HAHN CAPITAL MANAGEMENT, LLC
REGISTERED INVESTMENT ADVISORS

Mid Cap Equity Strategy **4th Quarter 2023 Commentary**

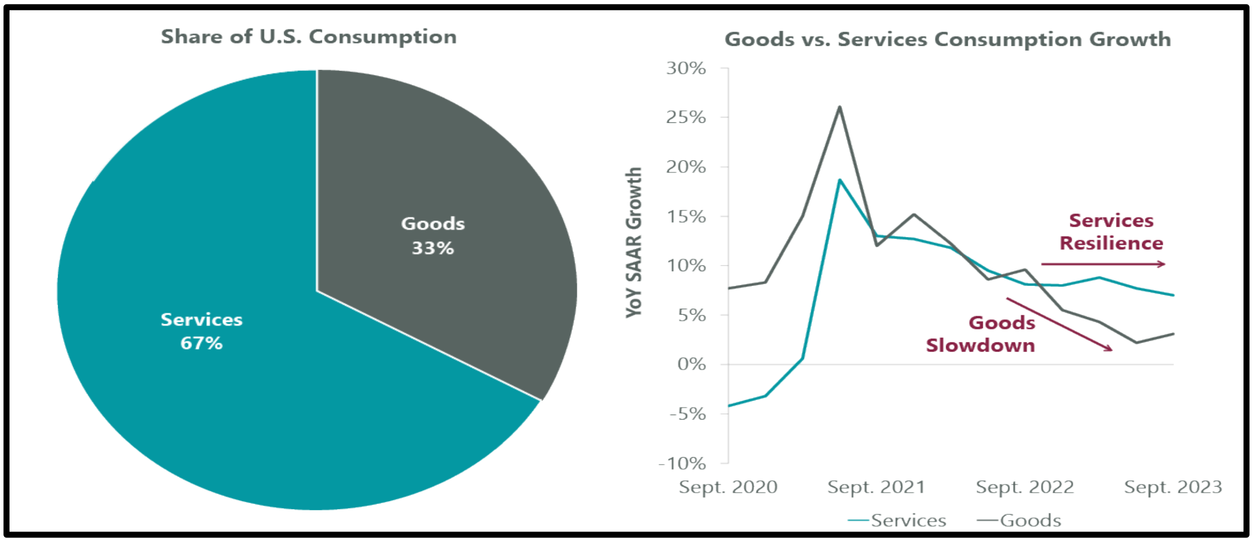
Source: Barrons

There is Good News and Bad News

The fourth quarter offered a distinct final chapter to the shifting quarterly narratives of 2023. The "higher for longer" interest rate concerns of the third quarter gave way to optimism that the Federal Reserve is done raising interest rates and that the economy, having skirted the much-anticipated recession thus far, was more likely to achieve the dream scenario of a "soft landing." Combine that with the Federal Reserve's signaling of potential interest rate decreases in the back half of 2024, and it made for a profitable holiday season. The various stock market indices finished the year with nine consecutive weeks of gains.

