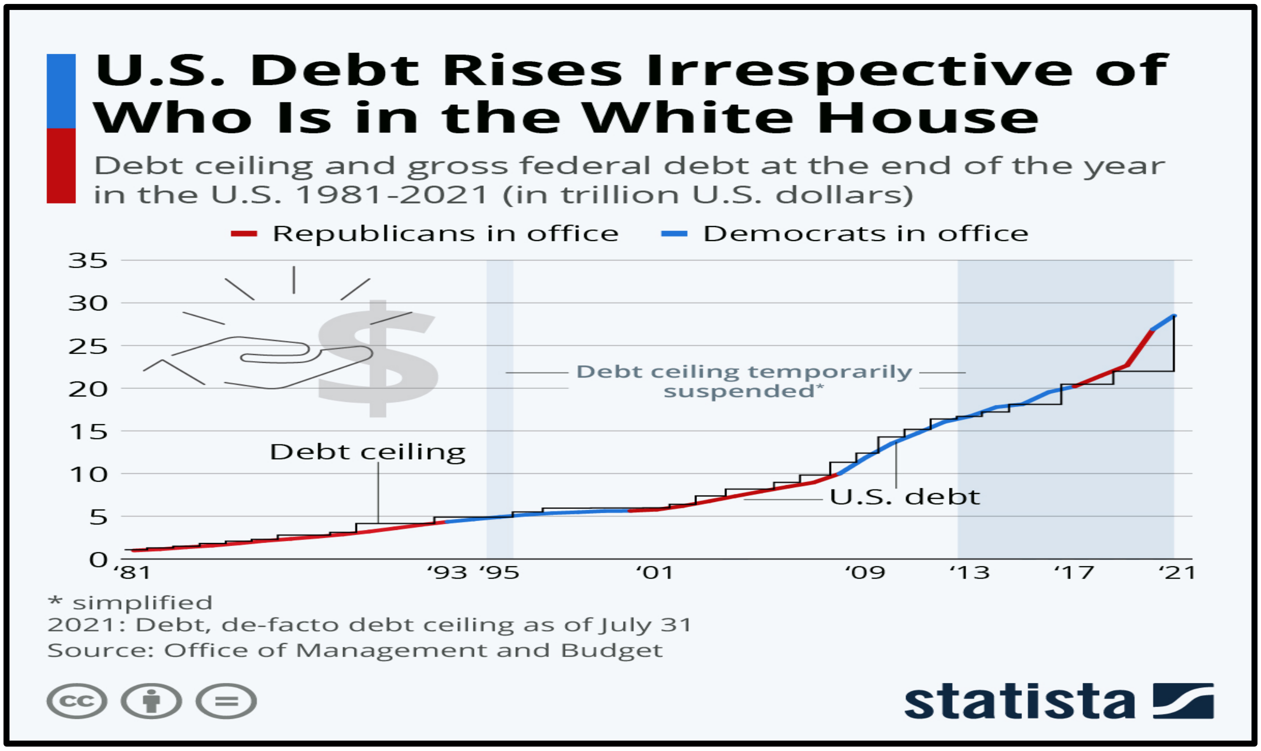
Index	3rd Quarter	YTD	1 Year	3 Years	5 Years	10 Years
S&P 500 (US Large Cap)	+0.6%	+15.9%	+30.0%	+16.0%	+16.9%	+16.6%
Russell Midcap (US Mid Cap)	-0.9%	+15.2%	+38.1%	+14.2%	+14.4%	+15.5%
Russell 2000 (US Small Cap)	-4.4%	+12.4%	+47.7%	+10.5%	+13.5%	+14.6%
MSCI ACWI X-US IMI Net (Foreign Equity)	-2.6%	+6.8%	+25.2%	+8.3%	+9.1%	+7.7%
MSCI EM (Foreign Emerging)	-8.1%	-1.3%	+18.2%	+8.6%	+9.2%	+6.1%
Barclays Aggregate Bond	+0.1%	-1.6%	-0.9%	+5.4%	+2.9%	+3.0%
Barclays Muni Bond	-0.3%	+0.8%	+2.6%	+5.1%	+3.3%	+3.9%

Past performance is not an indication of future performance.

