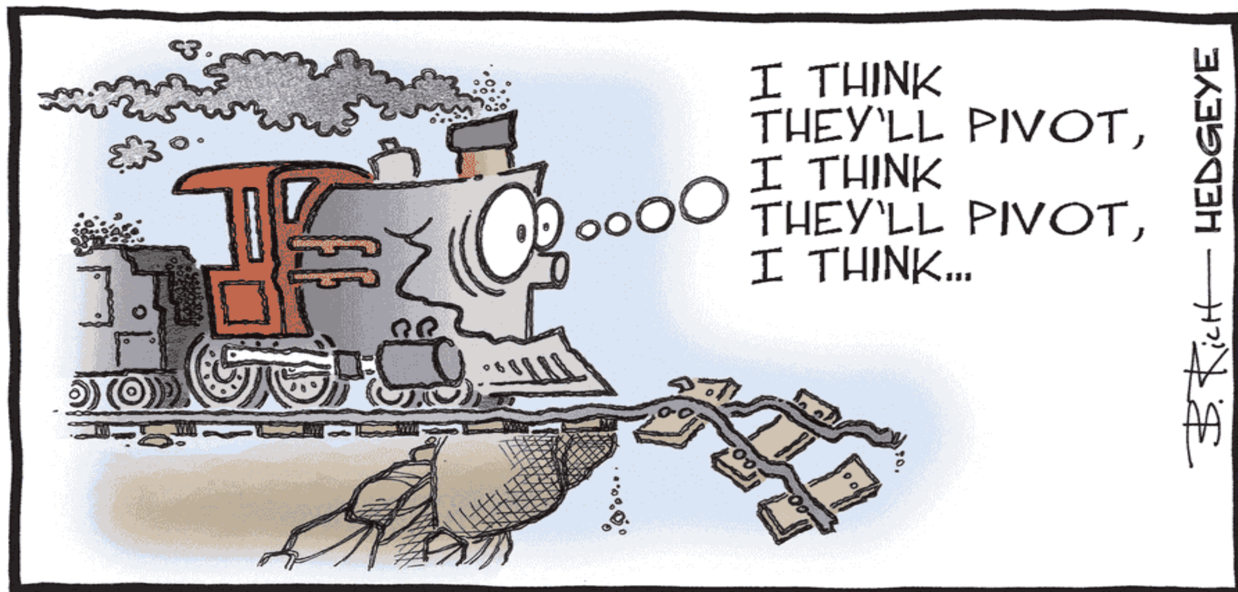
Mid Cap Equity Strategy — 4th Quarter 2022 Commentary



As the Fed Turns

One year ago, the S&P 500 Index was levitating near its all-time high of around 4,800. The 10-year Treasury yield was at 1.5%, 30-year fixed rate mortgages were offered at 3.1% and Fed funds futures indicated short-rates would end 2022 below 1%. Despite these then-benign conditions, a tempest of inflation was gathering due to the extraordinary monetary and fiscal stimulus of 2020. Inflation was well above the Federal Reserve's comfort zone, quickly approaching double-digit increases on an annualized basis, and Fed officials were turning hawkish. At the same time, Russian troops were amassing on Ukraine's border, and US diplomats were sounding the alarm that this was not a drill. The warning signs were clear, yet markets were priced for perfection. In hindsight, it was a recipe for a sharp sell-off in financial assets. The damage across financial markets in 2022 is highlighted below.

