Chartwell Strategies Current Outlook and Investment Strategy

"Everyone wants to live at the expense of the state. They forget that the state wants to live at the expense of everyone." -Fredric Bastiat

Background

During the first quarter of 2021, the equity markets experienced a continuation of the bull market that began at the end of March 2020. The advance was broad, encompassing all major indices, however, stocks with small-capitalizations outperformed those with large-capitalizations and small-cap value outperformed small-cap growth. More specifically, the Russell 2000 Value Index rose 21.7 percent versus a gain of 12.70 percent for the Russell 2000, which contains both growth and value stocks. The Dow Jones Industrial Average, Standard & Poor's 500 and NASDAQ recorded total returns of 8.29 percent, 6.17 percent and 3.27 percent, respectively.

The now spectacular rebound from last year's frightening drop in stock prices has surprised most investors. Certainly, concerns about the COVID-19 virus remain and certain changes in the federal government's domestic policies do not appear to be friendly to either corporations, or investors. As a result, many investors are reported to be on the "sidelines" waiting for a major collapse in stock prices. Simultaneously, the skyrocketing prices for cryptocurrencies, unusually strong demand for residential housing and escalating prices of collectibles, such as baseball cards, add to fears that a speculative bubble is in the making.

There is no question that stocks and other asset classes are responding to conditions that have never been experienced in this country. The federal government's response to the pandemic has been massive in terms of cost. In just one-year, the federal deficit has risen by ten trillion dollars and at the end of March, had reached twenty-eight trillion dollars. That is the stated amount and it is now much larger than the country's Gross Domestic Product (GDP) of $20.9 trillion in 2020. This is the first time since the end of WWII that the total federal debt was larger than the annual GDP. If we add the unfunded Medicare benefits of $55 trillion dollars and another $41 trillion for unfunded social security benefits, the Nation's total debt reaches $124 trillion. According to the Chicago-based nonprofit, Truth in Accounting (TIA), this amounts to a debt of $796,000 per taxpayer. Moreover, a new multi-trillion dollar "infrastructure" bill is being introduced by Congress which will purportedly be paid for by higher taxes. Yikes!

Indeed, we know from both past and recent history that higher taxes reduce the economy's growth rate and can result in economic stagnation. However, the behavior of the stock market appears to be forecasting a period of growth for corporate earnings, accompanied by inflation. Perhaps the stock market is saying that the proposed tax hikes will not get through Congress.

Summary

- *In the first quarter of 2021, stock prices rebounded as the economy continued to recover from the pandemic induced recession.*
- *Chartwell managed accounts participated strongly in the rebound with all three strategies scoring double-digit total returns.*
- *While near term strength in the stock market is probable, the intermediate future may depend upon the ability of the Biden Administration to achieve its legislative goals. Unprecedented proposed fiscal outlays, coupled with rising corporate and investor tax burdens, could present a serious challenge to the economy and further gains in the equity markets.*
- *While the FRB contends that low interest rates and inflation will remain supportive of the expansion, investors must remain wary of higher commodity prices and other nascent signs of inflation.*

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Figures 1, 2, and 3 illustrate the prices of lumber, copper, and corn, respectively, as a few examples of the recent inflation in basic commodity prices. Lumber prices have risen to about four times their average price over the past five years and are now selling at all-time highs. Without a doubt, housing prices are headed higher, or the average size of a new home will become smaller. The twenty-year chart for copper prices reveals that it is now trading as high as it did prior to the Great Recession. Copper, which is fundamental to almost all electrical devices, can have a significant price impact on the production of everything from automobiles, housing, machinery and semiconductors. As the world recovers from the pandemic, prices of corn (see Figure 3), soybeans and wheat are rising sharply. Secondary effects of the inflation in agricultural products have been higher farmland and fertilizer prices. Nevertheless, Jerome Powell, Chairman of the Federal Reserve Board (FRB) remains confident that the FRB can keep interest rates low and inflation subdued.

LUMBER PRICES HAVE SOARED IN THE PAST YEAR 2016-2021

Figure 1. Price of Random Length Lumber Futures, 2016 - 2021. Price per 1000 board feet.
Source: Bloomberg

COPPER PRICES ARE NOW REACHING HIGHS LAST SEEN IN 2008 AND 2011. 2001-2021

Figure 2. Copper Futures Prices per 100 lbs. for Past Twenty Years.
Source: Bloomberg

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**The white lines in the chart represent the high, low and closing figures in the legend, and the color lines represent the moving average prices.*

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AS THE PANDEMIC HAS EASED, GRAIN PRICES HAVE RISEN DRAMATICALLY 04/28/2020-04/28/2021

Figure 3. Corn Futures Prices, $ per 100 bushels, No. 2 Yellow
Source: Bloomberg

**The white lines in the chart represent the high, low and closing figures in the legend, and the color lines represent the moving average prices.*

There is other evidence that inflation is becoming a problem. The real estate industry reports that 40 percent of existing home sales are settling at a premium to the sellers' initial asking price and the supply of new homes continues to lag demand. After their disastrous experience of the 2007 – 2009 period, homebuilders are likely to remain cautious in expanding supply.

