# CAMBIAR SMID FUND COMMENTARY 1Q 2023

# MARKET REVIEW

The U.S. equity markets started 2023 on a positive note, with the S&P 500 Index registering a gain of 7.5% for the first quarter. After incurring a bruising drawdown in 2022, growth stocks paced the market advance and led value stocks by a wide margin in the quarter. The mega-cap FAANG+ stocks were notable outperformers, with seven stocks providing almost all of the uplift in the S&P 500 for the period. The increased appetite for tech stocks can be attributed to a number of factors – anticipation of a pause/end to rate hikes, all things artificial intelligence (ChatGPT did not write this commentary), and safe haven status vs. the turmoil in the banks. Recent price strength notwithstanding, we cannot wonder if the newfound optimism towards big tech is warranted, as earnings remain under pressure for the group – i.e., the YTD gains are almost exclusively a function of multiple expansion. Small cap stocks also participated to the upside, although not to the same extent, with the Russell 2000 Index gaining 2.3% in 1Q.

Despite the appearance of a relatively healthy environment, intra-quarter price action showed a more tumultuous path for the equity markets. Hopes for the market to return to valuing stocks based on company-specific fundamentals vs. a fixation on Fed policy appear to be wishful thinking – as macro variables remain front and center for investors. A risk-on rally fueled by hopes of a Fed pivot in January gave way to selling pressure, as inflation data remained elevated and labor slack still tight. Two additional 25 bps rate hikes in the quarter resulted in the highest Fed Funds rate since October 2007, contributing to a liquidity crisis for regional banks in March as depositors sought higher return options. Yet the broader market shrugged off bank fears and rallied into quarter-end.

## Global Financial Crisis – Part II?

As discussed in our 3Q 2022 commentary, policymakers viewed some economic pain to be an acceptable casualty in their efforts to rein in inflation. Said pain surfaced in the quarter, as fissures in the financial plumbing began to appear – highlighted by the failing of two regional banks and elevated stress across many others. The weakness in banks was not contained to the U.S., as low capital levels resulted in the forced merger of Credit Suisse with UBS – an unfortunate end for a bank that was founded in 1856.

In aggregate, Cambiar views the failures of Silicon Valley Bank and Signature Bank to be outlier events, vs. a broader liquidity crisis within the banking system. Specific to Signature (and Silvergate), regulators sent a more pointed message: crypto-oriented financial companies are unlikely to receive government agency help if they have funding or capital problems.

While bank failures are not a new phenomenon, the size of these institutions and the speed in which the closures took place were notable. Given that most depositors can access their bank accounts via smartphone apps these days, the swiftness of the bank runs was exceptional. To their credit, the Federal Reserve acted quickly to provide a funding backstop via the newly created Bank Term Funding Program, which will provide unlimited access to liquidity via collateral pledges that will be valued (at par) vs. their current mark-to-market values. In 2008, the collateral was not good (at all), creating a systemic problem. That is not the case in this situation. This is not to suggest that caution is not warranted, as it is increasingly clear that after an extended period of low interest rates, vulnerabilities within the financial system are now surfacing in response to one of the sharpest hiking campaigns in history.

Another read-through from current events is that a Fed Funds rate in the 4.75%-5.00% range is becoming overly restrictive. The steepest yield curve inversion since the peak rates of the Volcker era suggests that the market believes current Fed Funds rates are far above a longer-term neutral interest rate. It is entirely possible that the financial system "runs" better at a 3% 10-yr Treasury yield, a 2% Fed Funds rate, and 3% inflation going forward (vs. the Fed's 2% goal). This is just one hypothetical scenario, but we think it has a good chance at being correct. That would then entail interest rates becoming less onerous by 2025, but not revisiting the zero interest rate environment and related asset price distorting features of the lowflation era.

Cambiar has had a more conservative allocation to banks across our domestic strategies, largely based on concerns that asset quality problems are likely to surface in areas that benefited from the prolonged accommodative posture that had been in place. The approximate $270 billion in commercial real estate mortgages coming due in 2023 (the highest figure on record according to data firm Trepp Inc.) is one such example. Tightening credit standards and higher



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savings rates to stem deposit flight will also crimp profitability. Net, while the disinflationary impulse that results from reduced loan activity should enable the Fed to take their foot off the gas pedal, we view the forward outlook for bank returns to be challenged vs. other areas of the market.