U.S. Asset Class Indices	Q4 Return	2022 Return
S&P 500 Index	7.56%	-18.11%
DJ Industrial Average	16.01%	-6.86%
NASDAQ 100	-0.04%	-32.38%
Russell Mid-Cap Value	10.45%	-12.03%
Russell 2000	6.23%	-20.44%
GS Commodity Index	3.44%	25.99%
Cash	0.33%	1.50%
BofA Fixed Income Index	5.50%	-16.70%

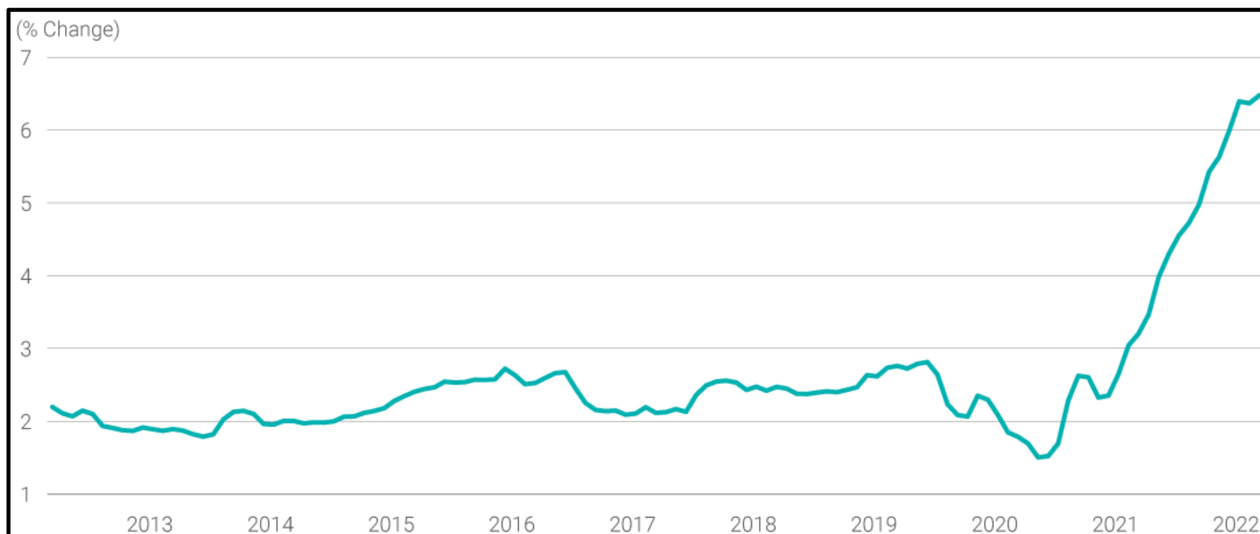
Source: Bloomberg

Notably, the typical safe haven of bonds in an equity bear market was nullified by sharply rising inflation and interest rates across the year, and both stocks and bonds recorded double-digit losses for only the second time in the last 100 years.

Achilles' Heel

First and foremost, inflation remains elevated in the mind of the Fed. Even if it eventually adjusts its preferred inflation level above 2%, current inflation metrics remain well above the Fed's comfort zone. Although market measures of inflation, such as the 5-year forward inflation expectation rate and break-evens of Treasury Inflation-Protected Securities (TIPS), remain contained, hard measures of inflation such as CPI and Personal Consumption Expenditures (PCE) remain well above the Fed's historical 2% target. Importantly, Core CPI remains elevated at over 6% (see chart below). This measure is calculated based on prices for specific goods and services within CPI that are considered less susceptible to change: medical services, rent, public transportation, and motor vehicle fees, and therefore more likely to incorporate future inflation expectations. Core Flexible Inflation, which has less of an impact on inflation expectations, has come down from a peak of nearly 20% in February, but remains elevated at over 5%.