Anecdotally, many small businessmen are finding it difficult to hire new employees at market wages. The disruptions in daily family life routines, coupled with a higher savings rate and government stimulus checks have apparently removed people from the work force, at least on a temporary basis. The speculation in cryptocurrencies (mentioned above), proliferation of Special Acquisition Companies (SPACs) and the expanding interest in non-fungible tokens (NFTs) are examples that fiat (government-issued currency not backed by a physical commodity) money is looking for a place to become invested.

The extent and duration of the present economic expansion, bull market, asset bubble, or whatever we are currently experiencing, will only be defined with certitude, retrospectively. The ability of the Biden Administration to pass their historically liberal agenda through Congress, the perceived outcome of the 2022 elections and the severity of the distractions raised by China and Russia are likely to be the ingredients that will determine the fate of the stock market over the intermediate term. In the near-term, interest rate levels continue to be supportive of the economic expansion as the Nation recovers from the COVID-19 setback.

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Current Strategy

Buoyed by the trajectory of economic re-openings and vaccine distribution, the momentum in smaller and value-oriented stocks continued in the first quarter, as discussed above. The Chartwell Growth Composite gained 17.3%, compared to +21.2% for our primary benchmark, the Russell 2000 Value (R2V), and +13.1% for the Russell Midcap Value Index (because we are not as small as the R2V, landing in between the return of these two indices is usually a reasonable expectation). The Chartwell Balanced Composite rose 11.7%, as compared to +11.5% for its blended benchmark. Finally, our Dividend Equity accounts gained 12.3%, ahead of the benchmark Russell 1000 Value's +11.3%

The three best performers in the Growth and Balanced accounts were: Synovus Financial (SNV, 1.9%)*, up 42.3%, Valley National Bancorp (VLY, 1.4%), up 42.0%, and United Rentals (URI, 1.3%), up 42.0%. It's not surprising that the top two gainers are banks; the group was boosted by rising rates, an improving economy and solid earnings results (the 10-yr Treasury yield went from 0.92% at year-end to 1.74% on 3/31/21). URI's business of equipment rental is also a beneficiary of economic recovery and should continue to do well if the infrastructure stimulus comes to fruition. The three worst performers in the Growth and Balanced accounts were: Vonage Holdings (VG, 1.5%), down 8.2%, FMC Corp. (1.8%), down 3.3%, and Landec Corp. (0.8%), down 2.3%. Vonage sold off as analysts were disappointed that they decided to keep their consumer business, but it partially recovered after a well-received analyst day. FMC had an uncharacteristic earnings disappointment; the agriculture-chemical company is seeing some challenges in Latin America and Europe; we took advantage of the weakness and added to our position. Landec was only down slightly in the quarter; they are still experiencing some Covid-related issues in their food business. We remain positive on the underlying asset values of the company.

In our Dividend Equity accounts, the three best-performing stocks were: Pioneer Natural Resources (PXD, 1.7%), up 39.9%, Foot Locker (FL, 2.7%), up 39.5%, and General Motors (GM, 3.0%), up 38.0%. During the quarter, Pioneer rode the wave of very strong returns in the energy sector as West Texas Intermediate crude prices went from $43 to $61 per barrel. Foot Locker saw sales pick-up as a consequence of government stimulus programs. GM is benefiting not only from a healthy auto-sales environment but also from a "halo-effect" coming from their continued investment in EV's (electric vehicles). The three worst-performing stocks in the Dividend Equity accounts were: Merck (MRK, 3.1%), down 4.9%, Arthur J. Gallagher (AJG, 2.2%), up 1.3%, and United Parcel Service (UPS, 2.6%), up 1.6%. When 2 of your 3 worst-performing stocks were up, you know it was a pretty good quarter. Insurance broker Gallagher and UPS were merely left behind in the rally, along with many other defensive stocks. Merck suffered the same fate, but they also underperformed the pharmaceutical group, despite ongoing success with their flagship cancer drug, Keytruda.

In the Chartwell Growth Composite, we had a few new purchases. Crown Holdings (CCK, 1.1%) is a packaging company that benefited from positive trends in aluminum cans. The growth of craft beers, spiked seltzer and other conventional beverages has added to volumes and margins, and with current tight supplies, Crown has pricing power. Earnings growth of 11-16% is expected over the next 3 years, and the stock is reasonably valued at 15.4x '21 estimates. Valvoline's (VVV, 1.3%) consumer oil business potentially will see demand increase as miles-driven increase this year. As the pandemic eases, we anticipate some margin improvement in the second half of the year is possible. Everest Re (RE, 1.2%) is a Bermuda-based reinsurance company. With one of the best markets for insurance pricing in two decades, RE has seen rate increases of 20%+, and renewal retentions remained strong across their entire portfolio. As mentioned above, we added to FMC on weakness and did the same with Vonage. Full sales from the portfolio were: ACCO Brands, Heidrick & Struggles, and Onto Innovation. We took advantage of ACCO's 100%+ return from last year's low to move out, seeing an ongoing difficult industry environment for them. A similar situation existed with Heidrick; the stock had doubled since just last September, and the trading pattern of the stock suggested that it was a good time to take profits. We reassessed our holdings in Technology during the quarter and concluded that we had similar exposures to ONTO's business in other stocks with stronger fundamentals, so we eliminated the position. Other partial sales of stocks -- on profit-taking or position-size adjustments --included: United Rentals (1.3%), Bloomin Brands (0.9%), Winnebago (1.1%), and Laboratory Corp. (1.9%).

