



PORTFOLIO UPDATE AND MARKET OUTLOOK

October 31, 2023

*Don't it always seem to go
That you don't know what you've got 'til it's gone
They paved paradise, put up a parking lot*

– Joni Mitchell

Higher for Longer – we've heard that phrase a lot lately. Are rates really that high?

Humans have an anchoring bias. Ads take advantage of it all the time. That mattress was \$1,000, now it's \$500. Great deal, right? Maybe, maybe not.

Interest rates have been kept unusually low by the Federal Reserve. Now, people see that as normal. In reality, it is abnormal – Abby-Normal if you are a Young Frankenstein fan.

[One of my [favorite movie scenes of all-time – fitting for Halloween](#)]

Is it surprising to find that the average rate on the two-year Treasury from 1/1/1977-10/25/2023 is 4.91%? Over that period, the highest rate was 16.96% in September of 1981. The low was 0.10% in February of 2021. On the day this was written (10/25/2023) the rate was 5.08%, not that different than average. The current 10-year yield (4.96%) is below its average of 5.82% (1962-present, max of 15.8%, minimum of 0.51%).

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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	-5.47	-5.47	+0.50	-5.47	-5.47	+0.50	0.21	-0.54	+6.67
Small/Mid Cap Value	-5.92	-5.92	-0.31	-5.92	-5.92	-0.31	-1.18	-1.81	+2.59
Mid Cap Value	-5.08	-5.08	-0.13	-5.08	-5.08	-0.13	-1.73	-2.33	+2.72
Micro Cap Value	-5.38	-5.38	+1.18	-5.38	-5.38	+1.18	-5.97	-6.67	+6.57

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	-2.10	-2.10	10.69
Nasdaq 100® Index	-2.04	-2.04	32.62
Russell 2000® Growth Index	-7.71	-7.71	-2.87
Russell 2000® Value Index	-5.97	-5.97	-6.46

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.



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Why does it matter? Implicit in the phrase “higher for longer” is the corollary “lower at some point.” Finance 101 says that the value of anything is the present value of its future discounted cashflows. Viewing average rates as high (anchoring bias) could lead to lower-than-warranted assumed future discount rates. This could have a significant impact on current valuations and relative stock performance until current rates are viewed as normal. As it relates to our portfolios, the future assumption of lower rates results in higher valuations of the non-earners in our benchmarks. Given our underweight, we see this as a near-term risk to relative performance, especially if the Federal Reserve signals a pause or cut.

However, if we are correct and current rates are “normal” going forward, we see an interesting implication for the active versus passive debate. Most active managers, growth and value, have some valuation discipline that involves buying expected future cashflow at a discount. Unusually low rates, like those seen since 2009, made “story stocks” with no immediate cashflow prospects attractive. Searching for unicorns became an investment obsession, both in the public and private markets. Money was almost free, and investors could afford to finance these companies.

Creating a discounted cashflow model to value a company with no cashflow isn’t easy. Like in the tech bubble of the late 1990’s, alternate valuation metrics came into vogue: subscriber growth, price to R&D, price to sales, etc. Similarly, disciplined, fundamentally focused managers had trouble keeping up with the indexes. Our benchmark is littered with non-earning companies. Currently, Jefferies estimates that 18% of the Russell 2000 Value is comprised of non-earning companies. The growth counterpart is estimated at 22%. As rates normalize and these companies are starved of capital, they will need to produce cash or go out of business. That could be a long tailwind for active managers.

We believe “normal” rates could bring active management back in vogue. We are not convinced most passive investors understand the significant portion of their investments in money-losing companies. Our Right Company, Right Price, Right Time fundamentally focused strategy of stock selection has the potential to add value for our clients in this environment. Time will tell.

Attribution:

U.S. equity markets declined for the third consecutive month. A rapid rise in Treasury yields to levels not seen since March of 2007 and the outbreak of the Israel-Hamas war weighed on investors. The Russell 2000 Value Index, down 6.0%, underperformed both the S&P 500 and the tech heavy Nasdaq (-2.2% and -2.8% respectively). For the month, value beat growth across all four of our benchmarks. Our small cap value and micro cap value strategies outperformed their respective benchmarks for the month of October, while our small/mid value and mid cap value strategies underperformed.

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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