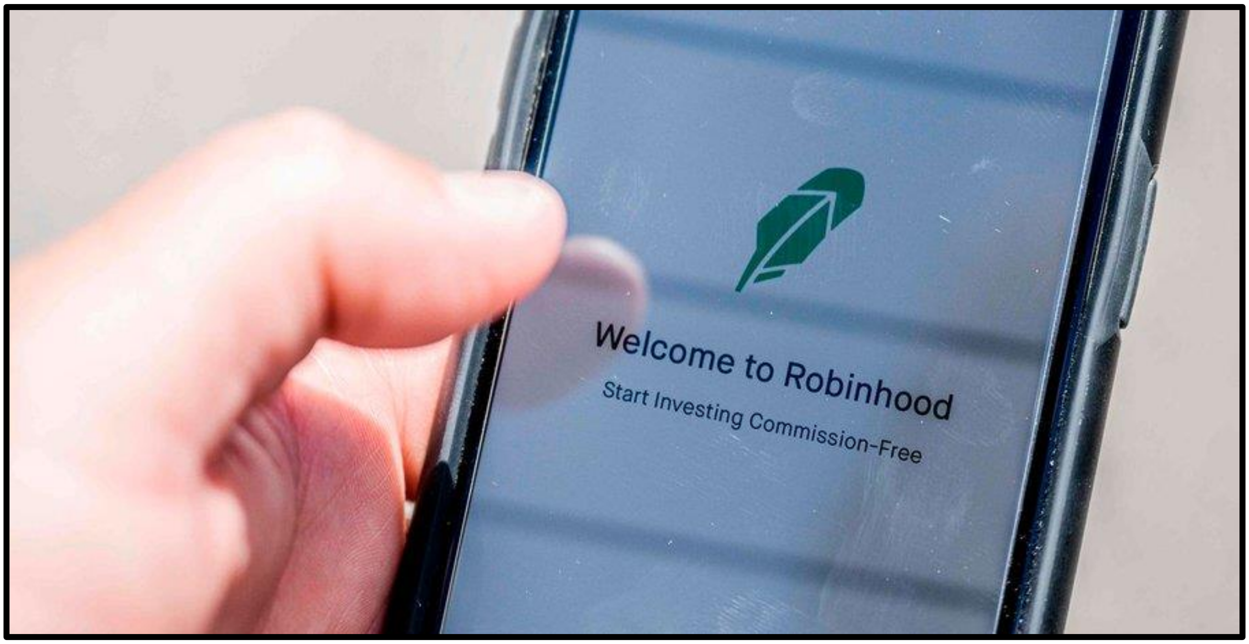
HAHN CAPITAL MANAGEMENT, LLC
REGISTERED INVESTMENT ADVISORS

Mid Cap Equity Strategy **4th Quarter 2021 Commentary**

Is the Party Over?



A year ago, 2021 seemed poised to bring back a sense of normalcy following the pandemic-stricken 2020, but a series of events provided plenty of bumps throughout the year. The emergence of COVID variants contributed to a sense of unease about the re-opening of the economy, while geopolitical events, particularly the continued emergence of China and Russia as destabilizing forces also impacted markets. The sole constant, it seems, was that the year produced strong equity markets, with the S&P 500 gaining nearly 29% in 2021, the third straight year of exceptional returns for the broad stock market index, which has doubled over the past three years on a total return basis.

The post-pandemic economic recovery generally remains on course and has provided fuel for the strong market returns. The final estimate of third-quarter GDP came in at 2.3%, a sharp deceleration from the 6.5% growth seen in the first half of 2021. The Federal Reserve now estimates full-year 2021 GDP growth of 5.5% for 2021 (down from 5.9%), while the initial outlook for 2022 is for 4.0% economic growth.

The consumer is the primary engine for the U.S. economy and remains generally strong and viable. Despite an array of headwinds, including COVID restrictions and surging inflation, consumer confidence surveys are rebounding and nearing pre-pandemic levels. Consumer confidence reached 115.8 in December as expectations for short-term growth prospects improved. However, retail sales did slow in November to 0.3% growth, a deceleration from stronger readings as wallet share shifted from goods to services. Also boosting the consumer side is a booming housing market where the S&P CoreLogic Case-Shiller Index showed an 18% annual gain in home prices.

The primary factor behind the equity market's strong gains were booming earnings, which are expected to show an advance of approximately 45% for 2021, according to Bloomberg. The earnings surge was enabled by a strong rebound in revenues coupled with high profit margins as companies were able to manage expenses during the pandemic. However, the impact of rising input costs as well as slowing revenue growth will likely challenge the profit growth outlook in 2022.