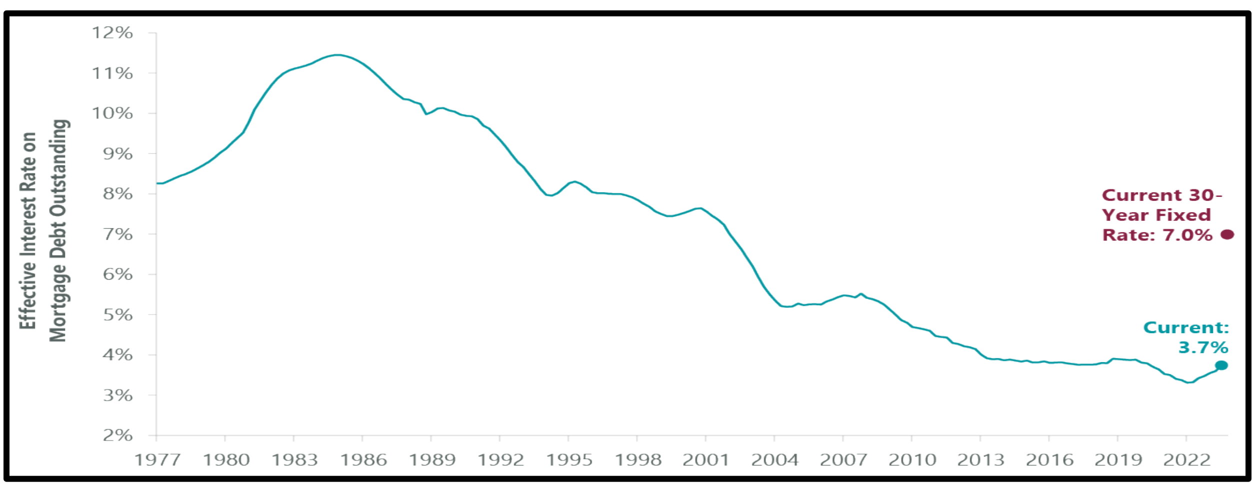
2023 was a very strong year in global stock markets, with optimism being driven by falling inflation, tight labor markets, and a resilient consumer. Equities screamed higher in the fourth quarter (and particularly so in the U.S.), as the Federal Reserve's December pivot toward 2024 interest rate cuts reignited investors' risk appetite. That said, financial conditions have tightened substantially, while global growth outside the U.S. has slowed and remains modest. Government deficits are high, debt service costs are on the rise, and global debt levels are hitting new records. Equity valuations are elevated in the U.S. Large Cap arena where the concentration of the S&P 500 Index is extraordinary but are more reasonable elsewhere.

The fundamental question that divides bulls and bears is whether "this time is different," perhaps the four most dangerous words on Wall Street. Several dynamics are, in fact, different, including the unique nature of the pandemic-driven recession and the unprecedented fiscal stimulus which drove a "checkmark"-shaped recovery. The American consumer has shown staunch resilience, critical for the health of an economy where two-thirds of GDP is consumption. Demand for services has held up remarkably well even as goods demand wanes, which has short-circuited normally reliable recession indicators like the ISM Manufacturing PMI, which focuses on the smaller, but more volatile, manufacturing sector.



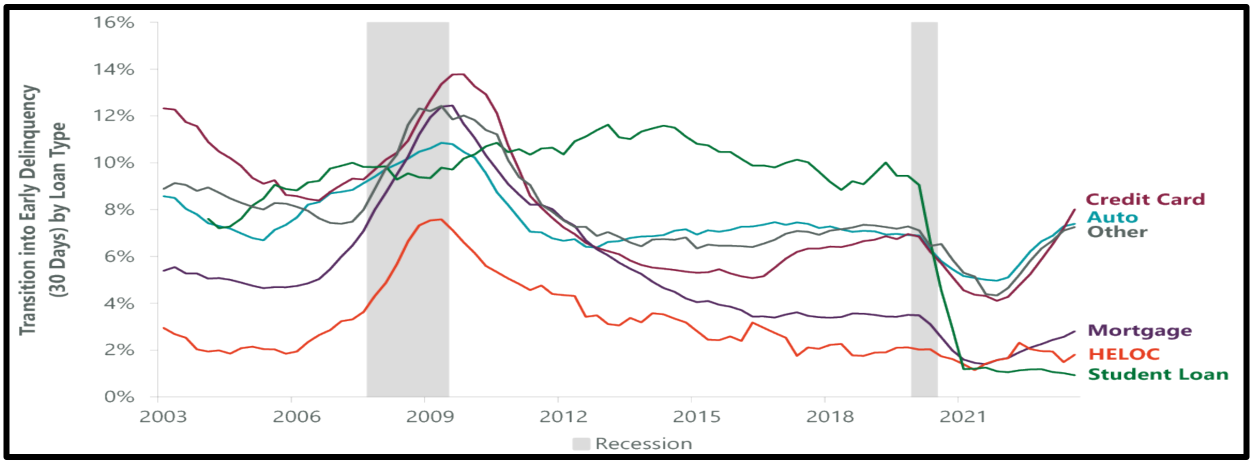
Source: Bureau of Economic Analysis

Another key difference is that consumers (as well as corporations) are far less sensitive to changing interest rates. In the aftermath of the most aggressive Fed hiking cycle in over 40 years, the effective outstanding mortgage rate in the U.S. has risen to just 3.7% from a recent low of 3.3%. This is the result of homeowners taking advantage of the low-rate environment early in the pandemic to term out their debt and lock in 15- and 30-year fixed rate mortgages. The unique structure of the U.S. mortgage industry has insulated many Americans from the bite of higher interest rates when it comes to their largest monthly outlay. Corporate America looks similar with many companies locking in their borrowing needs for multiple years at lower rates.



