Catalyst

INTEGRITY ASSET MANAGEMENT

PORTFOLIO UPDATE AND MARKET OUTLOOK

April 30, 2024

CELEBRATING 20 YEARS OF INTEGRITY 2003-2023

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"Here I am just waiting for a sign
Asking questions, learning all the time
It's always here, it's always there
It's just love and miracles out of nowhere"

– Kansas: Miracles out of Nowhere

I participated in a roundtable with the CFA society of Cleveland. Most questions centered on interest rates, something we have devoted a lot of space to in our Catalyst commentaries.

Heidi Adelman from our sister franchise, Victory Income Investors, was also a participant. I'll first share her view as she definitely knows more about it than me. Heidi believes the most likely case for this year is no rate cuts. Strong employment and sticky inflation are making it hard for the Federal Reserve to reduce rates. Furthermore, with this being an election year, the calendar is another obstacle. The Federal Reserve doesn't want to appear politically motivated, cutting rates in the run up to an election. Moreover, as Heidi points out, Chairmen Powell has said that they will watch quarterly data. This shortens the timeline even further.
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Preliminary Performance (%)

Representative Accounts

	MTD			QTD			YTD		
	Gross	Net	vs. Benchmark*	Gross	Net	vs. Benchmark*	Gross	Net	vs. Benchmark*
Small Cap Value	-5.72	-5.79	0.66	-5.72	-5.79	0.66	-0.45	-0.78	3.21
Small/Mid Cap Value	-5.49	-5.56	0.79	-5.49	-5.56	0.79	2.83	2.54	3.43
Mid Cap Value	-4.59	-4.66	0.64	-4.59	-4.66	0.64	5.34	5.06	2.78
Micro Cap Value	-6.11	-6.18	1.49	-6.11	-6.18	1.49	-2.71	-3.03	1.54

Source: SEI

Past performance does not guarantee future results. Representative accounts are those of the Integrity Small Cap Value Equity Strategy, Integrity Small/Mid Cap Value Equity Strategy, Integrity Mid Cap Value Equity Strategy, Integrity Micro Cap Value Equity Strategy. Performance is preliminary and subject to change. Benchmark comparison is versus gross performance.

Market Returns (%)

	MTD	QTD	YTD
S&P 500® Index	-4.08	-4.08	6.04
Nasdaq 100® Index	-4.43	-4.43	3.90
Russell 2000® Growth Index	-7.70	-7.70	-0.70
Russell 2000® Value Index	-6.37	-6.37	-3.66

Past performance does not guarantee future results. Indices represent different segments of the market and are not correlated to the strategies above, with the exception of the Russell 2000® Value Index, which is the benchmark for Integrity Small Cap Value Equity.

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Along those lines, I read an interesting article in the Wall Street Journal (Even if the Fed Cuts, the Days of Ultralow rates are Over, 4/28/2024).

This is a topic we have discussed numerous times in the past that is finally getting some traction in the market. Zero or near-zero rates are an anomaly, not normal. Furthermore, we have been in a 40-year period of secular interest rate declines. That long cycle, coupled with massive Fed easing post the Great Financial Crisis, resulted in the Fed's projection of long-run interest rates falling from 4.25% in 2012 to 2.5% in 2019. The Fed seems to be forecasting interest rates like equity analysts raise price targets simply because the stock price went up. The biggest head-scratcher in the article came from Fed Governor Christoper Waller who said, "you have to explain to me why real rates on safe, liquid government debt fell for 40 years and why suddenly it turned around…no one has really given very good answers to that." I feel that comment ignores the long-term history and cycles in interest rates. He is basically arguing that rates should stay low because they are low. One wonders what his rate outlook would have been in 1982. Perhaps this also explains why inflation was viewed as transitory.

The market seems to expect rates to head back to ultralow levels anytime there is a dovish hint from the Fed. This expected "miracle out of nowhere" doesn't foot with our view on normal interest rates. While the Fed will ease at some point, we feel we are currently closer to the level of normal long-term rates. We believe this has implications for future asset allocation, setting the stage for relative outperformance from small cap stocks. Steve DeSanctis points out some interesting observations in his recent SMID-Cap Strategy Piece (5/2/2024). He points out that higher interest rates, higher inflation, and higher borrowing costs have historically benefited small cap stocks. This fits with previous work we have cited from Empirical Research Partners showing that most of the improvement in large cap free cashflow margins has come from lower interest rates and lower taxes.

