# Mid Cap Equity Strategy — 2nd Quarter 2018 Commentary

## 2nd QUARTER MARKET SUMMARY

The U.S. economy continued to chug along in the 2nd quarter with the economic expansion that began in 2009 entering its 109th month. The rest of the world's economies have also decided to join the fun, for that rarest of things, synchronized global growth. Indeed, most economies (including our own) seem to be gaining steam and there aren't any meaningful red flags on the horizon that would suggest a change in momentum anytime soon.

While no one would argue that the current economic expansion isn't long in the tooth, that doesn't mean it can't continue for a good while yet. First, the depth of the recession and accompanying unemployment crisis caused by the Great Financial Crisis was severe, and the recovery that has ensued has been shallow and slow. Second, that downturn was caused by a truly extraordinary excess of leverage and risk taking in the credit markets, conditions which do not exist today. Finally, business conditions, including tax policy and sweeping attempts at de-regulation, have created the most pro-business economic environment since the Reagan Administration.

The less positive news is that the stock market is reflecting a good proportion, if not all, of the good news. Most valuation parameters are in a zone that reflect vary modest return expectations for the near future, and some asset classes appear to be materially over-valued. Volatility in the stock market remains near historic lows, representing a sort of complacency about the certainty of positive future returns, which we do not believe will ultimately come to pass. There is a "pro-risk" environment in most investable markets today, characterized by a reach for returns and yield that is akin to picking up nickels in front of a steamroller. This environment represents a true challenge to prudent investors looking for excess returns while remaining disciplined in the risks they are willing to take.

This is exactly the point in time, however, when active management is the most valuable to investors. When risk premiums are low, the economic expansion is mature and the investing markets are heating up, risk management becomes paramount. We have often said to our clients that all of our peers in the equity management business sell the concept of Alpha (excess returns on a risk adjusted basis) to investors and the vast majority of them simply deliver Beta (excess volatility). The strategy that we have always employed in the management of your precious capital is to "refuse to dance" when the music has played for too long. While it is our mandate and belief that we should remain fully invested, we will deploy funds only in a manner that reflects our very healthy respect for, and knowledge of, the risks inherent in today's stock market.

## For the Record

Our **preliminary return** for the Hahn Capital Management Mid-Cap Value Composite was 2.81% gross of fees in the second quarter of 2018. For the quarter, we outperformed our primary benchmark, the Russell Mid-Cap Value Index, by 0.40 percentage points. For the quarter, our outperformance was primarily due to our exposure to the Real Estate, Information Technology, Energy and Industrials sectors, partially offset by negative contributions from our exposure to the Financials and Consumer Discretionary sectors. The most significant contributors in the quarter were Keysight Technologies (KEYS), Becton Dickinson (BD), and CBRE Group (CBG), while the most significant detractors were Mohawk Industries (MHK), Albemarle (ALB) and SEI Investments (SEI). Total portfolio turnover remained in line with our low historical average with only one new addition (Air Lease Corp. - AL). In addition, we added to our position in Genpact (G) and reduced our positions in Snap-On (SNA) and BankUnited (BKU).

## HCM PERFORMANCE HISTORY

| % Annualized Returns As of 06/30/2018 | 2Q 2018 | 1 Year | 3 Years | 5 Years | 7 Years | 10 Years | Since Inception 06-30-88 |
|---|---|---|---|---|---|---|---|
| HCM Gross of Fees | 2.81% | 14.07% | 8.17% | 10.10% | 11.58% | 10.71% | 14.23% |
| HCM Net of Fees | 2.56% | 12.97% | 7.11% | 9.03% | 10.50% | 9.63% | 13.13% |
| Russell Mid Cap Value Index | 2.41% | 7.60% | 8.80% | 11.27% | 11.70% | 10.06% | 11.64% |
| Russell Mid Cap Index | 2.82% | 12.33% | 9.58% | 12.22% | 11.89% | 10.23% | 11.56% |

Link to: HCM Performance Disclosures

## PORTFOLIO ACTIVITY

### Positions Added

**Air Lease Corp (AL) –** We initiated a position in Air Lease during the quarter. Air Lease is a leading global lessor of commercial aircraft. It was founded and is run by the "godfather" of the aviation leasing industry, Steven Udvar-Hazy, who successfully managed and sold his prior company, International Lease Finance, to AIG in 1992. Air Lease has an industry leading return on equity, a differentiated strategy in the aircraft leasing industry and the potential to more than double its current run rate of revenues and earnings over the next several years. We were successful in acquiring our initial position at a significant discount to underlying intrinsic value and expect this value to expand at well-above-market returns for the foreseeable future.