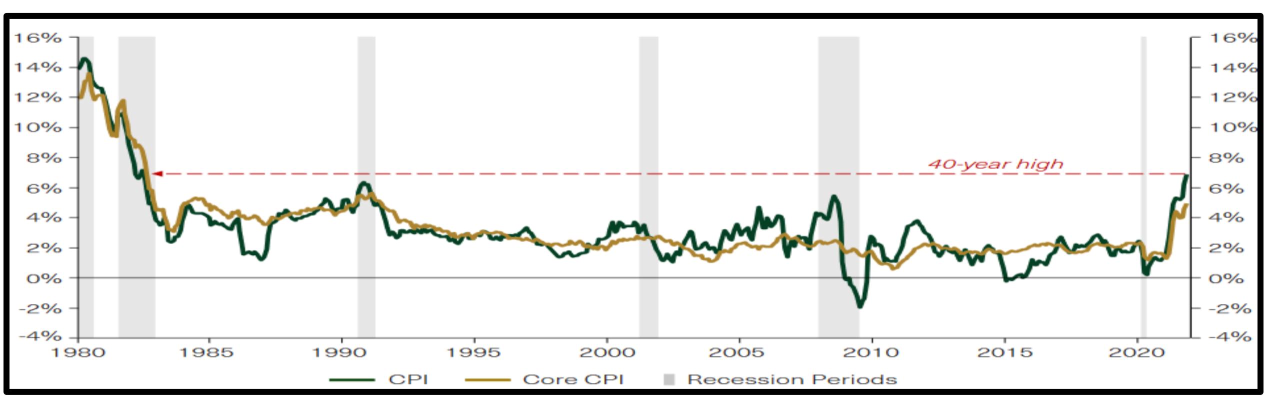
Market Index Returns as of December 31, 2021		
Equity Indices	**4th Quarter 2021**	**2021**
S&P 500	**11.02%**	**28.68%**
Dow Jones Industrial	**7.87%**	**20.95%**
NASDAQ	**8.47%**	**22.21%**
S&P 500 Growth	**13.37%**	**32.00%**
S&P 500 Value	**8.30%**	**24.86%**
Russell 2000 (small-cap)	**2.12%**	**14.78%**

Source: Bloomberg

Due to current high inflation levels being viewed less and less as "transitory," the Federal Reserve meetings during the quarter were closely watched. At its November meeting, the Fed announced a future tapering of its bond buying program. The December meeting provided additional color, as the Fed accelerated the pace of the anticipated reduction in its bond buying plan, which signaled to markets that its "Quantitative Easing" program is completed a few months earlier than previously expected in 2022.

As the FED currently anticipates the economic recovery to continue, the Fed has also signaled that it is ready to move on from the 0% Fed Funds rate policy. In fact, the market now expects up to four rate hikes during 2022, which could start as early as March 2022. The hawkish pivot from the Fed has come as it deals with inflation levels hovering near four-decade highs and unemployment rates back near pre-pandemic levels.