Source: Mortgage Bankers Association

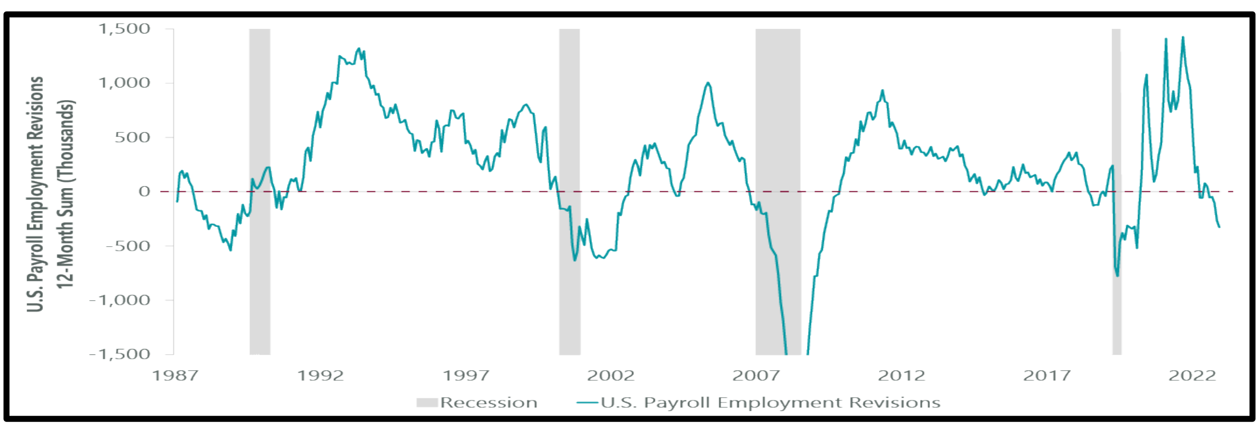
However, not all companies termed out and locked in fixed rates, and not all Americans own their homes. In fact, 36% of households rent according to the Census Bureau's 2019 estimates, and the CPI rent sub-component has risen by 25% since 2019. This equates to a nearly $500/month increase for the national median monthly rental, according to rent.com. Consumers are increasingly showing signs of balance sheet fatigue, with newly delinquent credit card and auto loans rising above pre-pandemic levels. The spike in delinquencies is notably higher for low-income households, which are feeling the pain of higher rents, general inflation and credit card rates (+6% since 2019), as this cohort is the least likely to own their home and more likely to carry a balance on their credit cards.



Source: National Bureau of Economic Analysis

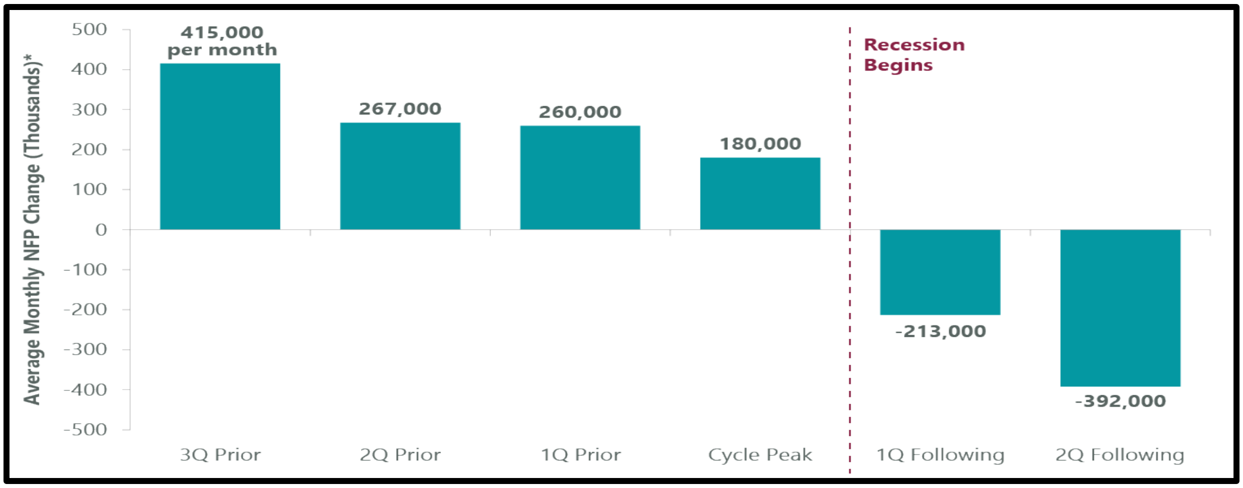
Importantly, other recessionary signals continue to flash warning signs, suggesting the economic cycle may have been elongated rather than eliminated. These include an inverted yield curve, contracting money supply, ongoing quantitative tightening, leading economic indicator weakness and a slowly but steadily softening labor market. While the overall pace of job creation remains healthy, the labor market is showing signs of deterioration beneath the surface.

