

Market Commentary

It was quite a year for stocks in 2020, and the manner in which the fourth quarter ended just might prove to be an inflection point for value-oriented equity strategies. Are we finally on the cusp of a longer-term rotation away from technology and growth stocks? Only time will tell, but there have been promising signs that we may be in the early stages of a new economic cycle, which in turn could favor traditional value sectors.

To understand where we are in the cycle today might require a look back at this historic and unusual year. In the first quarter of 2020, an emerging pandemic shook the markets globally. Stocks were pummeled by SARS-CoV-2 (severe acute respiratory syndrome coronavirus 2, the virus responsible for COVID-19). But almost just as quickly, U.S. equity markets rebounded in the second quarter and continued to move sharply higher to start the third quarter before taking a breather in September. And then the year ended with the strongest fourth quarter equities rally in history.

The massive fiscal and monetary stimulus that helped keep businesses open, people in their homes, and important services funded during the early stages of the economic downturn obviously fueled financial markets. Then came growing optimism for an effective vaccine (developed faster than even the best-case scenario). On top of that, election clarity and the potential for less mercurial policies of a new presidential administration also helped push investor sentiment to a multi-decade level of exuberance. And once again in the fourth quarter, stocks were propelled by expectations for more fiscal stimulus.

After much negotiating and drama, Congress delivered on its fiscal promise with more direct payments, more unemployment insurance, and additional aid to businesses. All this fiscal stimulus appears to have bridged the pre-pandemic economy to what is slowly emerging as a “new normal” economic environment. It also has been a catalyst for a rotation into the market’s cheaper and economically sensitive sectors during the fourth quarter. The monetary and fiscal backdrop may, in our opinion, be setting up nicely for longer-term tailwinds for value-oriented strategies.

In terms of style performance during the fourth quarter, value-oriented stocks, as measured by the Russell 3000[®] Value Index, increased 17.21%. This bested growth-oriented stocks, as measured by the Russell 3000[®] Growth Index, which were up 12.41% during the same period.

Small-cap, mid-cap, and large-cap stocks all performed well during the quarter, as measured by the Russell family of indices. The Russell 2000[®] Index rebounded sharply on a relative basis, returning 31.37% during the fourth quarter, while the Russell Midcap[®] Index returned 19.91% and the Russell 1000[®] Index returned 13.69%. Meanwhile, the Russell 2000[®] Value Index was the best performing U.S. equity style, up 33.36% during the fourth quarter. This reflects, in part, the view that small-cap value companies that had not participated in the strong performance of U.S. equity markets were priced too conservatively.

Performance Review

For the three months ended December 31, 2020, the RS Concentrated All Cap Value strategy outperformed its benchmark Russell 3000[®] Value Index (the “Index”) and returned 18.85% net versus a return of 17.21% for the Index.

In the fourth quarter, strong performance from stock selection in Information Technology aided relative performance, while stock selection in the Financials sector detracted.

Investment Strategy

The RS Value Team seeks to invest in good companies, led by strong management teams, which are attractively valued. Our decision to invest in any company starts with business analysis and an understanding of the company’s unit-level economics. Our work on unit-level economics helps us determine the quality and key drivers of the business. We are Return on Invested Capital (ROIC)–focused investors and seek to invest in companies that can create shareholder value due to an improvement in the returns of the existing assets or through attractive reinvestment opportunities. We are long-term investors who use our investment time horizon as a competitive advantage and are attracted to out-of-favor and/or misunderstood companies in the market.

The next step in our process is to assess the management team. Our evaluation of a company’s management team is critical to our investment decision. We regularly meet with management to gauge how they think about their business: Are they focused on (and compensated for) growing earnings at any cost, or do they understand return on invested capital (ROIC) and how value is created? Additionally, we perform detailed historical analyses of management’s capital decisions—looking at acquisitions, asset sales, and measures of capital stewardship. This analysis provides us with the conviction to invest with strong management teams that are able to navigate through short-term market volatility and deliver long-term shareholder value.

The final step in our analysis is valuation. To the RS Value Team, value investing is buying a business at a discount to what we believe it is actually worth. We determine what a company is worth by assessing a company’s current share price versus its future cash flow streams or long-term net asset value based upon the management team’s plan for value creation. ROIC is the lens through which we analyze that value creation. Our research has shown that, over time, stock price performance has a higher correlation to improving ROIC as opposed to traditional valuation measurements like price to earnings (P/E). We seek to invest in companies that can create shareholder value due to an improvement in the returns of the existing assets or through attractive reinvestment opportunities. We pay close attention to a company’s financial strength, scrutinizing financial statements, and we run various financial models to understand our downside. This quantitative analysis gives us confidence in our investment thesis and helps us determine at what stock price we are comfortable investing.

Select Position Review

Below, we review two businesses in an effort to use tangible examples to highlight our investment process.

Sensata Technologies (ST) provides sensors to automotive, industrial, and heavy vehicle customers around the world. Despite being a relatively small amount of the total cost of the end product, Sensata's solutions are critical in measuring the performance and operations of their clients' products, so customers are willing to pay for Sensata's premium technology. For example, Sensata sensors optimize fuel efficiency in trucks, measure tire pressure in automobiles, regulate temperature of batteries in electric vehicles, and manage industrial pumps.