Core CPI Year Over Year Change



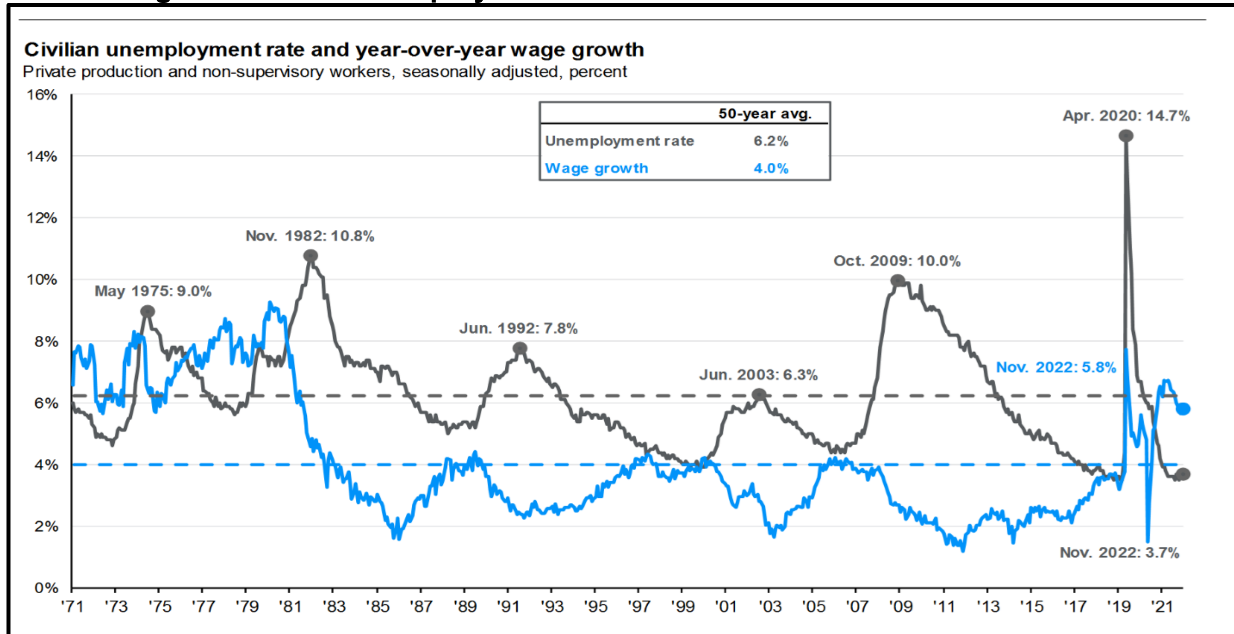
Source: Federal Reserve

Long Live Labor

The labor market continues to be a bright spot in an otherwise gloomy environment, with the unemployment rate at 3.7% as of November, just 0.2% above its 50-year low in 2019. However, the economy is now losing momentum, even in the labor market. Job openings have come down and will likely fall further, as businesses reel back hiring efforts in the face of slower demand and higher costs. Initial and continuing jobless claims have also begun to trend higher, although they still sit below historical averages. Still, there is also a limit to how much weakness we may see in employment going forward, as U.S. businesses face a structurally smaller labor force than prior decades. Diminished legal immigration, particularly over the course of the pandemic, and Baby Boomers reaching retirement age have left the economy very short of workers. This will somewhat resolve itself as higher wages and a higher cost-of-living lure some workers back into the labor market, allowing the economy to see additional months of solid job growth and low unemployment. As such, the unemployment rate may only nudge slightly higher in the near term.

Wage growth has also moderated and will likely slow further, providing some relief to businesses and inflation.