Source: Bloomberg

Despite some recent progress, perhaps the most immediate concern overhanging the market is the struggle to raise the national debt ceiling before it is breached on October 18. On September 30, the House of Representatives agreed to a short-term spending bill to avoid a partial government shutdown but a battle over the debt ceiling remains.

The debt limit has repeatedly been raised or suspended by both parties over the past couple of decades but doing so has become increasingly political. Republicans have vowed to block even a temporary measure in the Senate. If the ceiling is not raised, the US faces defaulting on its obligations for the first time, which will significantly harm our global reputation and could wreak havoc with the markets. As the fight plays out in Congress, the movement to permanently abolish the debt ceiling is drawing more attention.



Source: Statista

Since the onset of the Covid 19 pandemic, more than $5.3 trillion in fiscal stimulus has already been injected into the economy. Congress is debating another $1 trillion infrastructure bill and $3.5 trillion investment in social safety net and climate protection measures. Infrastructure has bipartisan support, but progressive Democrats want to tie both bills together to ensure passage of the second bill to achieve Biden administration's goals (campaign promises). To earn the full support needed among Democrats for passage, the scope of spending may be trimmed down. Passage of either or both bills would be another injection of cash into the US economy that may spur growth even beyond the market's currently lofty expectations. Our belief is that, though the infrastructure portion of the bill may be warranted, the social spending agenda will have little positive impact on economic activity. It is a classic wealth transfer agenda and, politics aside, will do little to address structural imbalances in social equity longer term.

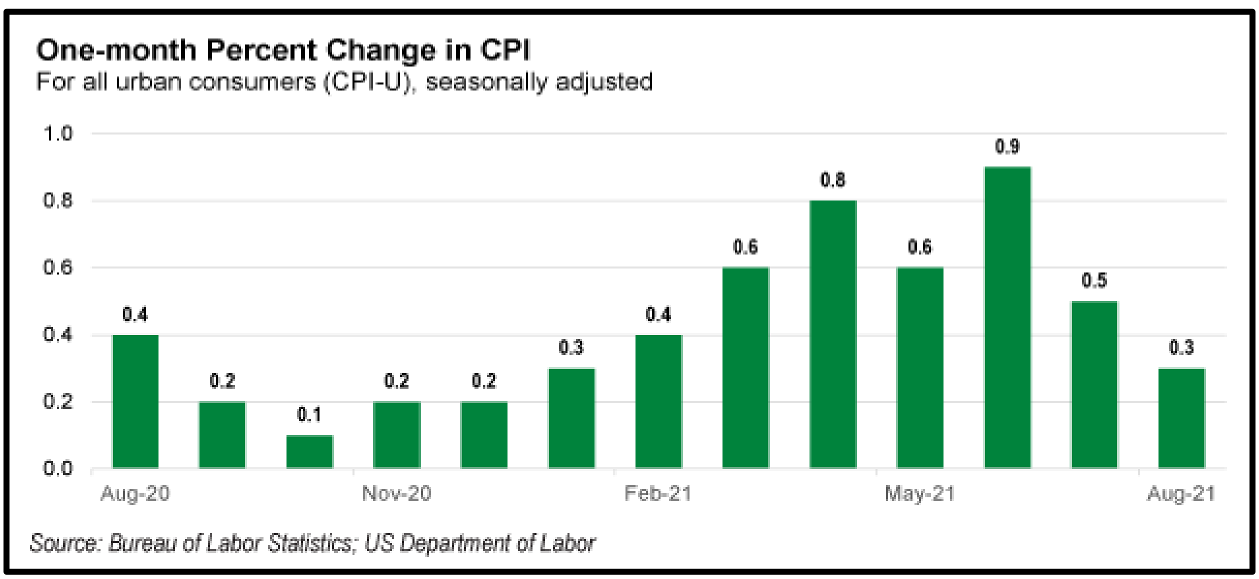
To help pay for the proposed bills and previous stimulus bills passed by the Trump administration, Democrats are also attempting to raise taxes. The most likely change is an increase to the corporate tax rate. The most recent proposal is to raise the rate from 21% to 26.5%. Also being considered are a 3% surcharge on any individual income over $5 million and an increase in the long-term capital gains rate from 20% to 25%.

