Teton Advisors

KEELEY
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# Small-Mid Cap Value

Fourth Quarter 2021 Commentary

Past performance does not guarantee future results. The performance data quoted represents past performance and current returns may be lower or higher. The investment return and principal will fluctuate so that an investor's portfolio, when liquidated, may be worth less than the original cost/balance. As with any investment, there is a potential risk of loss. Smaller and medium-sized company stocks are more volatile and less liquid than larger, more established company securities.

## Performance

For the quarter ended December 31, 2021, the Small-Mid Cap Value Strategy increased 5.82% gross (5.54% net of fees) compared with a 6.36% increase for the Russell 2500 Value Index. For all of 2021, the Strategy gained 27.37% gross (26.27% net) versus to a 27.78% increase for the benchmark.

## Macroeconomic Review

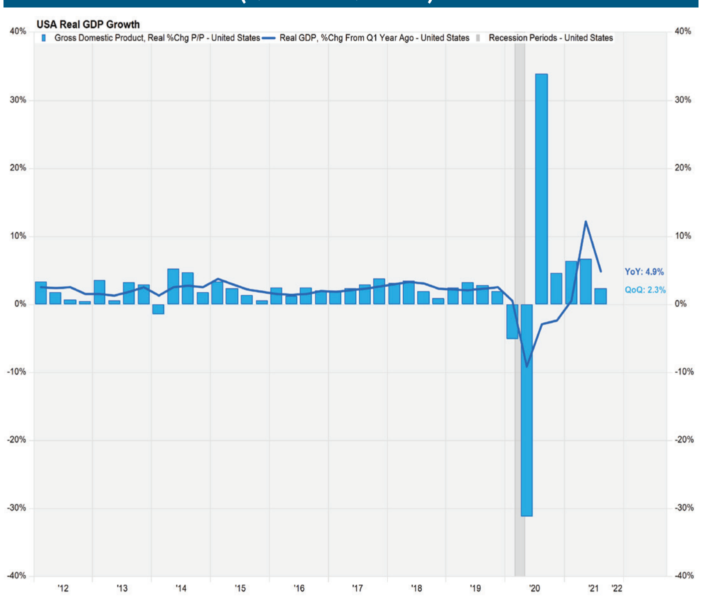
Stock markets around the world experienced strong gains. Among more than 40 major and minor stock markets around the world, we find only five posting a decline. In the US, all the major indices advanced. Large-cap, midcap, and small-cap stocks all rose. Value stocks gained, as did growth stocks. All eleven economic sectors rose at a double-digit pace with Energy leading the pack and Communications Services trailing.

**Market Performance**

| **As of December 31, 2021** | 3 Months | 1-Year | 3-Year |
|---|---|---|---|
| S&P 500 Index | 11.0% | 28.7% | 26.1% |
| Russell 3000 Value Index | 7.5% | 25.4% | 17.6% |
| Russell 3000 Index | 9.3% | 25.7% | 25.8% |
| Russell 2500 Value Index | 6.4% | 27.8% | 18.3% |
| Russell Midcap Value Index | 8.5% | 28.3% | 19.6% |
| Russell 2000 Index | 2.1% | 14.8% | 20.0% |
| Russell 2000 Value Index | 4.4% | 28.3% | 18.0% |
| Bloomberg Barclays Agg. Bond Index | 0.0% | -1.5% | 4.8% |

Source: eVestment.

**USA Real GDP Growth (Q1 2012 - Q3 2021)**




Source: U.S. Bureau of Economic Analysis, Factset. Grey represents recession periods.

The strong rebound in the economy on waning concern about the COVID pandemic and the Federal stimulus continued to drive a snapback in corporate earnings. Earnings for the S&P 500 look like they will increase 55% in 2021 from the 2020's depressed level. This is a full 32% more than what was expected at the beginning of the year. As a result, we actually saw P/E multiples contract despite the strong share-price gains.

The most interesting trend in the US market was the relative performance difference between growth and value across the market cap spectrum. When you look at performance by market cap, you see that large-cap stocks (Russell Top 200) gained 28%, far outpacing the 23% increase in midcaps (Russell MidCap) and the 15% lift in small caps (Russell 2000). By style, the Russell 3000, as well as its growth and value sub-indices all rose 25%-26%. This looks more interesting if you look a little deeper. Indeed, in the Russell Midcap and Russell 2000, value dramatically outperformed growth: 28% vs 13% in midcaps and 28% vs. 3% for small caps. In large caps, however, growth outperformed value, 31% vs. 23%.