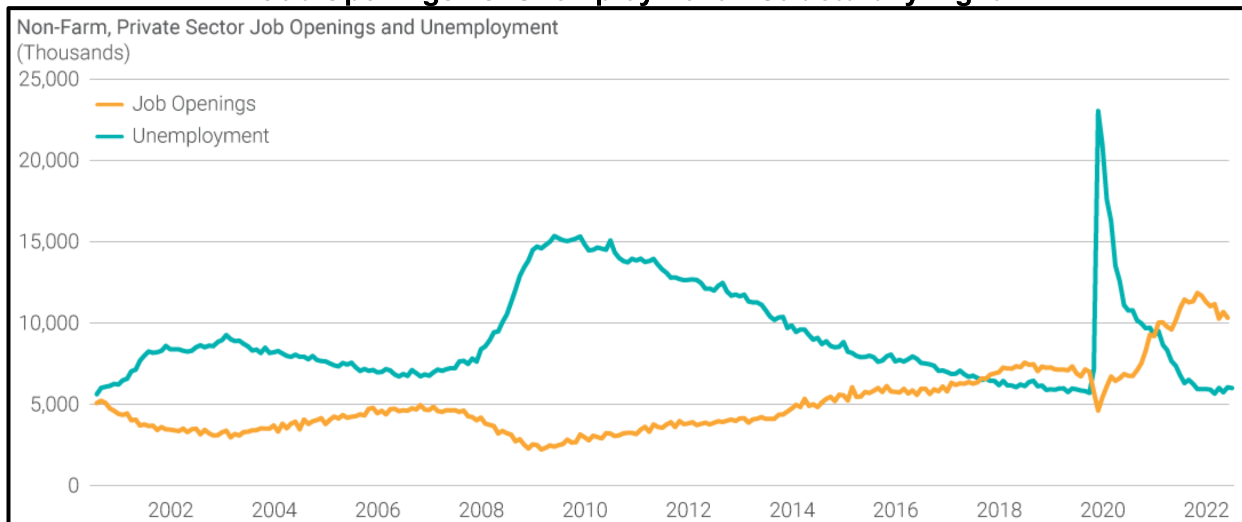
Wage Growth vs Unemployment Rate – Between a Rock and a Hard Place



Source: Federal Reserve

Unless there is a material pick-up in the participation rate or an increase in productivity, the Fed will continue to grapple with both wage price inflation and slowed economic growth. As the following chart demonstrates, the tightness of the labor market is very real and likely will be stubbornly persistent unless millions of workers join the labor force, which likely only happens if wages continue to rise.

Job Openings vs. Unemployment – Structurally Tight



Source: Federal Reserve

Et Tu Monetary Policy?

The Federal Reserve raised its policy rate by 425 basis points in less than a year, an aggressive pace of tightening, as it sought to reassure markets and consumers of its unwavering commitment to fighting inflation. Given the strength of the labor market and the persistence of inflation, the

Fed has been clear that the job is not done. Markets are pricing an additional 50 bps of rate hikes in Q1 2023 despite the Fed's own December Summary of Economic Projections, which suggests 75 bps of hikes will take the terminal rate to 5.1%. The actual terminal rate matters less than the length of time that the Fed keeps rates elevated. Financial markets may be underestimating the likelihood of a higher-for-longer rate scenario, given that the Fed needs to see core inflation sustainably near its 2% target.

Another facet of financial tightening is the Fed's balance sheet run-off, as shorter-term Treasuries expire, and the Fed chooses not to reinvest the proceeds. In 2022, the Federal Reserve indicated that its balance sheet holdings of Treasuries and mortgage-backed securities (MBS) would decline by $47.5 billion per month from June to August and then $95 billion per month from September onward. Of the $95 billion per month of asset run-offs, $60 billion was intended to be from Treasuries while the remaining $35 billion would be from MBS. The reality is that from 31 August to 28 December, the total decline in Treasury holdings was only $194 billion while MBS holdings fell by $68 billion. This total run-off of $262 billion is far short of the targeted $380 billion that was meant to be accomplished by December 31. This run-off will likely accelerate in 2023, which will further contribute to decelerating inflation. The impact of this is somewhat unpredictable, with estimates putting the equivalent tightening effect at anywhere between 25 to 150 bps. This incremental tightening will likely impact asset prices as bond yields rise and recession risks change.

