RS SMALL CAP VALUE STRATEGY QUARTERLY COMMENTARY

RS Investments®
A VICTORY CAPITAL® INVESTMENT FRANCHISE

As of December 31, 2020

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 Small Cap Value strategy marginally underperformed its benchmark Russell 2000® Value Index (the “Index”) and returned 33.05% net versus 33.36% for the Index.

In the fourth quarter, relative underperformance was driven by challenged stock selection in the Materials and Consumer Staples sectors, which more than offset strong performance in Industrials.

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.

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Select Position Review

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

Carter's (CRI) is the largest multi-channel branded marketer and retailer in North America of apparel exclusively for babies and young kids, operating under the "Carter's" and "OshKosh B'gosh" brands. As the scale player in the marketplace they have an advantageous production cost position relative to competition. We established a position in the company starting in 2Q 2020 and have continued to add to the position throughout the year. As one might expect from a business operating in the retail channel, Carter's business suffered in 2020 as their own stores as well as some of their wholesale partners' stores were required to temporarily close and operate under limited capacity restrictions as a result of the pandemic. Given the company's fortress balance sheet with over $1 billion in cash and little net debt, we had zero doubt that the company could weather the short-term impact created by the pandemic. As the economy reopens and retail traffic normalizes, sales and profits at Carter's should recover to at or above pre-pandemic levels. With many weaker competitors forced to permanently shutter doors, we believe Carter's has the opportunity to take meaningful market share in a post-pandemic world. In addition, many of the cost and pricing initiatives undertaken by the company during 2020 will carry over into the future, leading to meaningfully improved profitability and ROIC. Lastly, the company is in the early innings of a decade-long international growth opportunity which will add to profitability. As all of these things unfold over the next 2-3 years we believe there's meaningful upside in Carter's share price.

Treehouse Foods (THS) is the largest private-label (PL) food manufacturer in the U.S. The company sells goods in over two dozen food categories to U.S. grocers, including Walmart, Costco, Amazon, Kroger, Trader Joe's, and Aldi. After years of mixed results for the company, Steve Oakland was appointed as the company's new CEO in 2018. Under his leadership, the company undertook an effort to optimize its category portfolio, improve manufacturing and customer service levels, and drive company-specific ROIC improvement. We established a position in the company during the back half of 2019 and early 2020, as shares traded well below our assessment of intrinsic value. While food companies in general performed fundamentally well during 2020, private-label categories underperformed on a relative basis during the pandemic due to the complexity of their supply chains, which caused in-stock positions to be less than optimal during this time of elevated demand. In addition, Treehouse shares underperformed the market in the back half of 2020 as the market rotated to more cyclically exposed areas of the market. The stock now trades as cheaply as it ever has in its 15-year life as a public company and well below our assessment of intrinsic value. Our conversations with food retail channel partners underscore the belief that the market share shifts of 2020 are temporary and that future demand for Treehouse's private-label categories will be quite strong. We see shares recovering nicely over the next couple years as the improved operating performance under the leadership of its new CEO unfolds.

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.

Portfolio holdings are subject to change and should not be considered a recommendation to buy or sell individual securities. A complete list of all recommendations of security selection is available by request for the previous 12 months. Victory Capital Management Inc., and its affiliates, as agents for their clients, and any of its officers or employees, may have a beneficial interest or position in any of the securities mentioned, which may be contrary to any opinion or projection expressed in this report. This information should not be relied upon as research or investment advice regarding any security in particular.

The RS Small Cap Value Strategy primarily invests in a diversified portfolio of small-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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