Our takeaway from this is that the value rotation that started in the fourth quarter of 2020 seems to be continuing – for most stocks. Focusing on small- and mid-caps, we still find the absolute valuations average and the relative valuations compelling. At year-end, the forward P/E multiple on the Russell 2000 Value Index was 15.9x, slightly below its average since 1999. Midcap value stocks are slightly above their long-term average at 15.7x, but not high in an absolute sense. Relative to their comparative growth indices, they trade at 37% for R2V/R2G and 46% for RMV/RMG compared to long-term averages of 59% and 70%. While value outperformed growth in the smaller market caps by a wide margin in 2021, it appears there is plenty of room left to run. Exactly how the market fares will likely depend on the outcomes to key developments surrounding COVID-19, inflation, interest rates, and valuation.

- COVID-19 – As we write this letter, the Omicron variant has created a surge in cases that has eclipsed prior peaks. Fortunately, this variant appears to be less serious and is infecting a population with higher vaccination rates and better treatments for those becoming ill. With more people becoming infected and more becoming vaccinated, hopefully we will approach the long-awaited herd immunity and life can return to whatever new normal emerges. The potential negative path is that a newer variant comes forth that is more serious. Our view is that the former is more likely than the latter.

- Inflation – Inflation has clearly not been as transient as the Fed had expected it to be earlier in 2021. The rate of change in prices has run at levels not seen in a long time. While we expect the price increases to slow as we anniversary some of 2021's increases, we think that inflation looks more widespread and stickier than some of the surges in prices in the past. Almost every commodity we look at is up double-digit percentages from a year ago and most were up strongly in 2020. Wages are rising at the fastest rate in a long time and the labor market looks undersupplied with job openings near records and quit rates at records. It seems likely that wages will have to rise further to close these gaps. This seems likely to drive both cost-push and demand-pull inflation.

- Interest Rates – Real rates are negative and more negative than they have been in a long time. Even if we assume (as we do) that inflation will slow, real rates are still probably negative. With the Fed signaling that it plans to continue to taper its bond buying and that it expects to begin to raise the Federal Funds rate, rates seem likely to rise. While we do not think that rates will increase a great deal, it is worth noting that they peaked at over 3% in 2018 when inflation and unemployment claims were lower than where they are today.

- Valuation – As we pointed out above, smaller cap stocks and particularly small cap value stocks look attractive relative to larger cap stocks and growth stocks. The stocks that drive the overall market, however, look expensive. The S&P 500 and Russell Top 200 indices trade at 21.1x and 21.9x next twelve months (NTM) earnings. The Russell Top 200 Growth Index trades at 30.0x NTM earnings. The positive is that these are all flat/down from a year ago despite strong stock performance. The negative is that these are all 1.5-1.7 standard deviations above their average since 1999. With 2022 unlikely to see as much strength in upward earnings estimates as we saw in 2021, multiple contraction could weigh on stock performance for these key benchmarks. Regardless of whether it does, we believe that smaller company stocks will outperform. To the extent that money moves out of these larger companies into smaller stocks, the performance of small and mid-caps could be very good. We saw a lot of press stories at the beginning of the year about Apple surpassing $3 trillion in market cap. The market cap of the entire Russell 2000 is only about $3.6 trillion. It would not take much reallocation between the one stock and the 2000 stocks to move those 2000 stocks!

## Portfolio Results

Weakness in a few Technology holdings largely accounts for the Strategy's underperformance relative to its benchmark during the fourth quarter. Looking a little more broadly, both the impact from Sector Allocation positioning and Stock Selection decisions detracted slightly. Within Sector Allocation, the biggest factor was the Strategy's underweighting in the surprisingly strong Real Estate sector. This was partly offset by an underweight in the weak Health Care sector. Stock Selection benefited performance in the Financials and Consumer Discretionary sectors while it detracted from performance in the Technology, Utilities, Real Estate, and Energy sectors.

- Stock Selection was particularly favorable in the Financials sector where the Strategy's biggest contributor, Amerant Bancorp (discussed further in the "Let's Talk Stocks" section of this report) accounted for much of the upside. The Strategy had a handful of other winners across the various subsectors of the financial industry such as Virtu Financial, Wintrust Financial, and Air Lease. It only had a couple stocks on the downside among its eighteen holdings.

- The Consumer Discretionary sector was a more mixed bag for the Strategy, but a strong gain in Tri Pointe Homes (discussed later) as well as solid appreciation in Wyndham Hotels and Bath & Body Works drove relative outperformance in the sector.

- Relative underperformance in the Information Technology sector more than accounted for the difference between the Strategy's performance and that of its benchmark, the Russell 2500 Value Index. Long-time holding Wex Inc. and recent spin Cognyte Software were the biggest laggards and are discussed later in this report. Aside from those two, the Strategy's holdings had some positives (Verint Systems, the former parent of Cognyte, and Black Knight) and negatives (recent spin N-able Inc. and Vontier Corp.).