De-FAANG'ed – A Retrospective

Over a year ago, in our 3rd quarter 2021 newsletter, we highlighted the extreme valuations and outlandish stock performance of a basket of eight mega-cap technology stocks (AAPL, AMZN, GOOG, META, MSFT, NFLX, NVDA, TSLA) These companies averaged a 16.4% return in Q4 CY2021 and 45.3% in CY2021. While we pointed out that stocks were expensive on multiple occasions, it was also true that, for the S&P500 to have a down year in 2022, investors needed to conceive a scenario where these securities retraced. Maybe price alone would have been enough in a year where money tightened in volatile fashion, or inflation expectations became embedded. As it turned out, all the above took place and the group of eight led the market downward. The "best" of the eight – MSFT – fell 23%. On average, the eight declined by 40% in 2022 which meant that as a basket, they ended up some 13% BELOW the level at the start of 2021. Tesla and Meta Platforms both declined over 60% in CY2022 reflecting fears over management, prior excessive valuation, and operational business issues. What looked like the strongest, most invincible group of companies was a collection of overpriced, overearning and profligately managed assets, all set in a goldilocks market environment.

Quarterly Performance

The return for the Hahn Capital Management Mid-Cap Value Composite (see Composite Performance History table on page 6) was 9.98% gross of fees and 9.73% net of fess in the fourth quarter of 2022. For the quarter, we underperformed our primary benchmark, the Russell Mid-Cap Value Index, by 0.47 percentage points gross of fees. For the quarter, sector allocations to Healthcare, Communication Services, Consumer Staples (no holdings), and Financials (relative to the benchmark) contributed, while those to Information Technology, Real Estate, Energy, Industrials, Materials, Consumer Discretionary and Utilities (no holdings) detracted. The most significant outperformers during the quarter were Ross Stores (ROST), Euronet Worldwide (EEFT), PVH Corp (PVH), Emcor Group (EME), and CBRE Group (CBRE), while the most significant underperformers were Albemarle (ALB), Black Knight (BKI), EastWest Bancorp (EWBC), First Republic (FRC), and Virtu Financial (VIRT).

For the calendar year 2022, the composite returned -17.16% gross of fees and -18.03% net of fees, compared to the Russell Mid Cap Value benchmark return of -12.03%. The underperformance on the calendar year basis was more than 100% attributable to negative sector selection, with stock selection adding 0.74 percentage points while sector selection detracted 5.75 percentage points. Our lack of exposure to energy was the main negative headwind, representing almost half of the underperformance. Information Technology (overweight) and Utilities and Consumer Staples (no weights) also weighed on sector selection results.

Hahn Capital Quarterly Performance Attribution – 4Q 2022

LINKED PERFORMANCE BY SECTORS

BENCHMARK: Russell Midcap Value Index
PORTFOLIO: Representative 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	18.93%	18.40%	0.52%	4.73%	9.44%	-4.71%	0.01%	-0.93%	-0.92%	0.00%	-0.92%
Information Technology	19.64%	8.94%	10.70%	8.21%	5.77%	2.44%	-0.46%	0.40%	-0.06%	0.00%	-0.06%
Real Estate	15.66%	10.62%	5.03%	7.56%	2.96%	4.60%	-0.37%	0.81%	0.44%	-0.01%	0.43%
Industrials	12.70%	15.55%	-2.85%	20.12%	14.31%	5.81%	-0.11%	0.67%	0.56%	0.00%	0.56%
Health Care	12.15%	7.19%	4.96%	17.87%	13.41%	4.46%	0.15%	0.52%	0.67%	0.00%	0.67%
Consumer Discretionary	7.89%	9.95%	-2.05%	31.76%	13.73%	18.03%	-0.10%	1.35%	1.25%	0.00%	1.25%
Materials	3.78%	7.65%	-3.87%	-17.86%	13.96%	-31.82%	-0.11%	-1.29%	-1.40%	0.00%	-1.40%
Communication Services	1.84%	3.22%	-1.38%	2.19%	2.11%	0.08%	0.13%	-0.02%	0.11%	0.00%	0.11%
Energy	2.20%	5.61%	-3.41%	2.72%	17.04%	-14.32%	-0.20%	-0.31%	-0.51%	-0.01%	-0.52%
Consumer Staples	0.00%	4.05%	-4.05%	0.00%	10.22%	-10.22%	0.04%	0.00%	0.04%	0.00%	0.04%
Utilities	0.00%	8.82%	-8.82%	0.00%	10.82%	-10.82%	-0.01%	0.00%	-0.01%	0.00%	-0.01%
Cash	5.21%	0.00%	5.21%	0.94%	0.00%	0.94%	-0.54%	0.00%	-0.54%	0.00%	-0.54%
Total Portfolio - Net of Fees				**10.06%**	**10.45%**	**-0.40%**	**-1.58%**	**1.19%**	**-0.39%**	**-0.01%**	**-0.40%**

