



## PORTFOLIO UPDATE AND MARKET OUTLOOK

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**“Now, the rest of the story.”**

– Paul Harvey



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Last month we wrote about our barbell positioning in the portfolio. In addition, we quoted some positive statistics for potential Small Cap outperformance from Steve DeSanctis. In that report (Jefferies Performance Scorecard 2/1/2023), DeSanctis also pointed out that Small Caps currently represent 4% of the market. That's lower than at the trough of the pandemic. The long-term average is closer to 7%. Furthermore, the five-year relative performance of small compared to large is in the 12th percentile. When performance has been this weak, it has typically ushered in a long period of better absolute and relative performance of Small Caps.

The old investing adage goes that sometimes things are cheap for a reason. Why have Small Caps lagged their larger brethren for so long and by so much? Empirical Research Partners (Small-Caps: Where We Stand 1/11/2023) offers some reasons. Since the great financial crisis (GFC), free cashflow (FCF) margins of small companies have not kept pace with larger ones. This explains some of the neglect from investors. Fifteen years of Zero Interest Rate Policy (ZIRP), globalization, and tax cuts benefitted larger, more global companies. Empirical estimates that half the gain in FCF margins came from lower interest rates. Roughly 25% came from tax rate reductions. The question we, as investors, have to ask is – what does the future look like?

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### Preliminary Performance (%)

#### Representative Accounts

	MTD			QTD			YTD		
	Gross	Net	vs. Benchmark*	Gross	Net	vs. Benchmark*	Gross	Net	vs. Benchmark*
Small Cap Value	-0.40	-0.42	+1.91	8.50	8.39	+1.49	8.50	8.39	+1.49
Small/Mid Cap Value	-1.72	-1.79	+1.11	8.32	8.16	+1.44	8.32	8.16	+1.44
Mid Cap Value	-2.48	-2.55	+0.73	5.90	5.75	+1.28	5.90	5.75	+1.28
Micro Cap Value	-1.24	-1.26	+1.77	8.22	8.11	+1.81	8.22	8.11	+1.81

Source: SEI

**Past performance does not guarantee future results.** Representative accounts include: Integrity Small Cap Value Equity Strategy, Integrity Small/Mid Cap Value Equity Strategy, Integrity Mid Cap Value Equity Strategy, Integrity Micro Cap Value Equity Strategy. Performance is preliminary and subject to change. Benchmark comparison is versus gross performance.

### Market Returns (%)

	MTD	QTD	YTD
S&P 500® Index	-2.44	3.69	3.69
Nasdaq 100® Index	-0.37	10.26	10.26
Russell 2000® Growth Index	-1.08	8.76	8.76
Russell 2000® Value Index	-2.31	7.02	7.02

**Past performance does not guarantee future results.** Indices represent different segments of the market and are not correlated to the strategies above, with the exception of the Russell 2000® Value Index, which is the benchmark for Integrity Small Cap Value Equity.

We don't have a crystal ball. However, it seems that the drivers of FCF margins for Large Caps have gone from positive to negative.

- **Globalization:** There is increased talk of onshoring or near-shoring. COVID and political tensions revealed the risk of relying on manufacturing half a world away. Onshoring is a potential positive for Small Caps as companies expand plant and equipment. Smaller companies tend to be the vendors for the materials and equipment used in plant expansion. Empirical even notes that Small Caps tend to outperform toward the peak of capital expenditure cycles. We see this threat to globalization as negative for larger companies.
- **Tax Cuts:** The current administration instituted minimum global tax rates to close loopholes in the tax code of using foreign subsidiaries to shelter income from U.S. taxes. This impact will be felt more by larger companies (Greater than \$1 billion in foreign income). Lower taxes accounted for 25% of FCF improvement. We believe this is now a drag on margins.
- **Interest Rates:** We believe that the era of ZIRP is over. ZIRP was an anomaly in the long history of interest rates. It could happen again, but we think it is highly unlikely. ZIRP was the single-largest driver of FCF improvement for Large Caps. We believe this positive is now a negative.

We are of the opinion that the long reign of Large Caps is coming to a close. We see the drivers of their superior performance turning negative. We continue to believe that, in an era of normal interest rates (not ZIRP), historical relationships between asset classes could revert to the mean. This would likely mean a period of outperformance for Small compared to Large and Value compared to Growth.