DeSanctis goes on to show an interesting setup for small caps from a valuation perspective. Small Cap stocks have been relatively cheaper only nine percent of the time. Interestingly, the top five companies in the S&P 500 are 3.5 times larger than the total market value of the Russell 2000. Finally, a knock on small companies, particularly value, has been higher leverage and their access to financing. Countering this has been tight high yield spreads allowing smaller companies to finance or refinance at reasonable rates.

We don't know if or when the market will come to this realization. While not expecting something similar, the bursting of the tech bubble saw a rapid and significant shift of performance from large cap technology to small cap value. Given the relative size of just the top five S&P 500 stocks referenced above, we don't think we need a bubble burst. We just need a little recognition of the attractive valuation setup combined with the potential relative fundamental improvement that higher rates, some inflation, and tighter credit spreads could portend.

Based on the latest Russell rebalance projections from Jefferies, the Industrials sector weight continues to decline across the board and remains a notable sector change. On the industry front, the Biotech weight is now expected to decrease less in the Russell 2000 Value and Russell 2500 Value. Hopes for a lower weight to non-earners appears short lived, as the weight is now projected to rise in the Russell 2000 Value and Russell 2500 Value. The Russell Midcap Value, however, should see the non-earner weight decline further. Relative to the prior forecast, the indices are getting smaller (weighted average market capitalizations), while the betas are coming down less.

Russell's official preliminary lists will be released Friday, May 24th. Look for next month's piece to provide a more detailed analysis of the changes.

Attribution:

U.S. equities slumped in April, posting their first monthly decline of the year. The S&P 500 (-4.2%) and the tech heavy Nasdaq (-4.4%) fell as data continues to show that inflation remains stubbornly high, leaving investors to soften their hopes for multiple interest rate cuts by the Federal Reserve for the year. The Russell 2000 Value Index underperformed its larger market cap peers with a monthly return of -6.37%. Value outperformed growth across all four of our benchmarks for the month of April. In addition, all four of our strategies outperformed their respective benchmarks for the month as well.

INTEGRITY ASSET MANAGEMENT

Composite Performance (%) *as of December 31, 2023*

	1 Year		5 Year		10 Year	
	Gross	Net	Gross	Net	Gross	Net
Small Cap Value	18.87%	17.69%	13.78%	12.65%	8.72%	7.64%
Small/Mid Cap Value	15.38%	14.23%	14.06%	12.92%	8.90%	7.81%
Mid Cap Value	13.51%	12.55%	13.49%	12.55%	9.40%	8.50%
Micro Cap Value	16.14%	14.99%	11.99%	10.87%	8.95%	7.86%

Returns for periods greater than one year are annualized. Returns reflect the reinvestment of dividends and other earnings and are expressed in U.S. dollars. Gross-of-fees returns for the representative account are presented before management and custodial fees but after all trading expenses.

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All investments carry a certain degree of risk including the possible loss of principal, and an investment should be made with an understanding of the risks involved with owning a particular security or asset class. Interested parties are strongly encouraged to seek advice from qualified tax and financial experts regarding the best options for your circumstances.

Each representative account serves as the model against which all accounts in each respective strategy are managed. The representative accounts are actual portfolios and the information provided, including performance, will vary for other accounts. The representative accounts are being used solely as tools to help demonstrate how performance can be attributed to the investment policies applied in the management of each strategy.

Net-of fees returns reflect gross performance less investment management fees, which are calculated by deducting 1/12 of the highest tier of the standard fee schedule in effect for the period noted (the model fee). The composite model fee for each period is either the highest tier of the current fee schedule or a higher value, whichever is required to ensure the model composite net-of-fee return is lower than or equal to the composite net-of-fee return calculated using actual fees. Actual fees may vary depending on, among other things, the applicable fee schedule and portfolio size. The firm's fees are available on request and may be found in Part 2A of its Form ADV.

*The Integrity Small-Cap Value Equity Strategy is benchmarked to the Russell 2000® Value Index. The Integrity Small/Mid-Cap Value Equity Strategy is benchmarked to the Russell 2500™ Value Index. The Integrity Mid-Cap Value Equity Strategy is benchmarked to the Russell Midcap® Value Index. The Integrity Micro-Cap Value Equity Strategy is benchmarked to the Russell Microcap® Value Index.

Index returns reflect the reinvestment of dividends and other income but do not reflect advisory fees or any other expenses. Indexes are unmanaged and one cannot invest directly in an index.

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Advisory services offered by Victory Capital Management Inc., an SEC-registered investment advisor, 15935 La Cantera Parkway San Antonio, TX 78256.

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