One red flag for the labor market is downward revisions to the jobs report. Historically, labor revisions for the prior year turning negative indicates an economic downturn is on the horizon. Over the last 12 months, payrolls have seen a cumulative net downward revision of -329,000, firmly in the danger zone. Regardless of a hard- or soft-landing emerging, we may look back at this period and realize that job creation was much weaker than initially thought when all the revisions were made, a process that takes a few years to fully play out.



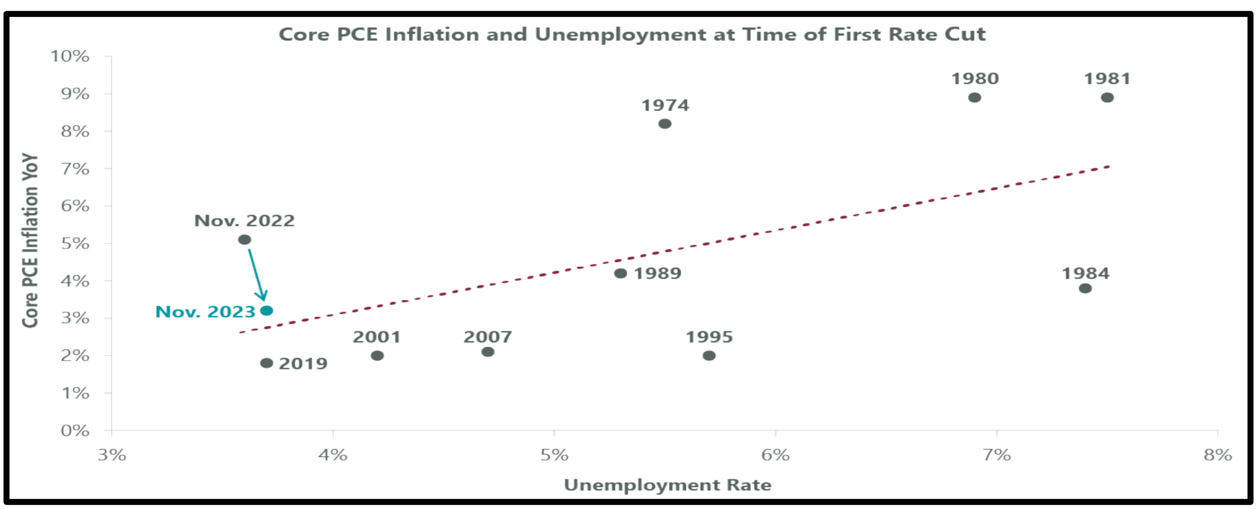
Source: Federal Reserve Bank

Although the fourth quarter saw mostly encouraging economic data, this does not rule out a recession. Historically, the economy tends to turn down non-linearly as a slowdown builds steam. This can be seen near cycle peaks in the labor market, with the economy quickly transitioning from strong job formation to outright losses. Since 1948, the average job creation is 180,000 per month (adjusted for the current size of the labor force) in the three months leading up to the cycle peak, and -213,000 per month in the three months after. Over the past three months, job creation has averaged 203,667, consistent with what has been seen ahead of past recessions. Put differently, strength in the labor market - a notoriously lagging indicator - does not mean we are out of the woods just yet.