The market is complex and has many moving pieces. We could be wrong on our thesis. However, we think the historic relative discount, combined with a change in the interest rate environment, makes it a compelling hypothesis. Regardless, we will continue our search for Good Value and Good News, focusing on risk-control and the goal of consistency for our clients. And that's the rest of the story.

#### **Some Explanation:**

For those younger – Google Paul Harvey. He did a radio show called “The Rest of the Story.” It was a 3-4 minute segment usually dealing with unknown aspects of a famous person's life. He would reveal the person at the end. He began his shows with our quote above and ended with – “And that's the rest of the story.” I felt this was the rest of the Small Cap story we started last month. In addition, I feel Small and Value are unpopular asset classes with an interesting story. Here's one of his stories:

#### **Something to Make You Feel Old:**

MTV's debut date (8/1/1981) is closer in time to Pearl Harbor than to today – Yikes! (For those keeping score, it's 14,483 days since Pearl Harbor and 15,185 days since MTV launched). Credit to Super 70's Sports Twitter account.

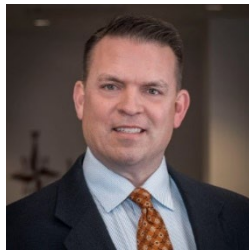
#### **Attribution:**

After a strong start to the year in January, equity markets pulled back in February as investors grappled with the realization that inflation isn't cooling to the extent the Fed would like to see. The Russell 2000 Value Index, down 2.3% underperformed the tech heavy Nasdaq which was down 0.4%. The S&P 500 underperformed both the Russell 2000 Value Index and the Nasdaq as it posted a return of -2.4%. Growth outperformed value across all of our respective benchmarks for the month. Longer term, on both a one year and three-year basis, value continues to outperform growth. All four of our strategies outperformed their respective benchmarks for the month.

**Composite Performance (%) as of December 31, 2022**

	1 Year		5 Year		10 Year	
	Gross	Net	Gross	Net	Gross	Net
Small Cap Value	-6.67%	-7.61%	5.76%	4.71%	10.74%	9.64%
Small/Mid Cap Value	-6.97%	-7.90%	6.75%	5.68%	10.91%	9.81%
Mid Cap Value	-6.04%	-6.84%	7.29%	6.43%	11.69%	10.78%
Micro Cap Value	-10.73%	-11.63%	5.29%	4.24%	11.56%	10.45%

Returns for periods greater than one year are annualized. Returns reflect the reinvestment of dividends and other earnings and are expressed in U.S. dollars. Gross-of-fees returns for the representative account are presented before management and custodial fees but after all trading expenses.

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**All investments carry a certain degree of risk including the possible loss of principal**, and an investment should be made with an understanding of the risks involved with owning a particular security or asset class. Interested parties are strongly encouraged to seek advice from qualified tax and financial experts regarding the best options for your particular circumstances.

Each representative account serves as the model against which all accounts in each respective strategy are managed. The representative accounts are actual portfolios and the information provided, including performance, will vary for other accounts. The representative accounts are being used solely as tools to help demonstrate how performance can be attributed to the investment policies applied in the management of each strategy.

Net-of fees returns reflect gross performance less investment management fees, which are calculated by deducting 1/12 of the highest tier of the standard fee schedule in effect for the period noted (the model fee). The composite model fee for each period is either the highest tier of the current fee schedule or a higher value, whichever is required to ensure the model composite net-of-fee return is lower than or equal to the composite net-of-fee return calculated using actual fees. Actual fees may vary depending on, among other things, the applicable fee schedule and portfolio size. The firm's fees are available on request and may be found in Part 2A of its Form ADV.

\*The Integrity Small-Cap Value Equity Strategy is benchmarked to the Russell 2000® Value Index. The Integrity Small/Mid-Cap Value Equity Strategy is benchmarked to the Russell 2500™ Value Index. The Integrity Mid-Cap Value Equity Strategy is benchmarked to the Russell Midcap® Value Index. The Integrity Micro-Cap Value Equity Strategy is benchmarked to the Russell Microcap® Value Index.

Index returns reflect the reinvestment of dividends and other income but do not reflect advisory fees or any other expenses. Indexes are unmanaged and one cannot invest directly in an index.

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