Inflation Stares Down the FED

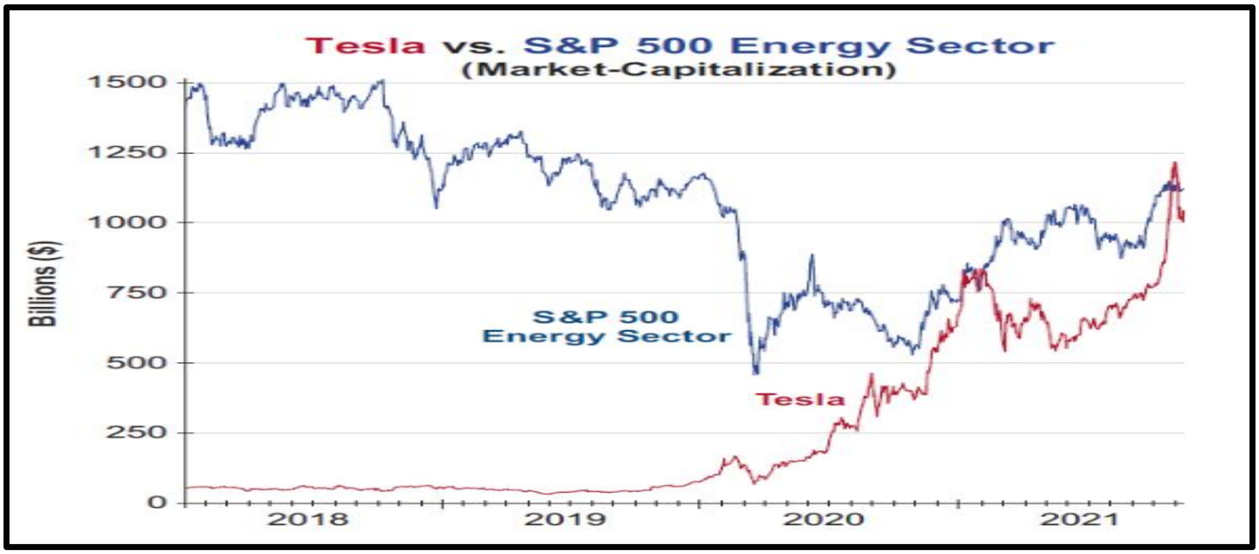


Source: Bureau of Labor Statistics

The Problem of Valuations and Expectations

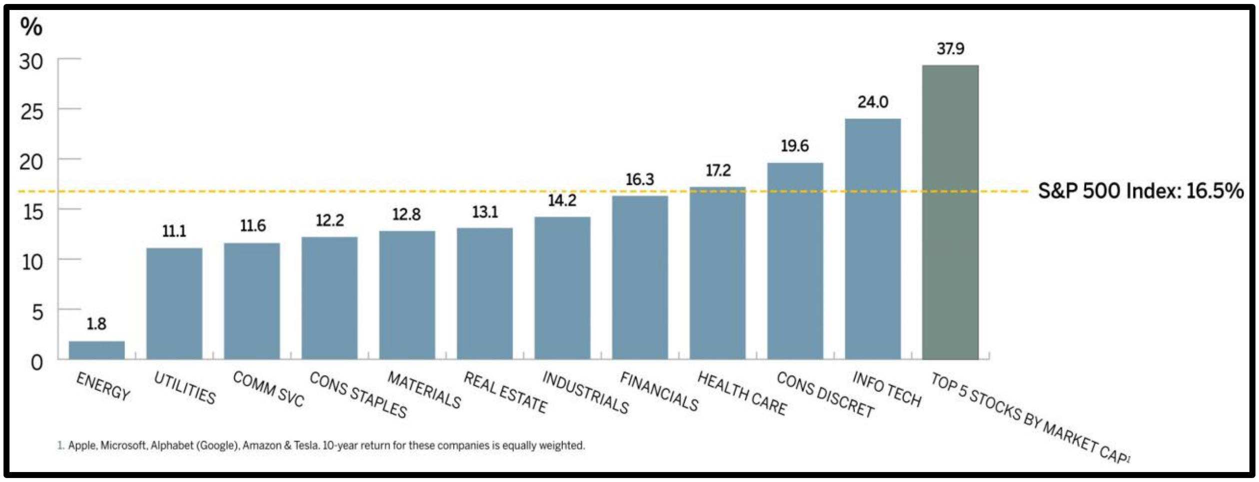
We have written extensively over the past two years about ever-rising stock market expectations, driven by a combination of extraordinarily easy monetary conditions, low inflation, low real yields and historic levels of fiscal stimulus. If the start to 2022 is any signal, the stock market is going to experience a very bumpy ride in 2022.

Today a small group of stocks dominate today's market to such a degree that Wall Street created the acronym FAAMG to identify this select group of stocks: Facebook (Meta), Amazon, Apple, Microsoft, and Google (Alphabet). These five stocks account for 23.1% of the S&P 500 Index's market capitalization at year end. The sixth largest company in the S&P 500 Index is electric vehicle company Tesla with a weighting of 1.94% and supporting a market capitalization of $1 trillion. The market capitalization of Tesla now exceeds the entire value of the energy sector within the S&P 500 despite the energy sector's trailing 12-month revenue of $897 billion, which dwarfs Tesla's revenue of $46 billion. In fact, the combined market value of the 21 energy stocks in the S&P 500 only equals the 2021 increase in Apple's market capitalization.



Source: Bloomberg

In a past version of our quarterly client communication, we pointed out similarly high expectations among software industry equities, which despite having declined over 15% from peak levels in 2021 continue to remain highly elevated related to any historical period. This again highlights the weight of expectations built into many of the stocks that have led the intense bull market rally of the last 10 years with the stock market compounding at 16.5% per year for a total gain of 362%, truly stunning returns.