### Positions Increased

**Genpact Limited (G) –** We added to our position in Genpact during the quarter as the company continued to gain traction in the business process outsourcing industry. In an era of lower growth, Genpact provides its customers with a unique value proposition, allowing them to re-engineer internal processes that allow them to continue to find ways to cut costs and drive improvement in their underlying profitability.

Our research indicates that Genpact continues to be successful in acquiring new customers, increase the size of engagements for existing customers and enter new areas of business, which have all resulted in above industry growth. We expect accelerating growth for Genpact in 2019 and beyond due to this unique value proposition for its customers.

### Positions Reduced

**BankUnited, Inc. (BKU) –**We continued to reduce our position in BankUnited as near-term growth has exceeded expectations but the prospects for longer-term growth have become a bit too murky for our taste.

BankUnited has executed pretty admirably for us since our initial purchases, and while we had higher expectations for its long-term growth outlook, we are also happy to accept the change in our circumstances for what they are and sell at a very respectable profit. BankUnited has undergone a change in management with long-time CEO and Chairman John Kanas leaving the board and with current management being much less inspiring relative to the dynamic leadership of Mr. Kanas. Despite enhanced growth in 2018, we believe that there are better opportunities available elsewhere in our portfolio.

**Snap-On, Inc. (SNA) –** We continued to reduce our position in Snap-On during the quarter as nagging concerns over anemic growth rates in the core automotive tools business continue to weigh on our opinion of the prospects for Snap-On to achieve above-market growth rates. In addition, we have become incrementally uncomfortable with the company's accounting policies as it relates to its large credit portfolio which we believe may have pulled forward growth to an unhealthy extent in relation to true underlying demand for its products. We have retained a small position in Snap-On in the portfolio as near term results have been more positive but are likely to exit the remainder of this position in the near future.

**Positions Sold**

**There were no positions exited during the 2nd quarter.**

**The Market**

International trade has burst front and center as a growing concern for the U.S. and global economies and financial markets. Until recently, this issue was considered a trade "war of words," but now there is increasing sentiment that it is escalating into a true trade war. International trade has become increasingly important throughout the world, including the U.S. Total U.S. trade, which is the combination of exports and imports, represents about 27% of total domestic economic activity as of the 2nd quarter of 2018. Assessing the probability that we are moving from a trade "war of words" to a true trade war is challenging given the political and economic policy variables that are at play. The hope is that the heightened rhetoric and initial posturing on tariffs are little more than negotiating tactics and that cooler heads will ultimately prevail. However, investors should never rely on hope in making investment decisions. As such, monitoring the trade situation is currently very important, warranting significant attention and caution.

We continue to expect stock market volatility to normalize (at a level higher than we have seen over the past few years) as the tailwinds of economic growth driven by tax reform, rising incomes and employment meet the headwinds of higher interest rates (both short- and long-term) as well as potential trade tariffs. Starting in July, public companies will begin releasing quarterly results. We expect that investors will begin to look to 2019 earnings growth as we move across the third quarter.

As it stands, the market should reflect a lower level of earnings growth in 2019 after the tax reformed-boosted level of growth this year. We consider ourselves "risk managers" first and foremost, and remain intensely focused on where risk may be rising in our portfolio, taking proactive actions to rebalance our risk-return portfolio structure where necessary. Our proprietary Risk Matrix Model has been very effective in identifying both sectors and stocks that present new or different risks early enough, to allow us to make adjustments before these risks affect portfolio performance. While broad market measures of valuation seem full, if not slightly overheated, we also recognize that in almost every market environment there are opportunities to make money; assets that are mispriced relative to their long-term prospects, thematic opportunities for those with vision and the experience to exploit them without taking unnecessary risk.

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