MANAGER COMMENTARY

SMALL CAP

GREAT LAKES ADVISORS
A WINTRUST WEALTH MANAGEMENT COMPANY

SECOND QUARTER 2017

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Market Review

The Russell 2000 Small Cap Index gained 2.5% in the quarter ending June 30, extending its first quarter gain and now stands up 5.0% for the first half of 2017. Most major equity indices gained ground in the quarter and remain near all-time high levels.

Overall, the Trump Administration has found it difficult to implement its legislative agenda, leading some to question the likelihood of an acceleration of U.S. economic growth over its current modest pace of expansion. Despite much anticipation, clear signs of boosted economic activity have yet to appear.

Oil prices declined by about 9% in the quarter, leading to a 20% decline in the small cap Energy sector. The yield on 10-year U.S. Treasury Notes was 2.27%, 80 basis points higher year-over-year but 12 basis points lower than March 31. The U.S. dollar weakened almost 7% against the Euro.

The Great Lakes Advisors Small Cap portfolio gained 0.6% in the second quarter, trailing the Russell 2000 index by about 180 basis points. For the first half of 2017, our portfolio has gained 1.8%, which is about 320 basis points behind the benchmark return of 5.0%.

Second Quarter Attribution

Sector	GLA Weighting	GLA Return	R2000 Weighting	R2000 Return	Active Contribution
Financials	18.7%	-3.1%	23.0%	1.6%	-0.9%
Technology	21.9%	-1.4%	17.2%	3.9%	-1.0%
Health Care	5.3%	2.1%	13.3%	8.9%	-0.9%
Consumer Discretionary	19.6%	1.4%	12.7%	2.1%	-0.1%
Industrials	22.4%	0.4%	14.7%	2.8%	-0.4%
Utilities	0.0%	0.0%	3.8%	1.9%	0.0%
Materials	1.4%	31.4%	5.1%	-0.8%	0.5%
Real Estate	3.9%	12.5%	4.3%	1.9%	0.5%
Consumer Staples	0.0%	0.0%	2.6%	-4.1%	0.2%
Energy	0.0%	0.0%	2.4%	-20.6%	0.6%
Telecom	0.0%	0.0%	0.9%	12.5%	-0.1%
Cash	6.8%	0.2%	0.0%	0.0%	-0.2%
TOTAL	**100.0%**	**0.6%**	**100.0%**	**2.5%**	**-1.8%**

Underweight position relative to benchmark   Overweight position relative to benchmark

Source: GLA, FactSet

The small cap portfolio posted a small gain for the quarter, but lagged the Russell 2000 index by about 180 bps. Our largest positions in the Information Technology and Industrial sectors were both down double-digits in the quarter. Additionally, another stock was -32%, dinging our performance by 70bps. Moreover, the Health Care and Financial sectors underperformed by 90 bps each. Helping to offset some of this pain was solid contribution from some of our investments in financial companies and our zero exposure to the Energy sector, which as mentioned earlier was the worst performing sector in the quarter.

- Our Technology sector holdings were -1.4% versus the benchmark return of +3.9%, lagging the benchmark by 100bps. One of our largest positions declined 15% due to weaker than expected fiscal 2018 financial guidance. The company expects no earnings growth in FY 2018 due to a confluence of issues including customer losses, an implementation of a new ERP system in North America, and restructuring efforts. We believe many of these issues facing the company are temporary and fixable, and the long-term outlook for the company remains bright.

- The Industrial sector cost us 40 bps of relative performance. All of this drag was due to one company. The industrial distribution industry was weighed down by the company's announcement of a drastic re-pricing strategy to combat Amazon. The company's stock sold off 17% in sympathy. We believe this sell-off was overblown as the company has a differentiated business model. We took advantage of the price decline and added our position in the company.
- Staggered by declining mall traffic and growing concerns with Amazon's market share gains from brick-and-mortar retailers, one consumer company's stock was under severe pressure in the quarter. While there's plenty to be worried about in the Consumer sector, we continue to hold this company due to an attractive risk/reward profile, a strong franchise in action-sports apparel, and a proven owner-operator.
- We underperformed the Health Care sector by 90bps, partly because of our continual underweight in the sector due to valuation concerns. Once again, Biotechnology and small cap pharmaceutical stocks outperformed, up more than 10% in the quarter. Our underweight position (we have no exposure to either industry) drove a 55 bps drag on relative performance. Additionally, one company's weak financial result, which was largely due to macro-related issues, detracted from performance. The company declined 13% in the quarter. Despite these near-term concerns, our intrinsic value remained unchanged. We remain confidence in the management team, and the company's dominant position in the neo-natal market remains strong. We increased our position during the quarter.
- Small Cap banks outperformed and insurers underperformed the Financial index in the quarter, leading to our 90 basis point underperformance. We took the opportunity to add to exposure in two companies.
- On the positive side of the ledger, two companies outpaced the benchmark by 50bps each. One company's stock rallied after 1Q results and guidance for 2017 was better than feared. The other company's stock was up 32% in the quarter. The company did a secondary offering at the end of March at $1.12/share which we participated in along with insiders buying 30% of the newly issued shares. The insider purchases were a big boost of confidence. While the equity offering diluted value, it was the right move by management to improve the company's balance sheet.
- After a strong rebound last year, the Energy sector has been the worst performing sector so for this year. The sector was -20% for the quarter and -31% YTD. Higher inventory levels combined with overproduction have investors concerned. As a result, crude oil prices have fallen back to $46 a barrel. Avoiding this sector has added 60bps of relative performance for the quarter. Generally, we tend to avoid commodity-oriented companies, but we are looking at some select service providers in the industry given the substantial stock price declines.

Market Outlook

In the economic and investment climate brought about by the Fed's monetary policies of the last 8+ years, investors have had to work increasingly harder scrounging for investment returns. As yields on "safer" investments (high quality bonds) have all but disappeared, investors have agreed to pay higher and higher prices in their quest for equity returns. It makes sense, of course, to pay a higher price for a solid business paying a stable dividend when interest rates are low, but certainly by now those opportunities have vanished. Many investors have paid very high prices (too high, in many cases) for shares of companies promising very high growth in the future. These companies might be able to show well-above average revenue growth, but are likely to have difficulty (or find it impossible) to translate that revenue growth into sustained profitability and free cash flow.

And so it is that growth is outperforming value by a wide margin again in 2017. Both the S&P 500 and Russell 2000 growth indices are outpacing their value counterparts by ten percentage points (13.3% and 10.0% vs 4.9% and 0.5%, respectively). Our style of investing places value on high returns on invested capital, goal congruence with management, prudent capital structures, and abundant free cash flow. As investors reach for returns, they are increasingly buying into "stories" of high revenue growth regardless of the likelihood that it will ever result in returns on investment that exceed the cost of capital, or ultimately provide a cash return to owners of the business.

The reality appears to be that growth will remain elusive. The Federal Reserve has done more than many thought plausible to prop up our economy, and is trying to find ways to unwind its massive balance sheet without disruption. Europe is in a similar position.

I am sure we sound stodgy and old-fashioned, and perhaps our style of building investment portfolios is truly outdated. We understand that our investment philosophy and process does not lead to index-beating results every month, quarter or even every year. But we do remain confident that our approach will continue to produce pleasing investment results over longer periods of time as economies and investment psychology cycles, and prudent and reasonable investment practices are again “in vogue.”

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