SMALL CAP EQUITY
COMMENTARY

The strategy was able to outperform the Russell 2000 Index in Q4 (31.8% gross of fees as compared to 31.4%) led by strong security selection in Financials, Information Technology, and Utilities while Health Care, Materials, and Real Estate were drags on performance. In the Morningstar Small Blend category, the strategy ranked in the 17th percentile for the time period. The three stocks that contributed most to total return during the quarter were Western Alliance Bancorp (WAL), II-VI Inc. (IIVI) and NCR Corp. (NCR) while the three biggest drags on performance were Atlas Air Worldwide Holdings, Inc. (AAWW), Luminex Corp. (LMNX), and TRI Pointe Group, Inc. (TPH).

The fourth quarter of 2020 saw a speculative fever return to financial markets as investors sought to profit with the major US equity indices marching to new all-time highs. Caution surrounding the US Presidential election was thrown to the wayside as investors embraced a Biden presidency and an “everything rally” ensued. Expectations for further economic stimulus and accommodative monetary policies allowed for a bullish narrative to be crafted for investments ranging from Bitcoin to large capitalization growth stocks and even to small capitalization value stocks. In other words, the overwhelming liquidity created by government policy eventually found its way into risk assets of all sorts and the individual investors who opened a record 10 million new trading accounts throughout the year added fuel to the fire. For the quarter, small capitalization indexes outperformed their large capitalization peers and value oriented indexes marginally out performed growth.

In 2020, small cap Value lagged small cap Growth (+4.6% vs 34.6%), the largest relative underperformance since the 1999 Dot Com bubble, and the second largest differential in the history of the Russell 2000 index dating back to December 31, 1978. This result led to small cap Growth outperforming small cap Value by the widest margin ever on a 10-year annualized return basis, as seen in the chart below.

Small Cap Value and Growth Stocks - Relative 120-Month Total Returns (Annualized)
December 31, 1978 through December 31, 2020

Source: FactSet

All information is as of 12/31/2020.

Surprisingly, much of the outsized return from growth oriented stocks was due to their relative resilience during the first quarter's COVID-19 related sell off. Investors typically prefer to own undervalued companies with superior profitability metrics in times of uncertainty, but that was not the case in 2020. With a Q2 US GDP contraction of -31% due to the COVID shutdown, investors chose to reward companies that were perceived to have growth capabilities outside of traditional economic factors. Once policy makers recognized that unconventional actions would be necessary, they enacted programs that saw the Federal Reserve expand its balance sheet by 75% to $7T, money growth (as measured by M2) expand by 25%, and deficit spending near 18% of GDP (the highest level since WWII), investment returns began to broaden.

There is no clearer evidence of the dramatic swing in investor emotions than the experience of our own portfolio. Given our philosophical preference for relatively undervalued and higher quality companies with positive earnings, the investment regime of late has been challenging. At the March 23 market low, the portfolio was down ~45% on a year to date basis as many of our holdings faced indiscriminate selling pressure. From that date until year end, the portfolio rebounded by ~113%. The COVID-19 economic shutdown was something unprecedented, and so too was the magnitude of the ensuing response from policy makers. There are sure to be many commentators who suggest that there was a logical course of action during this volatile period. That sort of advice won't be found in this piece. It was simply impossible to have positioned the portfolio for this truly unknowable event ahead of time. Two things that were abundantly clear in 2020 were the power of the Federal Reserve and the power of investment narrative in driving short term returns.

For the full year, the strategy returned 16.6% gross of fees as compared to the Russell 2000 Index return of 19.9%. In the Morningstar Small Blend category, the strategy ranked in the 31st percentile for the time period. Areas of strength were Industrials, Communications Services, and Information Technology while areas of weakness were Health Care, Consumer Staples, and Materials. The three stocks that contributed most to total return for the year were Atlas Air Worldwide Holdings, Inc. (AAWW), Penn National Gaming, Inc. (PENN), and II-VI Inc. (IIVI) while the three biggest drags on performance were Tivity Health, Inc. (TVTY), Pebblebrook Hotel Trust (PEB), and IBERIABANK Corp. (IBKC).

The strategy was able to outperform the Russell 2000 in three of the past four quarters, but the relative performance deficit incurred during the first quarter sell off proved to be difficult to overcome. Continued outperformance of negative earning companies as compared to the positive earning companies in which our strategy tends to invest was the major performance culprit, as can be seen in the chart below.

Glenmede Small Cap Equity- Positive vs Negative Earners - Year-to-date

	Small Cap Equity			Russell 2000			Attribution Analysis		
	Average weight (%)	Total return (%)	Contribution to return (%)	Average weight (%)	Total return (%)	Contribution to return (%)	Allocation Effect (%)	Selection + Interaction (%)	Total Effect (%)
Positive Earners	92.0	14.2	13.9	69.9	12.2	4.2	-1.9	3.4	1.5
Negative Earners	8.0	45.5	2.3	30.1	41.6	15.7	-4.7	-0.6	-5.3
Total	**100.0**	**16.2**	**16.2**	**100.0**	**20.0**	**20.0**	**-6.6**	**2.8**	**-3.8**

Source: FactSet (Non-GAAP LTM P/E)
All information is as of 12/31/2020. The Russell 2000 Index is an unmanaged, market value weighted index, which measures performance of the 2,000 companies that are between the 1,000th and 3,000th largest in the market. One cannot invest directly in an index. Past performance is not indicative of future results.