# SMID FUND

| | 1Q23 | YTD | 1 Year | 3 Year | 5 Year | 10 Year | Since Inception - Inv | Since Inception - Inst |
|---|---|---|---|---|---|---|---|---|
| CAMMX | 3.40% | 3.40% | 0.72% | 24.06% | 10.77% | 10.83% | 9.83% | - |
| CAMUX | 3.40% | 3.40% | 0.80% | 24.16% | 10.85% | - | - | 9.10% |
| R2500V | 1.40% | 1.40% | -10.53% | 21.80% | 5.61% | 7.72% | 8.13% | 6.49% |

*Inception Date: CAMMX (5.31.2011) | CAMUX (11.3.2014). All returns greater than one year are annualized.* ***The performance quoted represents past performance and is no guarantee of future results. The investment return and principal value of an investment will fluctuate so that an investor's shares, when redeemed, may be worth more or less than the original cost, and current performance may be lower or higher than the performance quoted. For performance data current to the most recent month-end, please call 1-866-777-8227.***

***As of 3/31/23, expense ratios are CAMMX: 1.09% (gross); 0.92% (net) | CAMUX 1.02% (gross); 0.85% (net). Fee waivers are contractual and in effect until March 1, 2024. Absent these waivers, total return would be reduced.*** *The Fund imposes a redemption fee of 2.00% on shares held less than 90 days. Your return will be lower if a redemption fee is applied to your account.*

The Cambiar SMID Fund posted a solid margin of outperformance for the first quarter. The excess return was a combination of positive stock selection across multiple sectors of the portfolio, in tandem with low exposure to the meltdown in regional banks. Over a longer arc, the SMID Fund continues to outpace the benchmark – on both an absolute and risk-adjusted basis.

Cambiar employs a three-pronged investment approach that we term Quality/Price/Discipline or QPD. Adherence to the 'D' was particularly additive in the quarter, given the shifting undercurrents in the equity market. Our team resisted the temptation to reach for higher beta/lower quality names that rallied in January, instead remaining focused on businesses with strong balance sheets and steady free cashflow. The SMID Value portfolio was therefore well-positioned (vs. the index) during the subsequent market drawdown in the February/March timeframe.

Buy/sell activity in the quarter consisted of three new purchases (all within Healthcare) and three sales. The portfolio's higher allocation to Healthcare is primarily a function of the unique businesses that we have identified in the sector - examples include a dental equipment supplier, a therapeutics company, and a diagnostics testing provider. The more acyclical nature of these companies has also proven complementary to the portfolio's more economically-sensitive positions. Portfolio sector exposures continue to be a by-product of where our team is finding opportunity, with an overlay focus on diversification. Despite the market's seeming obsession with monetary policy, we remain focused on building a portfolio of quality businesses that we believe can perform regardless of the macroeconomic backdrop.

While the broader market posted positive returns in the quarter, Financials were a notable outlier to the downside, as contagion fears reverberated across the regional banks. In a nod to active management, Cambiar's holdings in the Financial sector represented the top value-add for the SMID portfolio in the quarter. The positive contribution was as much a function of what we didn't own (i.e., a low allocation to banks), as it was what we did own in the sector. Although the

Diversification does not protect against market loss.

portfolio was not able to fully sidestep the weakness in the banks, Cambiar's ownership of non-bank financials such as WEX Inc. and Euronet offset the drawdowns in BOK Financial and EastWest Bancorp (the latter was sold in March upon review). Even after the liquidity crisis passes, Cambiar's appetite for additional exposure to banks is likely to remain tepid – as we anticipate that the combination of higher deposit costs, lower loan growth, and increased regulation will hamper earnings power (and multiples) within the space.