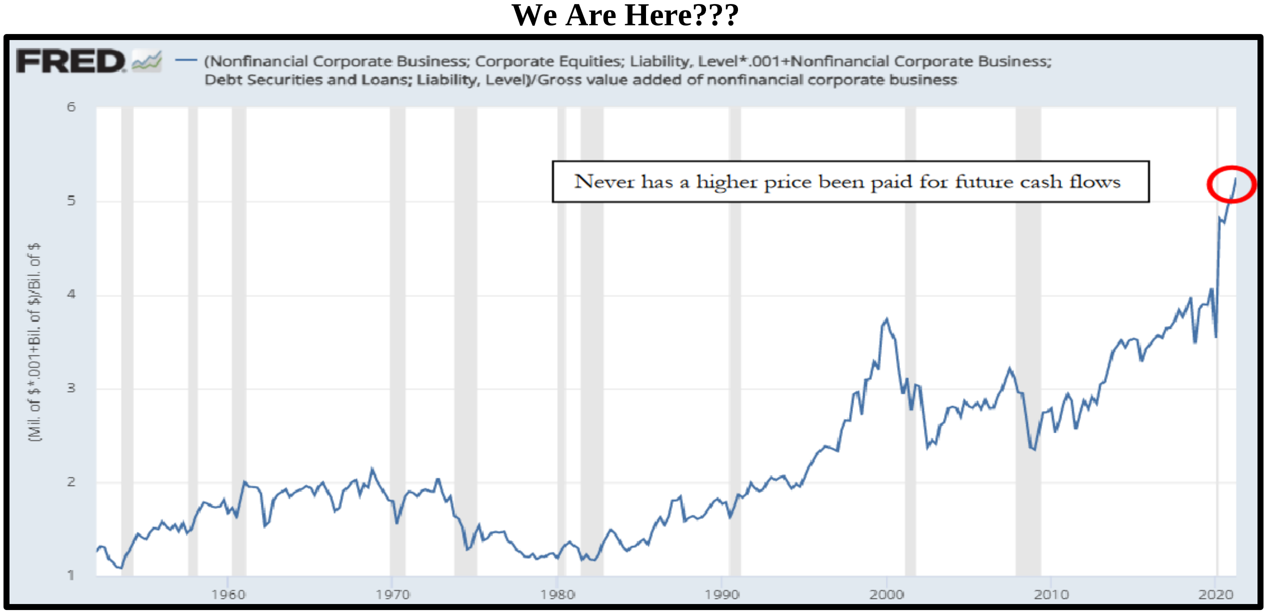


Source: Trahan Macro Research

This does leave the broad market with a valuation problem however, one that might take several years to grow into, or the worse alternative, a significant market correction to incorporate the risks inherent in such a rosy long-term outlook. What most investors view as wealth is just the current price of their future wealth. Except for individual investors who sell into the extreme valuations that are periodically offered by exuberant markets, stock prices are simply a measure of momentary supply/demand balance for the promise (hope) of those cash flows. For long-term investors, the wealth is and will always remain in an asset's actual cash flows.

According to economist John Hussman, when one divides the market's capitalization by the value-added production that generates the cash flows, one produces an insightful picture of future long-term investment returns. Hussman has long argued that valuation measures based on these comparisons are also the measures best correlated with actual subsequent market returns. At present, that picture has never been more extreme. Hussman's chart below shows the sum of equity market capitalization and debt for U.S. nonfinancial firms, divided by the gross value-added (essentially revenues) of those firms.

We Are Here???



Source: Hussman Econometrics

The previous chart does not tell the entire story, as it incorporates in its entirety the skewing of valuations that resulted from an unprecedented growth stock explosion over the past ten years. What has happened under the hood of valuations is a historic divergence between growth and value stocks which we have noted in past letters is at least partially explained by lower discount rates, especially the decline in the cost of debt over the past ten years. Academics like Cliff Asness of AQR Capital Management (a prominent value investor) have argued that the correlation between growth stock valuations relative to value stocks has very little correlation historically (https://www.aqr.com/Insights/Research/Journal-Article/Value-and-Interest-Rates-Are-Rates-to-Blame-for-Values-Torments) though we are inclined to give this factor at least a significant weight in our thinking. However, we would also argue that "animal spirits" have also played a major role in the divergence.