The US economic picture has continued to improve over the course of the year. After starting 2021 with an unemployment rate of 6.7%, the rate had dropped to 5.2% by August. Though the number of jobs added in August fell short of expectations, altogether an average of 586,000 new jobs have been added monthly in 2021.

The additional $300 in monthly unemployment benefits provided by the federal government expired September 7, which could supply further incentive for some unemployed people to find work.

As measured by increases in corporate earnings, the broader economy continues to gain strength. Earnings for companies in the S&P 500 are at all-time highs, and earnings per share are forecast to rise 27% in the third quarter (Bloomberg). Corporate hiring intentions remain very high; companies are hiring as fast as they can find qualified workers for those job openings. The number of job openings, at an all-time high of 10.9 million in July, continues to rise while the number of unemployed workers continues to fall. As more of the millions who left the job market during the pandemic return to work, companies will be able to produce more goods and services, creating even more profit growth, though potentially weighted by increasing wages. It is because of the improving US labor market, strong economic growth and inflationary pressures that the Federal Reserve is considering tapering its support for the bond markets.

In our 2nd quarter 2021 newsletter, we explained why we thought that inflation pressures, however painful in the present, would ultimately prove transitory. We would be the first to acknowledge, however, that many of the supply shortages pushing up prices have continued. A limited supply of computer chips has held new car manufacturing to much lower levels than normal and kept car prices higher. But in other areas, many of the rising prices appear to be cooling off as seasonally high raw materials consumption peaked during the summer months. For example, the S&P/Case Shiller US National Home Price Index rose just 1.6% in August, after rising by over 2% each month from April to July. Inflation, as measured by the Consumer Price Index, rose just 0.3% in August—the lowest monthly increase since January. While inflation is expected to rise by about 5% for all of 2021, the Fed is projecting inflation to fall back closer to 2% in 2022. We can't be sure that the FED will be accurate in its forecast, but we believe it will be directionally correct, down in 2022 compared to a supply chain-constrained 2021.



What we worry most about is valuation though there is a silver lining to that as well. Broad market valuations are by almost any popular measure (price to book, price to sales, CAPE PE, Schiller PE) at extremes not usually seen except at market tops. So why our optimism? Because the divergence between value and growth is also at historical extremes, even after giving some credit for the impact of lower interest rates on longer duration (high growth) assets.

Today, 60% of the Growth stocks in the Russell 3000 Index make no money, and this was true even before the COVID-induced recession. Yet these very companies have been generating huge returns in price movement over the past few years, dramatically outperforming their Value counterparts. The Russell 3000 Growth Index was up 84% cumulatively over the last two years through August (more than double the return of its Value counterpart). So, investors are making money on companies that make no money – never a good sign when it is done this pervasively and at these valuations. And while not common, it is also not unique. We all witnessed the same speculative behavior in the late 1990s and in the 2008 speculative bubble.

MAKING MONEY ON COMPANIES THAT MAKE NO MONEY:
% of Russell 3000 Growth Stocks with Negative Earnings

Source: GMO

The silver lining is that value stocks are the mirror image, cheaper, on a relative basis than they have been in many moons and represent a great opportunity in the years ahead.

Quarterly Performance

Our 3rd Quarter 2021 return for the Hahn Capital Management Mid-Cap Value Composite was 0.65% gross of fees. For the quarter, we outperformed our primary benchmark, the Russell Mid-Cap Value Index, by 1.66 percentage points. For the quarter, sector allocations to Real Estate, Materials, Communications and Consumer Staples (no holdings) contributed, while those to Financial Services, Consumer Discretionary, Energy (no holdings) and Utilities detracted. The most significant relative performers during the quarter were Albemarle (ALB), CBRE Group (CBG), Agilent(A), and Keysight Technologies (KEYS) while the most significant underperformers were SLM Corp (SLM), Virtu (VIRT), Ross Stores (ROST), and Black Knight Technologies (BKI).

