MANAGER COMMENTARY

SMALL CAP

GREAT LAKES ADVISORS
A WINTRUST WEALTH MANAGEMENT COMPANY

THIRD QUARTER 2017

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Market Review

The Russell 2000 Index gained 5.7% in the quarter ending September 30 and has appreciated by 10.9% as we enter the final quarter of the year. The broader market, represented by the S&P 500, gained 4.5% and closed at an all-time high; it is now up 14.2% year to date.

Global equity markets were led in the third quarter by Brazil (+22%), Russia (+16%), and Italy (+12%). Most European markets have gained more than 25% thus far in 2017, as have China and Brazil. In fact, most global equity indices gained ground in the quarter, and also remain at or near all-time high levels.

Oil prices jumped almost 10% in the quarter, leading to an almost 7% gain in the Energy sector. Natural gas prices, however, declined. The yield on 10-year U.S. Treasury Notes was 2.33%, up only slightly from the end of the second quarter, but well off its early September lows of 2.04%. The U.S. dollar weakened about 5% against the Euro and is now off more than 12% in 2017.

The Great Lakes Advisors Small Cap portfolio returned 0.9% in the third quarter, underperforming the benchmark by 480 basis points. Thus far in 2017, the portfolio has gained 2.0%, trailing the Russell 2000 by about 900 basis points.

Third Quarter Attribution

Sector	GLA Weighting	GLA Return	R2000 Weighting	R2000 Return	Active Contribution
Financials	16.7%	-1.2%	21.8%	5.3%	-1.3%
Technology	21.8%	2.4%	16.5%	4.9%	-0.6%
Health Care	5.0%	-13.4%	15.0%	7.9%	-1.4%
Consumer Discretionary	21.1%	-6.0%	14.9%	7.5%	-3.0%
Industrials	21.2%	7.4%	12.7%	4.3%	0.7%
Utilities	2.3%	92.9%	4.6%	6.5%	1.2%
Materials	2.8%	-1.2%	4.1%	1.3%	0.0%
Real Estate	0.0%	0.0%	3.9%	5.3%	0.0%
Consumer Staples	0.0%	2.5%	2.9%	7.1%	0.0%
Energy	0.0%	0.0%	2.6%	3.3%	0.1%
Telecom	0.0%	0.0%	1.0%	-0.1%	0.1%
Cash	9.1%	0.3%	0.0%	0.0%	-0.6%
TOTAL	**100.0%**	**0.9%**	**100.0%**	**5.7%**	**-4.8%**

Underweight position relative to benchmark Overweight position relative to benchmark

Source: GLA, FactSet

Much of the portfolio's underperformance in the third quarter came in the Industrial, Health Care, and Financial sectors. Solid results in the Consumer Disctretionary sector, in which we have an overweight position, provided a counterweight.

- In the Industrial sector, one company shocked investors in August with news that, despite assurances earlier in the year, they were still struggling with cost overruns at six new build renewable projects in Europe. The $115 million charge taken in Q2 required the company to obtain short-term financing on rather onerous terms, which pushed the stock to new lows. We were extremely disappointed with management's inability to manage this situation, as they had assured us that the issues were "contained" just 4 months earlier. Therefore, we sold out of our position. This mistake cost us about

200 basis points of relative performance in the quarter.

- The Healthcare sector continues to be driven by small cap biotechnology and pharmaceutical shares, which together accounted for more than 90% of the sector's 8% return in the quarter. These two sectors represent more than 8% of the Russell 2000 and more than one-half of the Healthcare sector; the biotechnology industry alone has leapt more than 50% thus far in 2017. Our lack of exposure to these industries has cost us more than 70 basis points in the quarter and 185 basis points year to date. Memories are short in the space, as last year this same lack of exposure benefitted our investment results by more than 300 basis points, as both declined by about 20% in a market that gained more than 20%.
- Our overweight position in small cap insurance companies hurt our relative results by 135 basis points in the Financial sector. We adjusted our forecast for two holdings, both of which participate in the catastrophe reinsurance market, to reflect their expected losses from hurricanes Harvey, Irma, and Maria. After doing so, the risk adjusted returns were less favorable than we had forecast, so we reduced our exposure, exiting one stock and trimming the other.
- Two Specialty Retailers reported continuing solid results in an environment dominated by fears of Amazon's effect on consumer shopping patterns. Our holdings in the specialty retail space have gained 22% so far in 2017, far outpacing the index's 3% decline. We continue to monitor the changing landscape closely, but remain confident that these two companies are executing on winning strategies.