Record Valuation Gap Between Growth and Value Stocks

Source: Trahan Macro Research

As value investors, we at Hahn felt spiritually compelled to provide this chart. Value investors are generally a gloomy lot, "hoping for the best preparing for the worst"-type of party spoilers but it also makes us sober and reflective, able to pivot as circumstances arise and recognize when true opportunity is at hand. This moment rhymes with March of 2000, and while all styles are correlated over longer periods of time, it is rare to see this type of divergence. It should represent a really sobering moment for growth investors and for us and our value peers, an opportunity to capitalize on what promises to be a very volatile near future.

Quarterly Performance

Our 4th Quarter 2021 return for the Hahn Capital Management Mid-Cap Value Composite was 10.22% gross of fees. For the quarter, we outperformed our primary benchmark, the Russell Mid-Cap Value Index, by 1.68 percentage points. For the year ended December 31, 2021, our return was 30.85%. For the year, we outperformed our benchmark by 2.54 percentage points. For the quarter, sector allocations to Communications, Real Estate, and Information Technologies contributed, while those to Utilities (No Holdings), Materials & Consumer Discretionary detracted. The most significant relative performers during the quarter were Xilinx (XLNX), Keysight Technologies (KEYS), Liberty Formula One (FWONK), and Virtu Financial (VIRT) while the most significant underperformers were Euronet (EEFT), Equinix (EQIX), East West Bancorp (EWBC), and Jacobs (JEC).

Hahn Capital Quarterly Performance Attribution – 4Q 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	20.63%	16.94%	3.69%	8.79%	6.36%	2.43%	-0.07%	0.50%	0.43%	0.00%	0.43%
Information Technology	18.24%	9.97%	8.27%	14.93%	12.94%	1.99%	0.37%	0.34%	0.71%	0.00%	0.71%
Real Estate	18.82%	11.26%	7.56%	15.38%	13.88%	1.50%	0.40%	0.27%	0.67%	0.00%	0.67%
Industrials	13.62%	15.66%	-2.04%	9.21%	8.76%	0.45%	0.00%	0.06%	0.06%	0.00%	0.06%
Health Care	11.64%	7.98%	3.66%	5.54%	4.28%	1.27%	-0.15%	0.13%	-0.02%	0.00%	-0.02%
Consumer Discretionary	9.39%	10.64%	-1.25%	4.33%	6.26%	-1.93%	0.03%	-0.18%	-0.15%	0.00%	-0.15%
Materials	2.96%	7.41%	-4.45%	6.94%	12.06%	-5.12%	-0.15%	-0.13%	-0.28%	-0.01%	-0.29%
Communication Services	1.53%	3.73%	-2.20%	23.01%	-6.13%	29.14%	0.36%	0.45%	0.81%	-0.01%	0.80%
Energy	0.00%	5.26%	-5.26%	0.00%	5.63%	-5.63%	0.15%	0.00%	0.15%	0.00%	0.15%
Consumer Staples	0.00%	4.15%	-4.15%	0.00%	10.70%	-10.70%	-0.09%	0.00%	-0.09%	0.00%	-0.09%
Utilities	0.00%	7.01%	-7.01%	0.00%	12.89%	-12.89%	-0.31%	0.00%	-0.31%	0.00%	-0.31%
Cash	3.16%	0.00%	3.16%	0.02%	0.00%	0.02%	-0.29%	0.00%	-0.29%	0.00%	-0.29%
Total Portfolio				**10.22%**	**8.54%**	**1.69%**	**0.25%**	**1.44%**	**1.69%**	**0.00%**	**1.69%**

Relative Performance by Stock – Quarter Ended December 31, 2021

Quarter Ended 12/31/2021 - 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	XILINX INC	0.52%	1	EURONET WORLDWIDE INC	-0.75%	1	Communication Services	0.80%	1	Utilities	-0.31%
2	KEYSIGHT TECHNOLOGIES IN	0.48%	2	EQUINIX INC	-0.23%	2	Information Technology	0.71%	2	Cash	-0.29%
3	LIBERTY MEDIA CORP-LIBERTY-C	0.43%	3	EAST WEST BANCORP INC	-0.17%	3	Real Estate	0.67%	3	Materials	-0.29%
4	VIRTU FINANCIAL INC-CLASS A	0.39%	4	JACOBS ENGINEERING GROUP	-0.14%	4	Financials	0.43%	4	Consumer Discretionary	-0.15%

HCM MID-CAP VALUE COMPOSITE PERFORMANCE HISTORY

% Annualized Returns As of 12/31/2021	4Q 2021	1 Year	3 Years	5 Years	7 Years	10 Years	Since Inception 06-30-88
HCM Gross of Fees	10.22%	30.85%	24.39%	14.98%	11.99%	13.86%	14.35%
HCM Net of Fees	9.97%	29.63%	23.20%	13.87%	10.90%	12.75%	13.25%
Russell Mid Cap Value Index	8.54%	28.34%	19.62%	11.22%	9.96%	13.44%	11.72%
Russell Mid Cap Index	6.44%	22.58%	23.29%	15.10%	12.23%	14.91%	11.99%

Link to: HCM Performance Disclosures

PORTFOLIO ACTIVITY

New Positions

There were no new positions added during the quarter.