The speculative fever that gripped financial markets in 2020 has also led to a record percentage of the Russell 2000 Index to be comprised of negative earning companies. As of yearend, a full 36% of the benchmark could be included in this group. These securities were concentrated in the Health Care sector, and in particular in the Biotech Industry, which now comprises 12% of the benchmark. It is of little surprise, therefore, that our strategy's lack of exposure to this group accounted for the majority of the strategy's underperformance for the year. In prior periods when investors have shunned companies with positive earnings in favor of more speculative issues, the dislocation has resolved itself with considerable downside mean reversion for the negative earners. We feel that this period will end in a similar manner and once again show that negative earner outperformance is a cyclical, not secular, phenomenon.

Portfolio Strategy

During the quarter, the portfolio established positions in four new holdings and sold out of three existing names. These transactions occurred in a variety of sectors and were driven by a host of company specific items. By way of example, a regional casino operator was sold due to significant share price appreciation and a market capitalization outside of the small capitalization range, while an online tax preparation and wealth management company was exited due to a deterioration in fundamentals and a degradation in its rank on our quantitative model.

In a similar manner, the new purchases were established across a number of sectors and were driven by attractive, stock specific opportunities. For example, a department store with attractive cash flows and restructuring opportunities was purchased in Consumer Discretionary and a life sciences tools company with strong recurring revenue and significant cash on the balance sheet was added in Health Care. With these transactions, portfolio turnover stands at 38% for the trailing one year.

From a portfolio positioning standpoint, the strategy maintains overweight positions in the Industrials and Information Technology sectors while taking underweight positions in Consumer Discretionary and Health Care. This positioning has been driven by the attractiveness of the individual stocks in each sector as opposed to a top down view. When analyzing business models in the consumer space, there is a concern that a sizeable portion of the stellar top line results that companies have reported is actually demand pull through from future quarters as opposed to a new normal. As a result, many companies have seen strong revenue growth and share price appreciation, but our concern is the sustainability as COVID uncertainties remain. For existing holdings that have similarly benefited, we have been looking to reduce exposure and find more attractive names.

Similarly, the underweight in Health Care has been driven by a dearth of attractive opportunities from a bottom up perspective. This sector, in particular, is the epicenter for the index's ever growing percentage of stocks with negative earnings. As of yearend, Biotechnology represents ~11.5% of the sector's 21% weight and these companies are virtually all chronic negative earners. A central tenet of our investment philosophy and process is that earnings matter over the long term, and therefore we have avoided this speculative area of investment.

Outlook

It is perhaps a fool's errand to offer an outlook for the coming months having just endured a year that showed the folly of forecasting. The nature of investing, however, requires that there is an overarching viewpoint that pulls together myriad data points into a cogent investment thesis. The continuing COVID related shut downs put an end to the last economic cycle and are hampering the beginning of the next cycle. Pent up demand, high savings rates, and continued government stimulus are likely to fuel the economy and profit growth in

2021. Commensurate with that, it appears that the $US should continue to slide and interest rates should continue to rise as signs of inflation continue to perk up. These expectations are not too far outside of Wall Street consensus which, of course, means that something else is likely to unfold.

An economic cycle has never before started anew due to government planning, but it seems that this is how our new economic cycle is set to begin. If this one develops in the way that other cycles have in the past, profit growth should be strongest in many of the areas of the market that were shunned by investors at the end of the prior cycle. Domestically, this means that smaller capitalization and cyclically oriented companies could see stronger earnings growth in 2021 as pent up demand and postponed capital expenditures lead to revenue growth. It is possible that equity markets discounted this future profit growth in the strong returns of the fourth quarter, but there should be more fuel for the earnings growth story in 2021 as the economy strengthens and business confidence improves.

It is also important to note that a straight line recovery is hardly the base case. There is still considerable risk from COVID and all of the societal implications that go along with it. Additionally, domestic political risks remain high and, of course, there is considerable geopolitical risk as foreign powers grapple with their own COVID difficulties and scramble for bigger seats on the global stage. It is likely that headline risk will remain high throughout 2021 as skittish investors navigate the year. The biggest wildcard, however, is likely to be policy actions from the Federal Reserve. Should fears of a taper tantrum take hold where investors believe that the Fed will tighten monetary policy prematurely, it is likely that a selloff in risk assets will ensue. At some stage policy makers will need to contend with the imbalances created by the extraordinary interventions of 2020, but investors would clearly prefer that to be at a date far into the future.

Mean reversion has long been a central tenet of financial markets, but the zero interest rate policy adopted by global central banks temporarily slowed this process. Existing trends simply carried on to ever greater extremes as the economic environment remained status quo. It is clear that the economic environment has shifted and it is likely that any of the winning investments in the prior regime may face challenges in 2021. To be fair, there are valid arguments to be made for the incredible resiliency seen in the large capitalization growth complex. That said, there is a high level of complacency on the part of investors in their continued allocations to NASDAQ related issues while shunning more economically sensitive small capitalization stocks. As a result, the bifurcation in valuation between growth and value has never been wider, and our strategy's valuation discount is at similar valuation extremes. The prospects for our portfolio remain bright as investors will undoubtedly realize that there is greater opportunity for profit in the neglected small cap universe than perhaps exists elsewhere. As a result, we feel that our portfolio of higher quality yet undervalued businesses will continue to outperform as company specific catalysts come to fruition.

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