Hahn Capital Quarterly Performance Attribution – 3Q 2021

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
Financials	20.29%	16.34%	3.95%	-2.85%	3.10%	-5.94%	0.13%	-1.20%	-1.07%	0.00%	-1.07%
Real Estate	19.04%	11.02%	8.02%	7.47%	2.30%	5.17%	0.25%	0.95%	1.20%	0.00%	1.20%
Information Technology	17.31%	9.98%	7.33%	-0.31%	-3.29%	2.97%	-0.18%	0.49%	0.31%	-0.01%	0.30%
Industrials	13.64%	15.77%	-2.13%	-3.62%	-3.14%	-0.47%	0.04%	-0.07%	-0.03%	0.00%	-0.03%
Health Care	13.18%	8.56%	4.62%	3.94%	0.10%	3.84%	0.08%	0.51%	0.59%	0.00%	0.59%
Consumer Discretionary	10.09%	10.87%	-0.78%	-8.14%	-3.57%	-4.57%	0.01%	-0.46%	-0.45%	-0.01%	-0.46%
Materials	2.63%	7.39%	-4.76%	30.20%	-2.21%	32.42%	0.06%	0.69%	0.75%	0.00%	0.75%
Communication Services	1.33%	4.05%	-2.72%	6.64%	-5.53%	12.17%	0.13%	0.16%	0.29%	0.00%	0.29%
Energy	0.00%	4.67%	-4.67%	0.00%	-0.07%	0.07%	-0.05%	0.00%	-0.05%	0.00%	-0.05%
Consumer Staples	0.00%	4.18%	-4.18%	0.00%	-2.74%	2.74%	0.07%	0.00%	0.07%	0.00%	0.07%
Utilities	0.00%	7.17%	-7.17%	0.00%	-0.39%	0.39%	-0.04%	0.00%	-0.04%	0.00%	-0.04%
Cash	2.48%	0.00%	2.48%	0.02%	0.00%	0.02%	0.05%	0.00%	0.05%	0.00%	0.05%
Total Portfolio				**0.61%**	**-1.01%**	**1.62%**	**0.55%**	**1.07%**	**1.62%**	**0.00%**	**1.62%**

Relative Performance by Stock – Quarter Ended September 30, 2021

Quarter Ended 09/30/2021 - Portfolio vs Russell Midcap Value Index

Top Four Holdings — Total Attribution

#	Holding	Total Attribution
1	ALBEMARLE CORP	0.66%
2	CBRE GROUP INC - A	0.47%
3	AGILENT TECHNOLOGIES INC	0.38%
4	KEYSIGHT TECHNOLOGIES IN	0.36%

Bottom Four Holdings — Total Attribution

#	Holding	Total Attribution
1	SLM CORP	-0.76%
2	VIRTU FINANCIAL INC-CLASS A	-0.44%
3	ROSS STORES INC	-0.34%
4	BLACK KNIGHT INC	-0.21%

Top Four Sectors — Total Attribution

#	Sector	Total Attribution
1	Real Estate	1.20%
2	Materials	0.75%
3	Health Care	0.59%
4	Information Technology	0.30%

Bottom Four Sectors — Total Attribution

#	Sector	Total Attribution
1	Financials	-1.07%
2	Consumer Discretionary	-0.46%
3	Energy	-0.05%
4	Utilities	-0.04%

HCM MID-CAP VALUE COMPOSITE PERFORMANCE HISTORY

% Annualized Returns As of 09/30/2021	3Q 2021	1 Year	3 Years	5 Years	7 Years	10 Years	Since Inception 06-30-88
HCM Gross of Fees	0.65%	49.15%	13.35%	13.82%	10.81%	14.89%	14.13%
HCM Net of Fees	0.40%	47.80%	12.24%	12.71%	9.73%	13.78%	13.03%
Russell Mid Cap Value Index	-1.01%	42.40%	10.28%	10.59%	9.60%	13.93%	11.54%
Russell Mid Cap Index	-0.93%	38.11%	14.22%	14.39%	12.15%	15.53%	11.87%

Link to: HCM Performance Disclosures

PORTFOLIO ACTIVITY

New Positions

There were no new positions added during the quarter.