Relative Performance by Stock – Quarter Ended December 31, 2022

Quarter Ended 12/30/2022 - 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	ROSS STORES INC	0.76%	1	ALBEMARLE CORP	-1.24%	1	Consumer Discretionary	1.24%	1	Materials	-1.39%
2	EURONET WORLDWIDE INC	0.54%	2	BLACK KNIGHT INC	-0.48%	2	Health Care	0.67%	2	Financials	-0.92%
3	PVH CORP	0.51%	3	EAST WEST BANCORP INC	-0.40%	3	Industrials	0.55%	3	Cash	-0.57%
4	EMCOR GROUP INC	0.46%	4	FIRST REPUBLIC BANK/CA	-0.34%	4	Real Estate	0.43%	4	Energy	-0.52%

Year-to-Date Ended 12/30/2022 - 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	ROSS STORES INC	0.77%	1	FIRST REPUBLIC BANK/CA	-0.76%	1	Industrials	0.92%	1	Energy	-2.77%
2	EMCOR GROUP INC	0.77%	2	ADVANCED MICRO DEVICES	-0.63%	2	Communication Services	0.87%	2	Financials	-1.53%
3	KEYSIGHT TECHNOLOGIES IN	0.57%	3	VIRTU FINANCIAL INC-CLASS A	-0.53%	3	Not Classified	0.45%	3	Real Estate	-1.52%
4	GENPACT LTD	0.53%	4	LABORATORY CRP OF AMER HL	-0.48%	4	Consumer Discretionary	0.33%	4	Utilities	-0.92%

HCM MID-CAP VALUE COMPOSITE PERFORMANCE HISTORY

% Annualized Returns As of 12/31/2022	4Q 2022	1 Year	3 Years	5 Years	7 Years	10 Years	Since Inception 06-30-88
HCM Gross of Fees	9.98%	-17.16%	5.39%	6.85%	9.13%	10.28%	13.29%
HCM Net of Fees	9.73%	-18.03%	4.34%	5.80%	8.06%	9.21%	12.19%
Russell Mid Cap Value Index	10.45%	-12.03%	5.82%	5.72%	8.73%	10.11%	10.95%
Russell Mid Cap Index	9.18%	-17.32%	5.88%	7.10%	9.61%	10.96%	11.01%

Link to: HCM Performance Disclosures

PORTFOLIO ACTIVITY

New Positions

There were no new positions during the quarter

Positions Increased

There were no positions increased during the quarter.

Positions Reduced

There were no positions reduced during the quarter

Positions Sold

We exited our position in First Citizens Bancshares (FCNCA) during the quarter. We received these shares when First Citizens acquired our former holding in CIT Group. We took advantage of a strong market during the first half of the 4th quarter to exit the position and got an excellent price during a significant rally for the banking sector.