- In a surprise to most, Utilities was the best performing sector within the Russell 2500 Value Index. While the Strategy's slight overweight helped a little, its holdings did not keep up with those of the Index. The Strategy did not have any "problem stocks", but it just did not have any of the big winners either. Given the small size of the sector, and the generally stable nature of the business which makes restructuring opportunities less common, quarters like this will happen.

- Real Estate was the third best performing sector in the Index (behind Utilities and Materials; not sure when you would ever group those three sectors together), but the Strategy's holdings did not keep pace. A decline in the shares of Sabra Health Care REIT was the biggest drag but lagging performance in a handful of other REITS also contributed to the shortfall.

- We saw very wide performance differences between stocks in the Energy sector this quarter. Within the Strategy's holdings, the exploration and production companies generally performed well, while stocks of the service companies declined. Indeed, producers Chesapeake Energy, Diamondback Energy, Oasis Petroleum, and Texas Pacific Land rose between 3% and 28% while ChampionX, Delek US, International Seaways, and TechnipFMC all declined by double-digit percentages. While the capital discipline that is helping the former is hurting the latter, all the service companies are relatively early in their restructuring programs, and we believe those will bear fruit.

During the quarter we added four new positions to the Strategy, eliminated six positions, and had one acquired for cash.

## Leading Contributors

**Amerant Bancorp (AMTB)** is a community bank with operations primarily in South Florida and Houston, Texas. It began life as a public company in 2018 when Venezuelan financial services conglomerate Mercantil Servicios Financieros (MSF), spun-off the business. While it struggled to grow since then and suffered from a high expense burden and high-cost deposits, new CEO Jerry Plush took over about a year ago and put forth a plan to lower expense and deposit costs and improve Amerant's growth profile. The pieces of this plan have been falling into place over the last several quarters and earnings have been improving. In the fourth quarter, the Strategy also benefitted when the company collapsed its dual-class share structure into one class immediately closing the discount at which the "B-shares" that the Strategy owned traded.

**Tri Pointe Homes (TPH)** is one of the nation's leading homebuilders. The company reported an excellent quarter beating consensus estimates as management continues to successfully navigate supply chain issues. This allowed Tri Pointe Homes to exceed expectations on homes delivered in the quarter. This was in stark contrast to peers who struggled with these same challenges. Housing fundamentals remain favorable supported by millennial household formations with that age cohort representing over 50% of Tri Pointe's backlog. Management anticipates solid demand across its geographies with the expectation of modest price increases as peak lumber inflation runs through the income statement over the next couple of quarters.

**Oasis Petroleum (OAS)** is an exploration and production company with operations focused on the Williston Basin and located primarily in North Dakota. During the quarter, Oasis executed a couple transactions to simplify its corporate structure and make its value more apparent. It sold its 70% stake in publicly traded Oasis Midstream Partners (OMP) for cash, debt reduction, and shares in Crestwood Equity Partners (CEQP) at a favorable price. It also closed a previously announced acreage acquisition that improves its land position in the Williston Basin. In addition, the third quarter surge in crude prices drove strong earnings which were reported during the fourth quarter. The earnings drove strong free cash flows which allowed Oasis to increase its regular dividend by 33% and spend a little on share repurchases, which was a little bit of a positive surprise. Looking at these results, it is hard to believe Oasis is only a little more than a year removed from bankruptcy.

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## Leading Detractors

**WEX Inc. (WEX)** is a leading transaction processing company which focuses on serving the transportation, travel, and health care markets. Shares fell sharply after WEX reported third quarter earnings, even though the results were ahead of expectations and it raised its forward outlook. Concern arose among investors about pricing trends for its services as its revenue capture percentages fell in two of three of its businesses. We believe the changes were more the result of a shift in revenues to lower capture services because of strength in travel and higher fuel prices than actual pricing pressure, but it may take some time for other investors to agree with us. With the company being one of a limited number of technology companies to still offer upside from normalization of activity when COVID abates and the stock trading toward the low-end of its historical valuation ranges, we think the sell-off was overdone.

**International Seaways (INSW)** is a shipping company focused on crude and petroleum product tankers worldwide. International Seaways continues to execute as best it can in a very difficult environment. Spot shipping rates for crude oil remain under pressure, which continues to weigh on reported results. However, the recent improvement in global oil demand coupled with declining inventories provides a favorable environment for an improvement in spot rates. In the quarter, International Seaways completed the all-stock merger with Diamond S Shipping expanding its fleet size, enhancing liquidity, and providing cost-saving opportunities. The company continues to trade at a discount to net asset value, which should narrow as global oil supply and demand recover.