Positions Increased

There were no positions increased during the quarter.

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.

Mid-America Apartment Communities (MAA) - We reduced our position in Mid-America Apartment Communities as price appreciation drove the weighting in our portfolio well above our 5% limit.

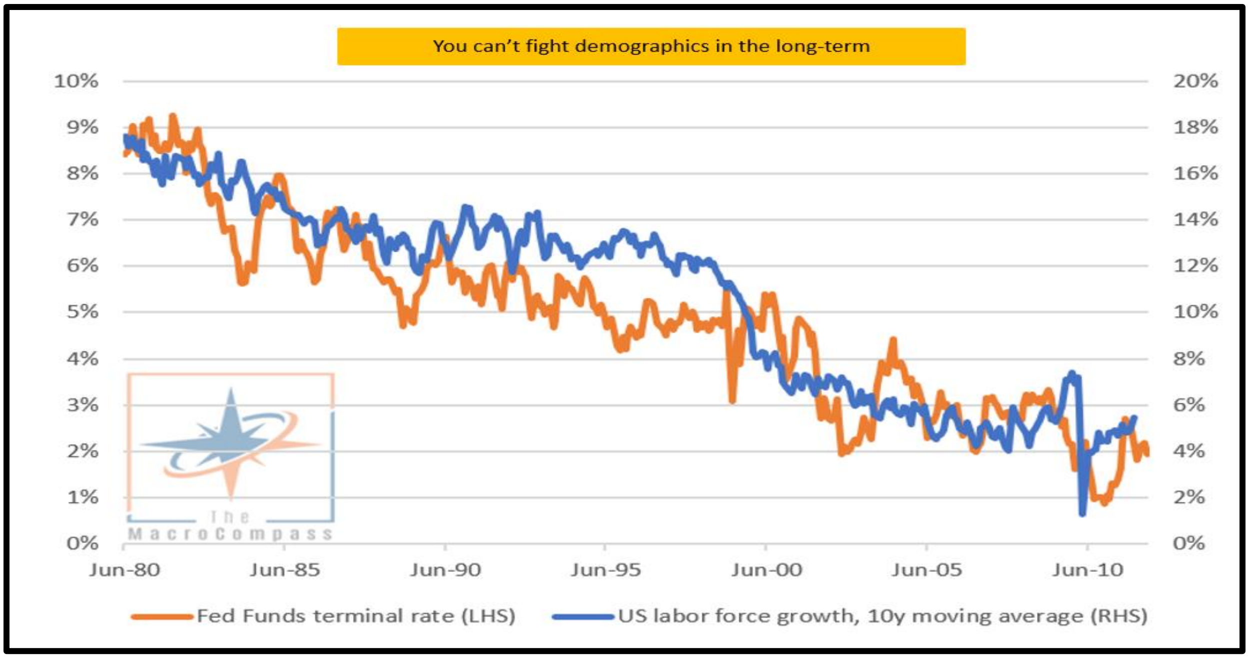
Positions Sold

No Positions sold during the quarter

Outlook

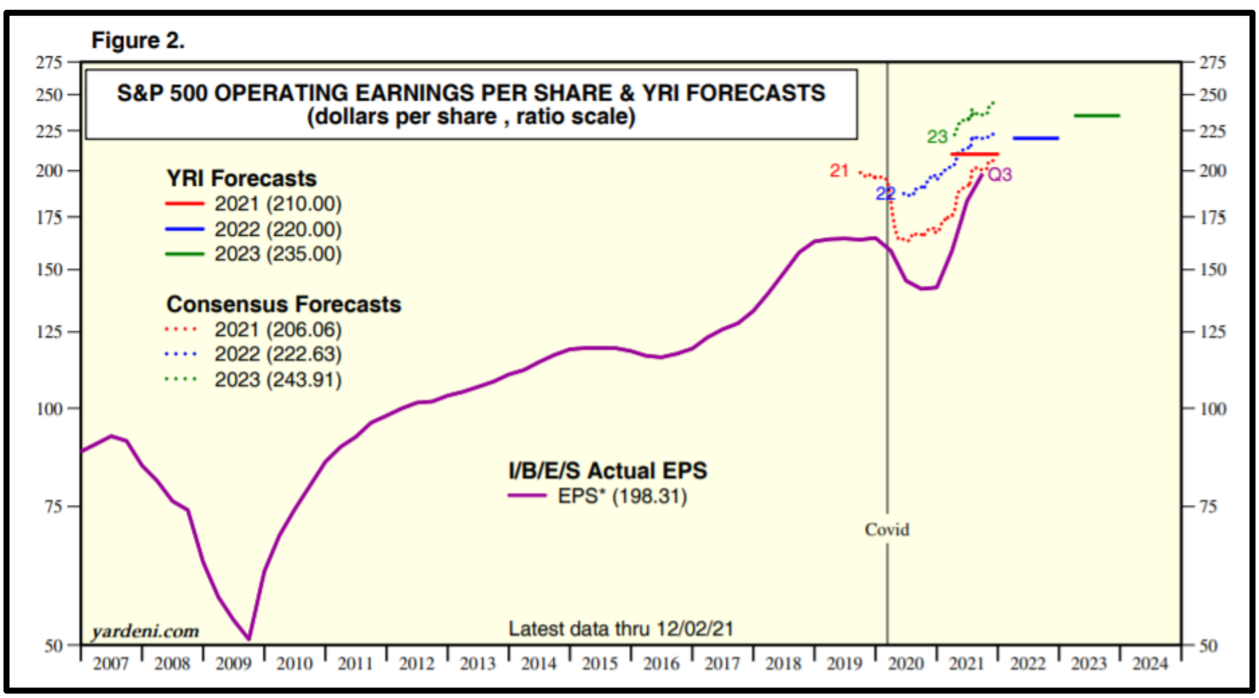
While 2021 equity returns were impressive by any standard, there are warning signs on the horizon that suggest much more muted returns in 2022. A combination of deeply negative real yields, negative demographic trends and high expectations for both real GDP growth and S&P 500 earnings suggest that there is a significant risk for the market to reprice lower.

Demographics continue to stagnate in the United States and throughout the world. U.S. population growth increased a mere 0.1% in the12 months ended July 1, 2021. This was the slimmest rise since just after the Revolutionary War. The natural increase in population was less than the net immigration, and the increase in population was less than one million, the first time since 1937. The birth rate also dropped again. Covid explains the jump in the death rate (though total deaths did not change materially for the year) but not the fall in births since many predicted that confinement would lead to increased births, which did not happen. The following chart demonstrates why the FED is in such a tight spot; it can tighten (very slightly) to combat near-term inflation but even the prospect of tightening has sent the market into an early tailspin in 2022. With no prospect of significant labor growth and high levels of indebtedness, don’t expect any tightening cycle to last very long, if it actually happens at all.