Source: Bloomberg; National Bureau of Economic Research

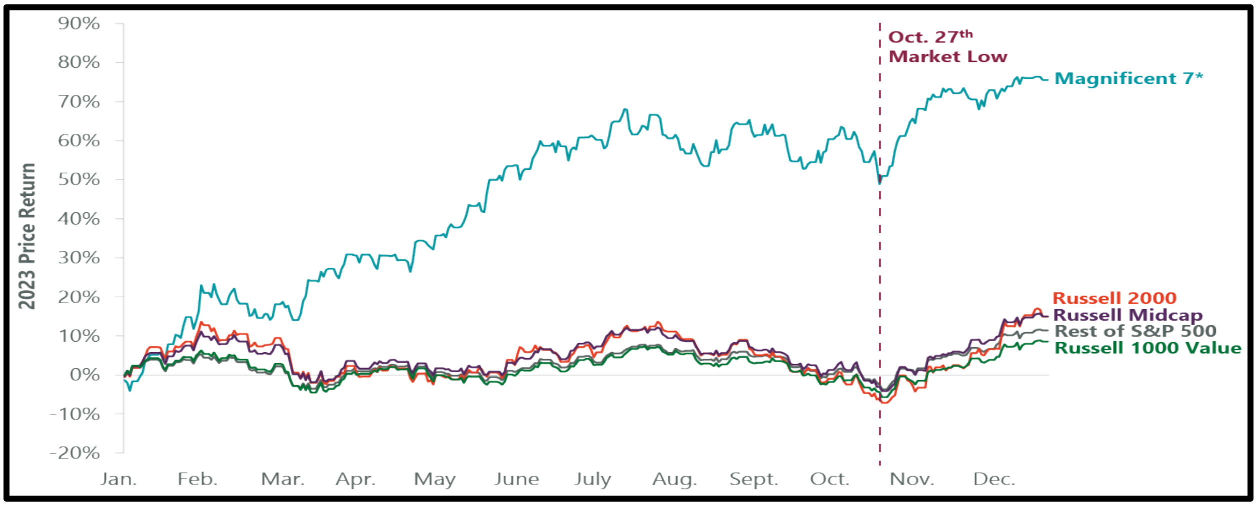
This is not to say that a soft landing can't or won't occur. In fact, the odds of a soft landing have increased over the last quarter on the back of improving economic data, a faster pace of disinflation and a potentially less restrictive Federal Reserve. Core PCE - the Fed's preferred measure of inflation - has come in at 1.9% on an annualized basis over the last six months, indicating that the Fed is on track to return inflation to its 2% target in 2024. This gives the Fed much more latitude to focus once again on its dual mandate of price stability and maximum sustainable employment. After last year's rapid progress on the inflation front, the Fed is now able to cut rates from their currently restrictive level, which should help support the economy. With inflation nearing target, the Fed has additional flexibility to cut rates even further in the case of outright job losses.



Source: Bureau of Labor Statistics; The Federal Reserve Bank

However, the economy is still feeling the lagged effects of the tightening cycle and the previous support from fiscal policy fading. For those reasons, it seems that a recession is still just as likely as a soft landing. The next few quarters will be telling as consumers continue to tighten their belts, commercial real estate markets continue to slow, and the money supply continues to decline.

The strength of the U.S. economy has coincided with a strong run for the stock market, which has now fully priced in a soft landing. The S&P 500 Index is currently trading at 19.5x NTM EPS, and those EPS expectations imply double-digit growth in 2024. With forecasts leaving little margin for error, the market may need a digestion period regardless of the economic outcome. One positive sign has been the broader participation across equity markets since the October 27 lows, with the Russell 2000 and Russell Midcap indices outperforming the Magnificent Seven that dominated market performance for most of 2023. Encouragingly, everyone else (the S&P 493) as well as the Russell 1000 Value have not been far behind during the recent period of improving market breadth.



Source: Bloomberg

Quarterly Performance

The return for the Hahn Capital Management Mid-Cap Value Composite (see table below) was ***12.26% gross of fees and 12.01% net of fees in the fourth quarter of 2023***. For the quarter, we outperformed our primary benchmark, the Russell Mid-Cap Value Index, by 0.15 percentage points gross of fees and underperformed by -0.10 percentage points net of fees.

For the quarter, sector allocations to Real Estate, Financials, Information Technology and Consumer Discretionary contributed, while those to Industrials, Materials, Communication Services and Energy detracted.

The most significant relative performers during the quarter were PVH Corp. (PVH), Agilent (A), Euronet Worldwide (EEFT), and Alexandria Real Estate (ARE), while the most significant underperformers were Jacobs Solutions (J), Genpact (G), Albemarle (ALB), and Emcor Group (EME).