Market Outlook

Equity markets sailed through the third quarter seemingly unfazed by the words and actions of "Little Rocket Man," the "Dotard," or Mother Nature. Perhaps Janet Yellen's voice trumps them all, as the Federal Reserve's clear signaling of future monetary policy, bolstered by several indicators suggesting economic activity is picking up, was well received by investors around the globe.

It is more than a little disconcerting when two world leaders in possession of nuclear weapons threaten to settle a juvenile name-calling spat by obliterating each other's existence. Perhaps equity prices should not move materially in such an event, as the likelihood of either of these reckless men taking such action is (we sure hope!) quite remote. However, how do we explain the apathetic response of the "fear gauge," or VIX, which supposedly measures short-term expected equity market volatility? The index briefly touched 15, which we consider to be its long-term average, before dropping back below 10 by month end. It seems clear to us that equity investors have placed enormous faith in the Federal Reserve's ability to reduce volatility and "manage" asset prices with monetary policy in almost any circumstance.

Hurricanes Harvey, Irma, and Maria wrought extensive damage in southeast Texas, Florida, and Puerto Rico, respectively. Estimates of damages run in the hundreds of billions, while insured losses could reach $200 billion. The storms left large swaths of human suffering in their wake, and it will take many years for those affected to rebuild. The storms will distort some economic indicators in the short run, and we may likewise see short term surges in other areas (autos, transportation, construction activity) as recovery continues.

The Trump Administration has thus far failed to bring any meaningful legislative changes to bear in the United States. Having failed several times at repealing and replacing the Affordable Care Act, they now move on to the subject of taxes. The administration's proposals at this time remain somewhat vague, but their stated objectives are to reduce the corporate tax burden, close loopholes, and provide tax relief to American taxpayers. These are all noble objectives, but early indications suggest that their cost ($2-5 trillion depending on the source) may simply be unsustainable in a country already carrying more than $20 trillion in debt. We will watch these developments closely, as "winners" and "losers" in this battle will see the value of their businesses affected.

As mentioned, economic activity in the U.S. does appear to have picked up as summer came to a close. The notable exception, however, is wage growth, which continues to be stuck near 2% per year. The unemployment rate hovers between 4-5%, which suggests wages should be improving, and small businesses in particular appear to be having a hard time filling skilled positions. Construction costs may face pressure as hurricane-stricken areas begin the arduous process of rebuilding. Interest rates have ticked back up, and the Fed has made it clear that there is likely one more rate increase coming in December, and that they will begin to slowly peel off some of the $4 trillion in fixed income securities they have purchased since the great recession.

With signs of economic activity perking up, investors seem to have taken renewed interest recently in “value” strategies. Nonetheless, thus far in 2017 “growth” strategies across all market capitalization ranges have outperformed their “value” counterparts by more than 1200 basis points (twelve percentage points). We have lamented the fact that investors have been reaching for returns, increasingly buying into “stories” of high revenue growth regardless of the likelihood that such stories will ever result in returns on investment that exceed the cost of capital, or ultimately provide a cash return to owners of the business. A shift back to a focus on buying good businesses at a fair price would certainly benefit our portfolios, and provide the cornerstone for solid long-term investment returns for our clients.

The stated Small Cap GLA Return data in the attribution table represent the net return for each sector and for a representative account for one quarter ending 9/30/17. Individual account returns may vary.

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