**The numbers in parentheses following each company mentioned reflect the percentage of the portfolio's net assets comprised of such securities as of 03/31/2021. Holdings are subject to change. A full listing of portfolio holdings is available upon request.*

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We purchased several new positions in the Dividend Equity accounts. Crown Castle (CCI, 2.1%) is a cell-tower REIT. We have held this stock in other strategies at Chartwell for quite some time, so we know it well. It has the unusual combination of providing participation in a growth industry (the growth of data and 5G) but also sports a 3% yield. Citigroup (C, 2.0%) will likely see the tailwinds that many banks are expected to have in 2021 and beyond (rising rates, a strong economy, capital return) with the additional kicker of being a play on the global recovery. CVS (CVS, 2.0%) is a very inexpensive stock (less than 10 Price-to-Earnings Ratio) that has upside potential from its acquisition of Aetna Healthcare, one example being cross-sell opportunities into Aetna's client base. Additionally, CVS's key role in the vaccine roll-out in our view should boost store sales from traffic increases. Omnicom Group (OMC, 1.9%) is an advertising-agency holding company, trading at a low relative PE multiple and a 3.5% yield. As the economy gains momentum and consumer spending accelerates, companies could return to healthy levels of ad spending. Other partial-position sales came out of stocks that had experienced strong runs, were getting close to price targets, or had gotten to out-sized weights in the portfolio: Ally Financial (ALLY, 2.1%); Canadian Pacific Railway (CP, 3.4%); General Motors (GM, 3.0%); Methode Electronics (MEI, 1.8%); United Parcel Service (UPS, 2.6%).

Chartwell News

As we are hopefully coming to the end of the Pandemic, we hope everyone is doing well and maintaining an optimistic outlook. As reflected in the letter, the economy continues to recover, and near-term stock market gains appear probable. And with the start of warmer weather and more re-openings, we maintain our optimism. We wish everyone a safe and enjoyable summer! And as always, if you have any questions regarding your account performance, or want to discuss changes in your investment objective, please do not hesitate to call Mike Magee (610.407.4867), Bob Killen (610.420.8650), or Pete Schofield (610.407.4858). Thank you for your continued trust in Chartwell Investments.

*The Chartwell Growth Strategy Composite includes all fully discretionary, fee-paying equity accounts with a growth objective whose asset size is $300,000 or greater at the beginning of the measurement period. For individual

bond holdings the fee is 5/8 of 1% and for bond mutual funds, including exchange traded funds, the fee is 3/8 of 1%. The fee for these accounts is negotiable.

*The Chartwell Balanced Strategy Composite includes all fully discretionary, fee-paying accounts with a balance between growth and income as a principal objective whose asset size is $300,000 or greater at the beginning of the measurement period. For individual

bond holdings the fee is 5/8 of 1% and for bond mutual funds, including exchange traded funds, the fee is 3/8 of 1%. The fee for these accounts is negotiable.

The composites do not include accounts where total cash flows exceed 10% of the account's value during any quarterly period or accounts holding securities purchased by anyone other than the Advisor. No accounts using leverage or short positions are included in the composites. An individual client's account may have performed better or worse than the composites' returns presented above. The composites contain taxable and non-taxable accounts. The returns are before taxes and net of all advisory fees and commission charges. The net performance results for each composite are presented after deducting the actual fee charged to each account in the composite based on the management fee schedule in the Firm's Brochure or the fee negotiated between the account holder and Chartwell. Returns include the reinvestment of dividends and interest (total return). Returns for other Chartwell composites are available upon request.

As of 03/31/2021 Chartwell managed $11.2 billion in assets, $10 billion as advisor and $1.2 billion as sub-advisor. During the most recent quarter, the Chartwell Growth Strategy Composite consisted of 5 accounts which represented 7.3% of total Chartwell Strategy Individually Managed Accounts and 0.1% of total Chartwell assets. During the most recent quarter, the Chartwell Balanced Strategy Composite consisted of 22 accounts which represented 42.6% of total Chartwell Strategy Individually Managed Accounts and 0.5% of total Chartwell assets. The Chartwell Growth Dividend Strategy Composite consisted of 4 accounts which represent 2.1% of total Chartwell Strategy Individually Managed Accounts and less than 0.0% of total Chartwell assets.

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