

Quality Matters Again

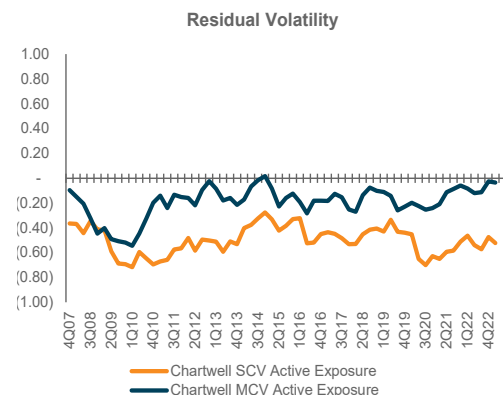
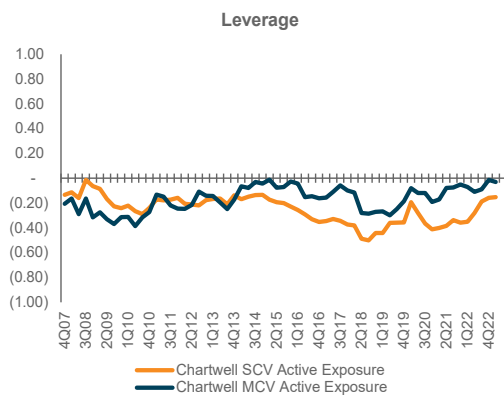
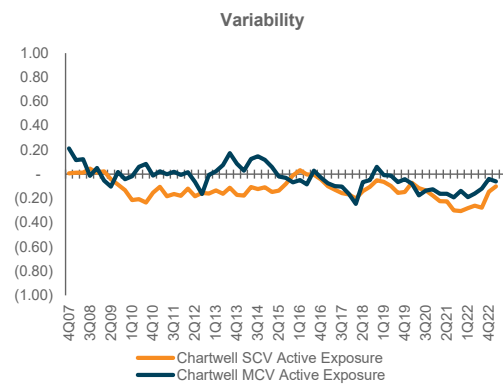
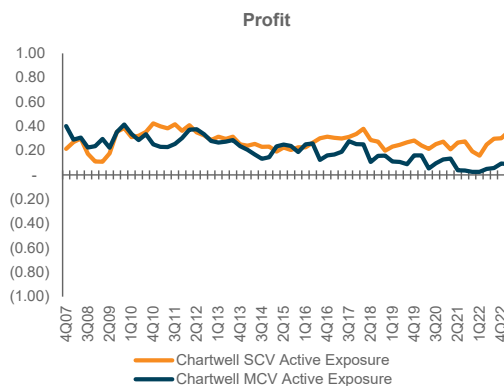
David C. Dalrymple, CFA, Senior Portfolio Manager
 T. Ryan Harkins, CFA, Senior Portfolio Manager

June 2023

A tilt to higher quality has been a successful approach to small and mid cap value investing, both prior to and since the pandemic-era risk bubble that formed in 2020-2021 in response to monetary and fiscal stimulus.

To outperform in the small and mid-cap value segments of the equity market, in our view, investment managers have to differentiate companies that are undervalued from those that are merely cheap - while avoiding the proverbial value trap*. At Chartwell, we employ a collaborative research process to help us make informed judgments about the business quality and financial strength of each company we consider for investment. Specifically, we look for single points of failure that can impair earning power and cause permanent loss of capital. Examples include technological obsolescence, customer concentration, government regulation, and excessive financial leverage. Our aversion to companies with these types of risks has resulted in portfolios with higher quality characteristics than relative benchmarks.

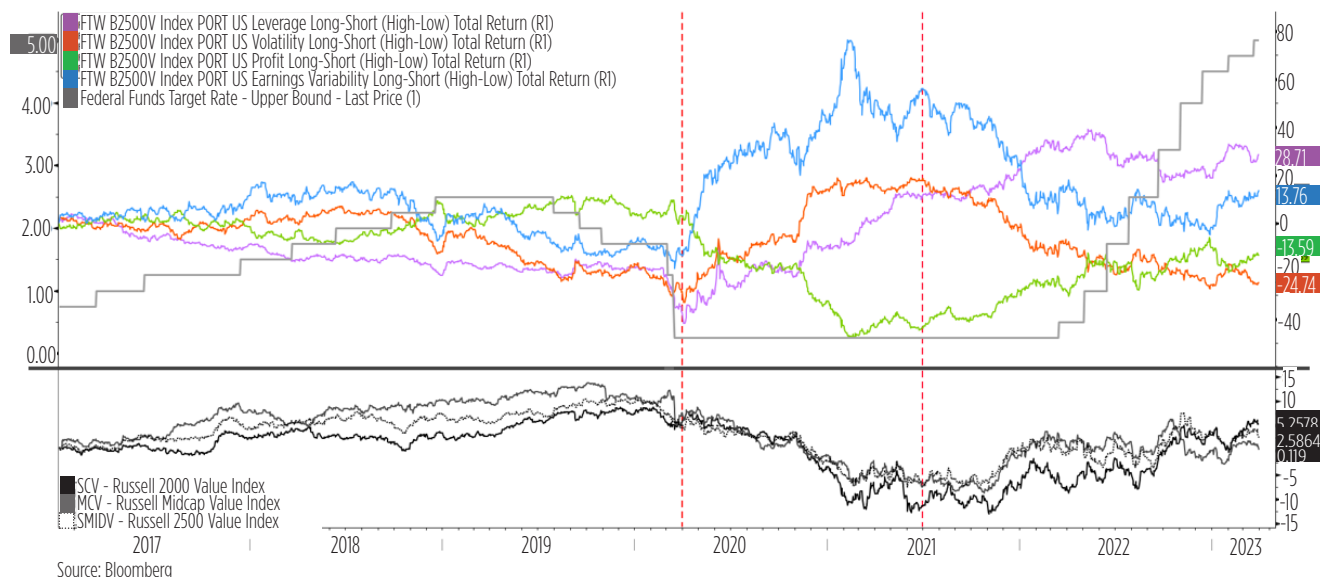
The charts below show that our value equity strategies have had consistently higher active exposure to high quality factors (e.g. profit) and consistently lower active exposure to low quality factors (e.g. variability, leverage, and volatility).