Hahn Capital Quarterly Performance Attribution – 4Q 2023

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	18.44%	17.33%	1.11%	19.80%	17.18%	2.63%	0.05%	0.48%	0.53%	0.00%	0.53%
Information Technology	6.85%	9.34%	-2.49%	17.24%	10.25%	7.00%	0.07%	0.44%	0.51%	0.00%	0.51%
Real Estate	18.26%	10.31%	7.96%	19.58%	16.59%	2.99%	0.36%	0.55%	0.91%	0.00%	0.91%
Industrials	21.75%	19.00%	2.75%	3.80%	13.58%	-9.78%	0.06%	-2.20%	-2.14%	-0.01%	-2.15%
Health Care	11.89%	6.85%	5.04%	11.44%	7.82%	3.63%	-0.23%	0.44%	0.21%	0.01%	0.22%
Consumer Discretionary	7.55%	9.08%	-1.53%	32.49%	15.86%	16.63%	-0.02%	1.10%	1.08%	0.01%	1.09%
Materials	1.98%	7.71%	-5.73%	-14.80%	8.94%	-23.74%	0.19%	-0.59%	-0.40%	0.00%	-0.40%
Communication Services	2.37%	3.32%	-0.95%	4.73%	11.40%	-6.67%	0.00%	-0.18%	-0.18%	0.01%	-0.17%
Energy	4.07%	5.67%	-1.60%	-7.67%	0.12%	-7.80%	0.22%	-0.39%	-0.17%	0.00%	-0.17%
Consumer Staples	0.00%	3.84%	-3.84%	0.00%	5.17%	-5.17%	0.29%	0.00%	0.29%	0.00%	0.29%
Utilities	0.00%	7.54%	-7.54%	0.00%	9.31%	-9.31%	0.22%	0.00%	0.22%	0.00%	0.22%
Cash	6.83%	0.00%	6.83%	1.38%	0.00%	1.38%	-0.79%	0.00%	-0.79%	0.00%	-0.79%
Total Portfolio - Net of Fees				**12.19%**	**12.11%**	**0.08%**	**0.43%**	**-0.34%**	**0.09%**	**-0.01%**	**0.08%**

Relative Performance by Stock – Quarter Ended December 31, 2023

Top Four Holdings Total Attribution			Bottom Four Holdings Total Attribution			Top Four Sectors Total Attribution			Bottom Four Sectors Total Attribution		
1	PVH CORP	0.78%	1	JACOBS SOLUTIONS INC	-0.88%	1	Consumer Discretionary	1.09%	1	Industrials	-2.15%
2	AGILENT TECHNOLOGIES INC	0.62%	2	GENPACT LTD	-0.68%	2	Real Estate	0.91%	2	Cash	-0.79%
3	EURONET WORLDWIDE INC	0.43%	3	ALBEMARLE CORP	-0.57%	3	Financials	0.53%	3	Materials	-0.40%
4	ALEXANDRIA REAL ESTATE EQUIT	0.43%	4	EMCOR GROUP INC	-0.55%	4	Information Technology	0.51%	4	Energy	-0.17%

HCM MID-CAP VALUE COMPOSITE PERFORMANCE HISTORY

% Annualized Returns As of 12/31/2023	4Q 2023	1 Year	3 Years	5 Years	7 Years	10 Years	Since Inception 06-30-88
HCM Gross of Fees	12.26%	6.68%	4.96%	11.21%	8.55%	7.37%	13.10%
HCM Net of Fees	12.01%	5.63%	3.92%	10.12%	7.49%	6.31%	12.00%
Russell Mid Cap Value Index	12.11%	12.71%	8.36%	11.16%	7.76%	8.26%	11.00%
Russell Mid Cap Index	12.82%	17.23%	5.92%	12.68%	10.07%	9.42%	11.18%

Link to: HCM Performance Disclosures

PORTFOLIO ACTIVITY

New Positions

Warner Music Group (WMG) – We initiated a position in Warner Music Group during the quarter. Warner Music Group (WMG) is the third largest music label in the world with ~15%

market share and operates in an oligopoly where the three largest firms' control > 75% of the market. Dating back to the 1950s, WMG has built a portfolio of some of the most recognized music labels in the world, including Atlantic, Warner, Parlophone, and Elektra Records.