Strong secular tailwinds including regulation, fuel efficiency, and electrification continue to drive more demanding operating requirements, allowing Sensata to gain content market share and become a critical partner to its customers. Unlike most of its competitors, Sensata benefits from electric vehicle growth because its dollar content is greater on EVs than internal combustion vehicles.

The sensor industry structure is also favorable, with a group of established institutions competing rationally and an ability to maintain content on a particular platform for the entire platform lifecycle. Sensata's return on invested capital (ROIC) will improve due to rising operating margins from increased scale and productivity improvements that are being implemented at recent acquisitions. We believe Sensata offers a compelling opportunity for value creation.

During the fourth quarter and throughout 2020, one area of underperformance was in property and casualty (re)insurance, where significant catastrophe losses hampered investment returns. In particular, our position in RenaissanceRe (RNR), a reinsurer with a dominant franchise in natural catastrophe reinsurance, was subject to losses from COVID-19. Although the losses from the pandemic have affected the stock price in the short term, as they have with our other property and casualty investments, our conviction in the name going forward has only increased. As a result of our focus on strong balance sheets, high quality capital allocators, and improving returns, our conviction in RNR has increased despite the losses from COVID-19.

In the world of (re)insurance, every major catastrophe leaves an impact on the industry and COVID-19 has done the same. Although total insured losses for the pandemic will continue to be calculated for some time in the future, history gives us some insight regarding how the industry may react. The lessons learned from Hurricane Andrew, September 11, Hurricane Katrina, and many others result in direct change in risk appetites, capital requirements, and (importantly) prospective assessment for pricing adequacy. The investment community response to these events typically follows a very similar pattern. Property and casualty stocks initially decline,

as investors myopically focus on the losses incurred and remaining capital adequacy. Once the losses can be determined, investor focus shifts to pricing improvement and the stocks typically perform well, as future earnings improvement is discounted into current valuations. While this has been a bit slower to play out than we would have liked, we expect this playbook to unfold once again.

In general, the valuations assigned to property and casualty (re)insurers remain very attractive and pricing power is likely to persist throughout our investment time horizon. The sector remains one of our higher conviction investment themes in these uncertain times, with RenaissanceRe (RNR) being one of our larger weightings.

Outlook

The range of outcomes for 2021, while more optimistic, rests on the rollout and efficacy of recently approved vaccines to fight COVID-19. Volatility, economic activity, and the level of interest rates will be impacted by the level of success of the vaccines. In addition, the United States presidential election has resulted in a shift in power, which provides some uncertainty as to how policy decisions may impact the economy and markets.

Interest and mortgage rates continue near historically low levels, inflation is nonexistent, and the economy struggles while we await broad distribution of the vaccines. We remain very watchful of inflation, particularly as a result of the size and speed of the monetary and fiscal response to the pandemic. We continue to carefully monitor the corporate debt market, but in general, U.S. corporate balance sheets are in better shape with access to low-cost debt. The Federal Reserve has stepped in to provide liquidity to support risk assets, but there does remain some concern regarding insolvency for some businesses if the absolute level of economic activity remains weak.

Equity valuations are in the top decile compared to historical levels, in part due to depressed earnings from COVID-19, but also as a result of multiple expansion in the six largest mega-cap stocks in the S&P 500®. Excluding the six largest mega-cap stocks, valuations are more reasonable, particularly if compared to the 10-year U.S. Treasury yield. Recovery in aggregate earnings will be tempered, as certain industries such as hospitality, entertainment, banking, and travel will take longer to return to pre-coronavirus levels. However, equities continue to look attractive when compared to Treasuries and high-grade corporate bonds after the flight to safety rally during the crisis. In any case, we feel the values inherent in your portfolio should attract other investors and acquirers over time.

We thank you, as always, for your support.

Sincerely,

RS Value Team

Performance quoted represents past performance and does not guarantee future results. Investing involves risk, including the possible loss of principal and fluctuation of value. There is no assurance the investment process will lead to successful investing.

Returns are expressed in U.S. dollars. Composite returns are net of transaction costs and net of non-reclaimable withholding taxes, if any, and reflect the reinvestment of dividends and other earnings.

Gross-of-fees returns are presented before management and custodial fees but after all trading expenses. Net-of-fees returns are calculated by deducting one-twelfth 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 on Part II of its Form ADV.

Index returns are provided to represent the investment environment during the periods shown. The index is fully invested, including the reinvestment of dividends and capital gains. Index returns do not include transaction costs, management fees or other costs. Non-U.S. indices are net of withholding taxes, if any.

The opinions are those of the authors as of the time of this writing and are subject to change at any time due to changes in market or economic conditions. The comments should not be construed as a

recommendation of individual holdings or market sectors, but as an illustration of broader themes.

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The RS Concentrated All Cap Strategy primarily invests in a diversified portfolio of small-cap, mid-cap, and large-cap companies.

Information relating to portfolio holdings is based on the representative account in the composite and may vary for other accounts in the strategy due to asset size, client guidelines, and other factors. The representative account is believed to most closely reflect the current portfolio management style.

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