Outlook

Economic & Market Outlook

There is a paradigm shift in inflation taking place that is driven in part by a reconfiguration of global supply chains (due to geopolitical factors, realizations derived from COVID-19 impacts, the cost of mitigating and adapting to Net Zero goals, etc.). We continue to expect the tightening cycle to uncover significant systemic fragilities that have been obscured by extremely low / negative interest rates for years. The crypto industry collapse of 2022 was the first casualty of higher rates, but it is unlikely to be the last after years of monetary stimulus has inflated an array of asset bubbles. Fiscal stability of governments is also a serious issue. Many investors have

become too complacent about sovereign fiscal risks, operating under the assumption that central banks can bail out their sovereigns. There are limits to deficit spending, and this could be a key challenge during the next several years, as evidenced by the market's reaction to fiscal proposals by the United Kingdom this past September. Finally, the energy transition has been deemed a critical imperative, but the Russian invasion of Ukraine has shattered the perception that the world can just disconnect itself from fossil fuels without a new alternative energy infrastructure in place.

We agree with the current consensus that the Fed is near the end of its hiking cycle; but we believe the market is underestimating the Fed's willingness to hold rates higher for longer. Our view is that a mild recession is likely, but, given that inflation is moderating and labor growth remains strong, a soft landing remains feasible.

What does this all mean for investors? We believe different asset classes are sending different signals about the economic and profit outlook. US equity markets are trading at levels that imply the United States will avoid a recession and that discount rates on future earnings will decline. This seems like an improbable best-case scenario to us, as it implies that inflation will continue to decline rapidly, allowing the Fed to both avoid a recession and loosen monetary policy. Debt markets, on the other hand, appear to imply a US recession by mid-2023 of sufficient depth to prompt a reduction in Fed funds rates by year-end. One, if not both, of these markets are wrong. If recession is avoided, that means interest rates will likely remain higher for longer, which in turn means we will see higher bond yields and lower multiples on stocks (due to higher discount rates on future earnings). If the economy does slide into recession, earnings expectations are likely to decline, perhaps materially, which means lower share prices.

Given our expectation for a mild recession, the truth might be somewhere between the bond and equity markets outlooks. In a typical recession, S&P 500 Index earnings decline by 10%–15%. Estimates for 2023 S&P 500 Index earnings remain at $232.50 representing a 5% increase from 2022 as of December 29. With the S&P 500 Index at 3845, this implies a forward valuation of 16.5x earnings for 2023. By comparison, the Moody's Baa Corporate Bond Index sports a yield of 5.86% which implies an investor would pay 17.1x earnings for this collection of bonds. Historically, the last time equities traded for a sustained period with a lower earnings yield, or a higher multiple, than the Moody's Baa Corporate Bond Index was in 2002 in the aftermath of the telecom bubble.

Portfolio Strategy & Positioning

Given the outlook summarized above, where do we allocate investment resources in 2023? We continue to like the quality and durability of the companies in our portfolio. Our portfolio trades at only 13 times our expected earnings for 2023 compared to 12.7 times for the Benchmark (These are our estimates, which are more conservative than the Wall Street consensus) while the return-on-equity (ROE) for our portfolio in aggregate is close to 20%, well above the 11.5% ROE for the Russell Mid Cap Value Index. This means we are paying an equivalent price for much higher quality companies. We have also accomplished this without taking incremental financial leverage risk as the weighted average debt-to-equity ratio of our portfolio is also lower than that of the benchmark. As such, we continue to be very optimistic about the outlook for what we already own.

We continue to see many opportunities to upgrade the quality of the portfolio as well. As damaging as the 2022 equity sell-off was to the broad market, it was particularly painful for several very high-quality, high-return businesses that had simply been bid up beyond any reasonable valuation despite being, at least in some cases, exceptional businesses. The past 12 months have been perhaps the busiest in the history of our firm in terms of the sheer number of these companies that we have

analyzed and, in some cases, approved for purchase. We are simply waiting for a price that gives us a margin for safety and the prospect of above market returns. This is the discipline we practice 100% of the time, regardless of underlying market conditions or the economic outlook. We continue to see interesting opportunities in Energy, Consumer and Financials particularly and are even starting to sift around in the rubble of the Information Technology sector though some areas, including software, continue to be unattractively priced.

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