Source: Bloomberg MAC3 Risk Model

This quality tilt has been an advantage in most market environments, particularly during times of economic uncertainty. Surprisingly, our disciplined focus on business quality and financial strength proved to be a significant disadvantage during the COVID-19 pandemic. Each of our strategies underperformed for five consecutive quarters in 2020-2021, marring otherwise strong track records. Their underperformance began in March 2020 when the Federal Reserve (the Fed) lowered interest rates to zero and announced emergency liquidity measures. Those actions, along with multi-trillion dollar fiscal stimulus packages, fueled an unprecedented speculative rally in low quality stocks and other risky assets (e.g. cryptocurrencies*, NFTs*, etc).

The following chart illustrates the divergence of low- and high-quality investment factors that began in March 2020, along with the corresponding underperformance of our value equity strategies relative to their benchmarks.



The euphoria persisted until the second half of 2021 when it became clear that the Fed would need to tighten financial conditions in response to surging goods and services inflation, another pernicious effect of pandemic monetary and fiscal policies. The chart above illustrates the dampening effect that tightening financial conditions has had on risk appetites, with low quality factors underperforming high quality factors since a change in monetary policy was first telegraphed. It also shows a positive impact on relative performance for each of our strategies.

After a series of rate hikes, inflation has decelerated but remains well above the Fed's target rate of 2%. There is much debate about the appropriate path forward, but, absent another global health crisis that shuts down our economy, we can't imagine that policymakers will seek to recreate the conditions that inflated the pandemic bubble in risky assets. Furthermore, the bursting of that bubble has reoriented investors and reminded them that quality matters, particularly when investing in undervalued small and mid-cap companies. We welcome this return to normalcy and are encouraged to see relative performance begin to recover for our strategies. Our clients' trust and patience during this extraordinary period has been greatly appreciated, and we believe our disciplined approach to value investing will serve them well in the coming years.

*Definitions

Bloomberg 2500 Value Index: a total return index that provides exposure to companies with superior value factor scores based on earnings yield, valuation, dividend yield, and growth.

Cryptocurrency: a digital or virtual currency secured by cryptography and based on a network that is distributed across a large number of computers.

Federal Funds Target Rate: a key interest rate used by the Federal Reserve to guide monetary policy toward desired economic outcomes.

Leverage: a factor measuring total debt relative to assets, book value, and market capitalization.

Non-Fungible Token (NFT): a cryptographic asset on a blockchain with unique identification codes and metadata that distinguish them from each other.

Profit: a factor measuring return on assets, return on equity, and net income margin.

Residual Volatility: a factor estimated by regressing excess stock returns against the excess return of the cap-weighted market portfolio.

Russell 2000 Value Index: an unmanaged index that measures the performance of those Russell 2000 companies with lower price-to-book ratios and lower forecasted growth values.

Russell 2500 Value Index: an unmanaged index that measures the performance of those Russell 2500 companies with lower price/book ratios and lower forecasted growth values.

Russell Midcap Value Index: an unmanaged index that measures the performance of those Russell Midcap companies with lower price/book ratios and lower forecasted growth values.

Value Trap: a company with low valuation metrics that experiences permanent impairment of earning power and is revealed to be overvalued.

Variability: a factor measuring variability in net income, sales, and cash flow.

Index or benchmark performance presented in this document is past performance which does not guarantee future results, does not reflect the deduction of advisory fees, transaction charges, or other expenses, which would reduce performance. Indexes are unmanaged. It is not possible to invest directly in an index. Any investor who attempts to mimic the performance of an index would incur fees and expenses that would reduce return.

This paper is for informational purposes only. It is educational in nature and not designed to be taken as advice or a recommendation for any specific investment product, strategy, nor is it a commitment from Chartwell or any of its affiliates to participate in any of the transactions mentioned herein, nor provide sufficient information to support an investment decision. Any forecasts, figures, opinions, or investment techniques and strategies set out are for information purposes only, based on certain assumptions and current market conditions, and are subject to change without prior notice.

London Stock Exchange Group plc and its group undertakings (collectively, the "LSE Group"). ©LSE Group 2023. FTSE Russell is a trading name of certain of the LSE Group companies. Russell® is a trademark of the relevant LSE Group companies and is used by any other LSE Group company under license. All rights in the FTSE Russell indexes or data vest in the relevant LSE Group company which owns the index or the data. Neither LSE Group nor its licensors accept any liability for any errors or omissions in the indexes or data and no party may rely on any indexes or data contained in this communication. No further distribution of data from the LSE Group is permitted without the relevant LSE Group company's express written consent. The LSE Group does not promote, sponsor or endorse the content of this communication.

To receive a complete list and description of Chartwell Investment Partners' composites, performance attribution for all securities, and/or a presentation that adheres to the GIPS® standards, please contact Chartwell at (610) 296-1400 or info@chartwellip.com.