Positions Increased

Black Knight Technologies (BKI) We increased our position twice in Black Knight during the quarter. Black Knight is the closest business to a monopoly that we own in the portfolio. It provides crucial database services to originators and holders of mortgage paper. Despite the massive scale of most of its core customers, Black Knight is able to provide these services at a price that is so competitive and at service levels so high that these massive customers choose not try and provide the service internally. Management at Black Knight has done an exemplary job of investing for the future, growing the core franchise and providing excellent value for customers.

Positions Reduced

CBRE Group (CBRE) - We reduced our position in CBRE Group as price appreciation drove the weighting in our portfolio well above our 5% limit.

Agilent (A) - We reduced our position in CBRE Group as price appreciation drove the weighting in our portfolio well above our 5% limit.

Positions Sold

Hexcel (HXL) – We sold one of our longer-term holdings this quarter in Hexcel, which we have owned continuously since the summer of 2008. During our 13 years holding period, Hexcel did many things well, including executing on an unprecedented expansion of its carbon fiber manufacturing capacity to supply the needs of giant customers Boeing and Airbus as those companies embraced the use of Hexcel's high performance carbon fiber parts as replacements for various metallic parts in the vast majority of commercial aircraft manufactured over the past 15 years. It was no small accomplishment, as we estimate that Hexcel increased its capacity 5-fold over that period. The Company, which earned about $0.75 cents per share in 2008, saw earnings grow to $4.00 by 2019. We made six-fold on our money despite the company suffering a significant slowdown due to the Covid-19 pandemic's effect on global aircraft build rates.

Outlook

Company earnings have been impressive by any measure. The S&P 500 in Q2 recorded the highest year-over-year earnings growth in over a decade. That may not seem like a high bar given dismal earnings last year amid the COVID-19 crisis and a powerful economic restart in 2021.

Perhaps more telling is the makeup of the earnings progress. Overall, companies have beat analyst expectations on both earnings per share (EPS) and revenue growth. But the latter has been particularly strong. This suggests to us that even as inflation has been driving an increase in input costs, companies have the pricing power to offset it. They have been able to raise prices and push higher costs on to the end consumer, a reflection of pent-up demand and consumer willingness (or perhaps, necessity) to pay.

While most companies have surprised to the upside and by a wide margin, the market reaction to the historically large beats has been undersized. Stock performance, especially among cyclicals, has not popped at a magnitude consistent with the beat. This suggests some skepticism among investors while also affirming that blockbuster results don't necessarily receive bigger rewards from the market. Expectations of sustained inflation may be why.

At the risk of stating the obvious, earnings must slow from here. The data back to 2003 shows no historic precedent for sales growth to sustain at this level. But recent results demonstrate corporate dynamism: Companies successfully managed costs through the crisis period. They have weathered inflation equally well, and we'd expect cost pressures to abate as pandemic-dented supply rebuilds and demand normalizes. In all, the likelihood for earnings to slow from historic peaks does nothing to sully our outlook on stocks.

Companies are feeling they can raise prices, and the level of revenue surprise is bearing this out. This is partly because consumer income and balance sheets are exceptionally strong and able to endure price increases. Personal savings saw a notable increase during the pandemic while consumer debt declined. Typically, economies see pent-up demand after a recession but an inability on behalf of the consumer to spend. This time, government infusions and reduced expenses during lockdowns helped to pad pocketbooks. More recent data from the Federal Reserve Bank of New York shows a second-quarter climb in household debt as mortgages and auto loans increased. Consumers are spending and are likely to continue to do so for the foreseeable future.

From a portfolio construction perspective, we continue to advocate for more of a stable growth bias that consists of a tilt toward certain real estate assets and other enterprises whose outlook is uncorrelated with the financial conditions that have led to extreme valuations in certain growth sectors. Healthcare should continue to pace economic growth in the U.S. along with certain areas of consumer spending and infrastructure-related industrials.