Profits from the music label business are derived from two categories: recorded music and music publishing. Recorded music accounts for 80-85% of the profits and is the traditional business of discovering artists, recording songs, and distributing their music (think of it as fees earned for the ownership of intellectual property (IP) rights). Music publishing comprises the fees generated from owning the IP rights tied specifically to the written music and lyrics of the songs themselves.

The music label business has gone through a substantial transition over the past 20 years. Prior to the downloading and streaming of music over the internet, the record labels were the gatekeepers to the industry as the capital costs required to produce and distribute music were so high that artists had no choice but to utilize a record label. Then in the early 2000s, the proliferation of illegal downloading of music presented an existential threat to the business, which in many ways was saved by the advent of streaming in the 2010s.

While digital production and streaming has helped to democratize the music creation and distribution process for artists (circumventing the "toll bridge" the music labels used to control), it has benefited the music labels in other ways, arguably strengthening their competitive position within the ecosystem. Because of steaming's ease of use, the number of songs that are created each year has exploded, making it significantly harder for artists to stand out. Likewise, the market for music has become increasingly global, and as such, distribution is still highly fragmented with the various mediums in which music can be consumed across the world. As a result, artists no longer come to the major record labels as their only route over the "toll bridge," instead, they come to them as their best chance of succeeding in a highly fragmented and competitive market.

This is a business that has high fixed costs, but as a result, it also has very high incremental margins – it costs a lot of money to find, produce, develop, and market an artist, but once these expenses have been made, it costs a label almost nothing to stream a song an additional time, so the more streams an artist generates, the higher the margins of this business. In addition, because of the valuable market position the record labels hold (they contractually own all the IP), the business generates a substantial amount of negative working capital (the labels get paid before they must pay their artists), resulting in the business generating some of the highest returns on invested capital of any business we have analyzed.

We believe the future growth prospects for this business remain incredibly attractive as streaming is still in the early stages of global adoption and the pricing agreements the record labels have entered with the streamers leave ample room for value capture. 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 an intelligent management team, all at a substantial discount to our estimate of intrinsic value. We expect this combination to lead to very attractive investment results in the long term.

<u>Positions Increased</u>

There were no positions increased during the quarter.

Positions Reduced

There were no positions reduced during the quarter.

Positions Sold

Mohawk Industries, Inc. (MHK) – We sold our position in Mohawk Industries during the quarter as the stock rallied significantly during the quarter. Mohawk owns a dominant franchise in flooring solutions in a largely duopoly industry along with Berkshire Hathaway subsidiary Shaw Industries. Despite that fact, Mohawk has only been able to increase its profitability in fits and starts while being plagued with a string of operational issues and a spotty track record of acquisitions. As we have owned this company in our portfolio for more than six years, it was time to re-allocate our capital to better opportunities (including Warner Music Group).

Outlook

Economic & Market Outlook

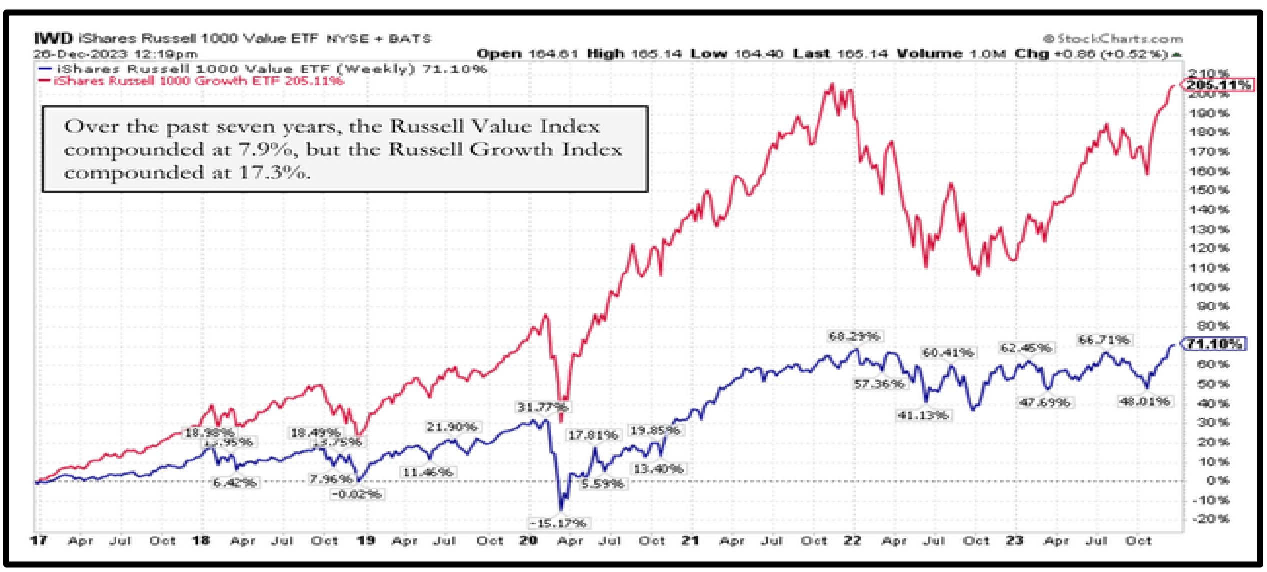
Since 1947, the S&P 500 Index's earnings per share have grown at 7.7% annually, while the U.S. economy expanded by 6.4% annually (in real terms). However, following a decade of abnormally high returns, many investors have become complacent and continue to expect elevated rates of return from the financial markets. This complacency is a basis for various justifications to rationalize overpaying for assets.