**Cognyte Software (CGNT)** develops and sells software used to manage data associated with physical and cyber security threats. Shares fell late in the quarter despite reporting October quarter results that exceeded guidance and consensus estimates. Cognyte lowered forward expectations due to expected delays in implementing its software at customers because of the recent uptick in COVID cases. With its growth trailing peers, the recent and expected slowdown in sales makes its intermediate-term targets look more difficult to achieve. While the stock looks cheap even on the reduced expectations, investors seem to be concerned about potential disappointments to come.

## Outlook

Overall, the factors likely to influence the market in 2022 are not that different than those that impacted stock prices in 2021. Some are a little more favorable (COVID, valuation), some less favorable (interest rates), and some wildcards or mixed (geopolitics, inflation). Regardless of the outcome, our job is to find stocks where investors undervalue the future and buy those stocks before that changes.

In conclusion, thank you for your investment in the Small-Mid Cap Value Strategy. We will continue to work hard to justify your confidence and trust.

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## Fourth Quarter Contributors and Detractors

| Fourth Quarter Contributors | | |
|---|---|---|
| **Top Contributors** | Total Return (%) | Contribution to Return (%) |
| Amerant Bancorp Inc. Class A | 11.14 | 1.75 |
| Tri Pointe Homes, Inc. | 32.68 | 0.41 |
| Oasis Petroleum Inc | 27.20 | 0.36 |
| Fortune Brands Home & Security, Inc. | 19.84 | 0.32 |
| nVent Electric plc | 18.17 | 0.29 |

| Fourth Quarter Detractors | | |
|---|---|---|
| **Largest Detractors** | Total Return (%) | Contribution to Return (%) |
| WEX Inc. | -20.32 | -0.26 |
| Perrigo Co. Plc | -17.26 | -0.22 |
| International Seaways, Inc. | -19.13 | -0.21 |
| Cognyte Software Ltd. | -23.75 | -0.20 |
| TechnipFMC Plc | -21.38 | -0.19 |

Source: Factset

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*Past performance is no guarantee of future results. As with all investments, there is a risk of loss. Any performance and/or attribution information contained herein are based on a representative account of the specific strategy discussed.*

*Market Performance presented solely for informational purposes. The S&P 500 Index is designed to act as a barometer for the overall U.S. stock market and consists of 500 stocks that are chosen on the basis of market size, liquidity, and industry grouping. The S&P 500 is a market value weighted index with each stock's weight in the index proportionate to its market value.*

*The Russell 2000® Value Index is an unmanaged index that measures the performance of the small-cap value segment of the U.S. equity universe and includes those Russell 2000 companies with lower price-to-book ratios and lower forecasted growth values.*

*The Russell 2000® Index is an unmanaged index that measures the performance of the smallest 2,000 companies by market capitalization of the Russell 3000® Index.*

*The Russell 2500® Value Index is an unmanaged index that measures the performance of the small to mid-cap value segment of the U.S. equity universe and includes those Russell 2500 companies with lower price-to-book ratios and lower forecasted growth values.*

*The Russell 2500® Index is an unmanaged index that measures the performance of the 2500 smallest companies by market capitalization of the Russell 3000® Index.*

*The Russell Midcap® Value Index is an unmanaged index that measures the performance of the mid-cap value segment of the U.S. equity universe and includes those Russell Midcap companies with lower price-to-book ratios and lower forecasted growth values.*

*The Russell Midcap® Index is an unmanaged index that measures the performance of the 800 smallest companies by market capitalization of the Russell 1000® Index.*

*The Russell 1000® Index is an unmanaged index that measures the performance of the 1,000 largest companies by market capitalization of the Russell 3000® Index.*

*The Russell 3000® Value Index is an unmanaged index that measures the performance of the broad value segment of the U.S. equity universe and includes those Russell 3000 companies with lower price-to-book ratios and lower forecasted growth values.*

*The Russell 3000® Index is an unmanaged index that measures the performance of the 3,000 largest U.S. companies by market capitalization.*

*The Barclays U.S. Aggregate Bond Index is a broad-based benchmark that measures the investment grade, U.S. dollar-denominated, fixed-rate taxable bond market, including Treasuries, government-related and corporate securities, MBS (agency fixed-rate and hybrid ARM passthroughs), ABS, and CMBS.*

*A direct investment into any of these indices is not possible.*

*The opinions expressed in this document are those of Keeley Teton Advisors, LLC as of the date indicated and are subject to change without notice and are not intended as recommendations of individual securities.*

*The net performance numbers shown are for informational purposes only. Management fees are negotiable and a table of standard fees is contained in the Firm's Form ADV Part 2A, which is available at no cost at www.keeleyteton.com.*

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