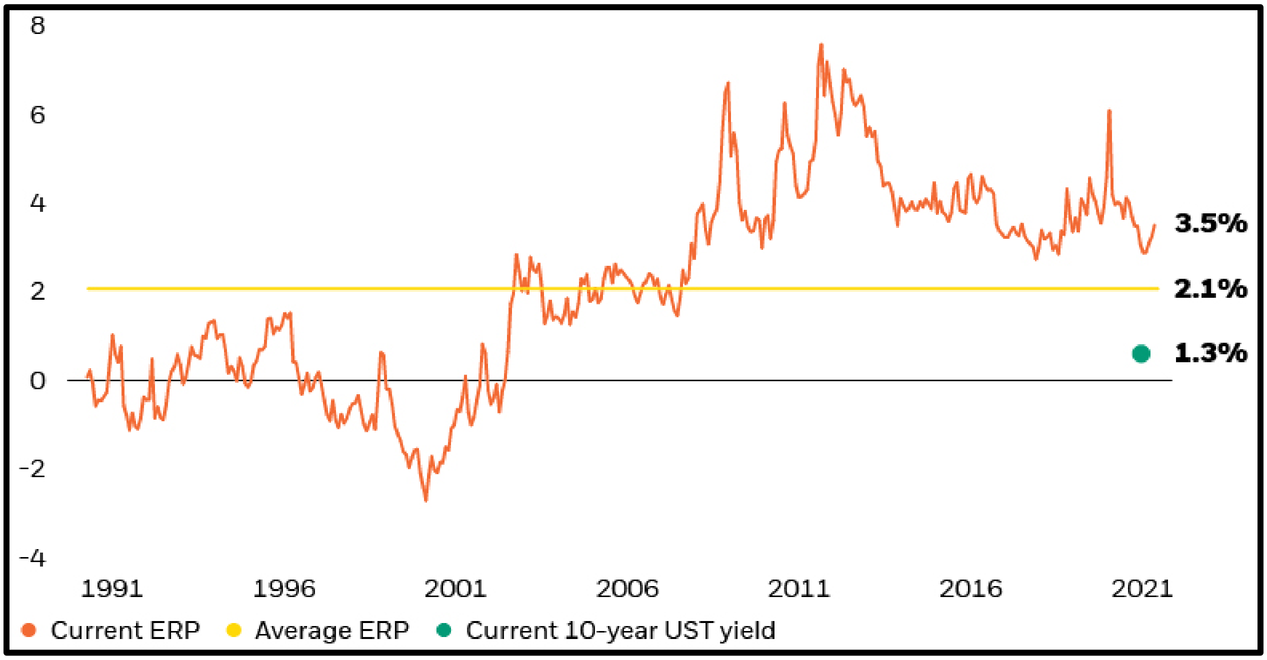
U.S. stock valuations are high on a price-to-earnings (PE) basis, which values a stock relative to its prior or future earnings potential. We'd make two points on this front: First, analyses of PE multiples versus returns over different time horizons have shown that PE has little ability to predict near-term returns (think one to three years) but does have greater predictive power over the longer term (think five to 10 years). This makes sense in that EPS estimates are changeable and the shorter the horizon, the greater room for anomalies. This year will be such an outlier.

Second, we believe PE is a less informative measure than the equity risk premium (ERP), which values stocks based on the prevailing 10-year Treasury rate. The ERP gauges whether investors are compensated for the greater risk in equities versus "risk-free" government bonds. The ERP has been well above its long-term average for the past 10 years, suggesting stocks are undervalued for the relative risk/reward they offer.

We don't see much room for change here. The 10-year Treasury yield would essentially have to double from its current level to compete with equities. As shown below, the ERP at the end of August stood at 3.5%, well above its 30-year average of 2.1% — a gap of 1.4% (see chart below).

By our assessment, the 10-year Treasury yield would have to rise by that much before equity risk/reward would begin to lose its appeal relative to bonds. This would imply 10-year Treasury yields in the area of 2.7%.

Equity Risk Premia Still Suggest Stocks Have Room to Move Higher



Source: Blackrock

We continue to look forward to a world that is not dominated by Covid-19-related headlines, though with the emergence of the Delta variant of this insidious disease, it looks like the new normal will be with us for a little while yet. We miss meeting with clients, interacting in the office with our colleagues and the energy that those conditions provide to us. Keep the faith, knowing that we are guarding your capital as if it were our own.

Sincerely,

John Schaeffer
President and CIO

Michael Whitfield
Dir. of Research and Co-Portfolio Manager