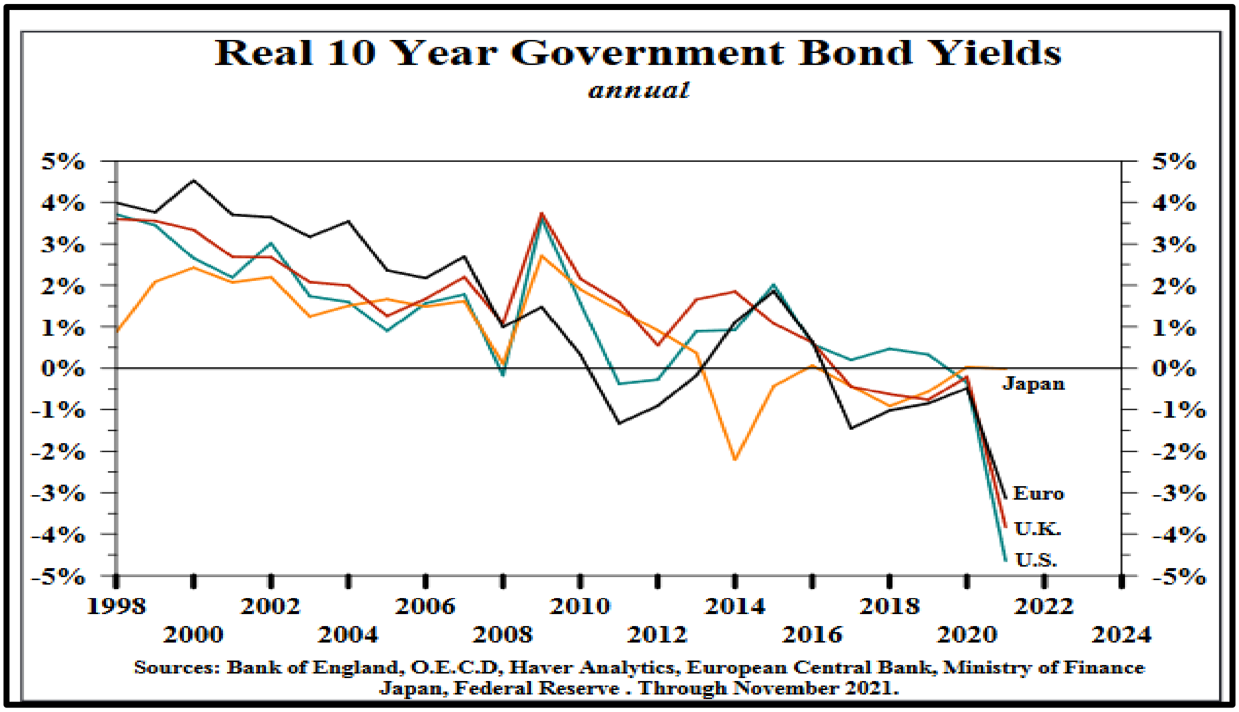
Source: The Macro Compass

In addition, earnings expectations seem to optimistic to us as well, at least partly due to the anchoring bias of a spectacular earnings rebound in 2021 and overly optimistic corporate executives and macro analysts. The consensus currently expects 10% growth in 2022 operating earnings per share and a further 8% in 2023. We'll save you the drama: this is pure fantasy. We are not so pessimistic on the economy as we are skeptical of the consensus in the face of lower levels of monetary liquidity, a FED tightening cycle and inflation pinching consumer and producer wallets significantly in 2022. Inflation may be "transitory" but it's hurting everyone now, and about 80% of our population will have 2-3% less disposable income in 2022 than they did last year. That's significant in GDP terms.



Source: Yardeni Research

Finally, nothing speaks to long-term economic growth potential like real yields. Heavily negative real yields are synonymous with very low (or even negative) growth expectations. Carmen Reinhart, Vincent Reinhart and Kenneth Rogoff in the Summer 2012 issue of the *Journal of Economic Perspectives* linked extreme sustained over indebtedness with the level of interest rates. The Cliff's Notes version of this article essentially demonstrates that high levels of indebtedness (any level beyond 80% Debt/GDP) cut severely into economic growth potential. Since 2000, real GDP growth has run at two-thirds the sustained rate between 1870 and 2000. Negative real yields instruct us that run-rate real GDP growth is headed lower still, notwithstanding the Covid re-opening rebound.



Source: OECD

From a portfolio construction perspective, we observe that, more than ever, quality of business franchise (Sustainable/Advantaged Business Models/Superior Balance Sheet Strength/Value Added Management) is paramount with high pre-existing stock valuations meaning that the cost of disappointment is very high. One recent example was the Netflix earnings announcement on January 20, 2022. Netflix had previously provided guidance on expected 1st quarter 2022 net subscriber additions of 6.25 million. On the earnings conference call, Netflix adjusted that expectation downward to an additional 2.5 million subscribers. Netflix market value decreased by 24% on that news. Investors in Peloton Interactive must have felt as though they were in the *Twilight Zone* based on the company's round trip from an IPO price of $29 to a Covid shutdown high of $162 and a recent close below $29. Notably, insiders sold more than $500 million in stock at prices above $100 per share during the stock's epic roundtrip. The cost of falling short of perfection is high when your equity is valued at greater than 10 times sales, even if you are a high-quality software company.

We said last quarter that we continue to look forward to a world that is not dominated by Covid-19 related headlines, which is a sentiment that already seems both outdated and unrealistic. While the news media and government bureaucrats remain obsessed with trying to control the virus, the rest of us have simply realized that it's time to move forward, in any event. Not that we should be surprised that the media and the government are both behind the curve but the degree to which this is the case should be embarrassing to both (if only they felt shame!). Please come see us this year or let us come see you, it's long overdue and we look forward to interacting with you in person in 2022.

Sincerely,

John Schaeffer
President and CIO

Michael Whitfield
Dir. of Research and Co-Portfolio Manager

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