The gap between fundamentals and valuation may lose significance if policymakers actively support asset prices. Markets can detach themselves from underlying economic activity for lengthy periods as speculative excess separates market prices from fundamental realities. Regrettably, future investment returns may disappoint those who invest based on today's recent market trends. It is important the investor acknowledges that recent excess returns resulted from a monetary illusion of the "new normal." Dispelling this illusion may pose challenges for market participants seeking to navigate the potential consequences of a decade of financial distortion. The chart below highlights the strong long-term relationship between growth in the U.S. economy and stock returns. When stock returns rise well above the trend line for economic growth, it's a very reliable indicator that valuations are stretched and either a significant correction is in store, or just as likely, a significant period of low returns are on the horizon. This is the bad news.

Source: Bloomberg, The Federal Reserve Bank

The much better news is that small- and mid-cap stocks value stocks (representing the companies that we invest in), unlike their growth and large capitalization peers, are much more reasonably valued. Over the past 7 years, growth stocks have outpaced value stocks by a truly extraordinary margin; compounding at 17.3% compared to 7.9%. These two asset classes have similar long-term return profiles but euphoria over hyper-growth prospects has been so tremendous that recent years have witnessed this extreme divergence.

The forward Price Earnings Ratio for the Russell Growth Index is a lofty 19.7 times with the current consensus expectation for 12% earnings growth in 2024. By comparison, the Russell Value Index is currently valued at 14.3 times the forward consensus for earnings growth, which is expected to increase by just over 8%. The set-up is quite clear, value stocks represent at least the prospect for reasonable (mid- to high-single digit returns) while growth stocks are in a bubble.



Source: Stock Charts, Bloomberg

Portfolio Strategy & Positioning

We thought it might be helpful to revisit one of our core principles in selecting the companies in which we invest on your behalf. While value investing has been difficult over the past few years, it is still one of the most powerful concepts in all of finance and will again see success.

The concept of "compounding" in equities - holding an investment for a lengthy period to enable the concept of compound interest/return from reinvested earnings to work its magic – is not complex. The selection of the investment is where the controversy starts. The best-known compounding company on earth – Berkshire Hathaway – has done so via multifarious means ranging from the adroit use of profitable insurance and reinsurance cash flow/float, selection and retention of high-quality, publicly-listed securities, purchase of strong businesses at attractive prices and retention of high levels of liquidity to avoid cyclical distress, promote strength and partnership capacity together with bouts of opportunism rarely seen elsewhere. This is effectively, the Hahn Capital Management playbook, investing in companies that can reliably increase intrinsic value over multiple market cycles due to the inherent strength in their business models, conservative balance sheet management and astute management.

Our float is the capital you have entrusted to us, and we expend all of our energies, protecting that capital first and expanding it. Compounding sits logically alongside the Hahn Capital Management Mid-Cap Strategy since we are long-term owners of these businesses. We wish you much health and happiness in 2024 and thank you for your support.

John Schaeffer
President and CIO

Michael Whitfield
Dir. of Research and Co-Portfolio Manager