The SMID Fund also generated above-benchmark returns in the Technology sector, which rebounded in the quarter as investors perceived the space to offer a more reasonable risk/reward after their decline in 2022. Possessing strong balance sheets, steady returns, and defensible moats via patents/licensing portfolios, we view our tech holdings to be relatively defensive vs. the more speculative options in the sector.

Comprising ~23% of the portfolio, Cambiar's holdings in Industrials were an additional bright spot in the quarter, with Cambiar benefiting from both positive stock performance as well as an overweight allocation to this outperforming sector. The Industrials sector is comprised of a wide range of businesses with varying end markets. Representative holdings include traditional 'metal banging' businesses such as an HVAC equipment supplier and a tools/accessories manufacturer, but also asset-light companies such as logistics services and a management consulting business. While we anticipate some moderation in cost pressure for our holdings, the ability to maintain price and preserve (if not expand) margins remain key inputs to the underlying investment case for our holdings in the sector.

Cambiar's non-participation in Materials resulted in a drag on relative performance, given the strength in the sector during the quarter. In our view, the risk/reward within Materials remains unattractive (vs. other areas of the market) given elevated valuations. Stock selection in Consumer Discretionary was an additional performance headwind in the quarter, as apparel company V.F. Corp. continues to struggle with excess inventories in its flagship Vans brand. The company is making a number of moves to improve results (e.g., selling non-core assets), but market sentiment is clearly in 'show me' mode. Operating conditions in the apparel space have been challenging over the past year (i.e., V.F. Corp. is not alone), and we are reasonably confident that better days are ahead for the company. That said, we need to see tangible signs of progress in the coming quarters.

The higher cost of capital environment provides a supportive backdrop for active management – particularly in the down cap segment of the equity market where there is a high percentage of non-earners. In aggregate, the Cambiar team remains focused on well-managed companies that have low leverage, stable margins and free cashflow that can be reinvested back into the business vs. being used to pay higher interest expense. Despite the risk-on sentiment that was in place for much of the quarter, we believe downside protection may take on increased importance as the effects of higher rates and associated credit contraction have yet to be fully priced into the economy.

# LOOKING AHEAD

Although U.S. equity indices are positive to start the year, the gains thus far have been largely driven by narrow, top-heavy leadership. Whether the rally in growth stocks and related speculative instruments (e.g. Bitcoin) is a sign of resilience or denial remains to be seen. Given a declining earnings backdrop and the higher probability of the economy slowing (vs. accelerating), recent price strength in the more speculative pockets of the market is all the more tenuous in our view. We are generally pleased with how the Cambiar SMID portfolio fared in the quarter; that said, our focus remains on outperforming over longer timeframes.

The Federal Reserve and monetary policy continue to take center stage for many investors. Adding to a growing list of questionable decisions, the Fed's most recent move to continue tightening in the face of a potential banking crisis may result in a 'win the battle but lose the war' outcome. Economic signals are sending a mixed message – while the rise in interest rates has begun to filter its way into the economy via lower output in manufacturing activity and residential construction, consumer spending patterns remain strong, and unemployment is low. Elevated borrowing costs are almost certain to suppress economic activity – which we do not believe to be fully priced into stocks (as illustrated by the one-year forward P/E of ~18-19x for the S&P 500). Yet underneath the surface, there are an increasing number of companies that in our view possess reasonable upside as conditions begin to normalize. The potential may be even greater in small/mid cap equities on a risk/reward basis, given lower absolute valuations vs. history as well as relative to large caps.

For Cambiar, portfolio buy and sell decisions remain based on company-specific fundamentals vs. macro-economic predictions. We believe the current environment provides a two-sided opportunity to generate excess returns – via the companies we own as well as through selective avoidance. The recent turmoil in banks illustrates that alpha can be as much a function of abstention as it is stock selection. Portfolio construction continues to favor self-funding companies with durable business models that we believe can generate strong through-the-cycle returns.

We appreciate your continued confidence in Cambiar Investors.

# IMPORTANT INFORMATION

***To determine if a Fund is an appropriate investment for you, carefully consider the Fund's investment objectives, risk factors, charges and expenses before investing. This and other information can be found in the Fund's summary or full prospectus, which may be obtained by calling 1-866-777-7227 or by visiting our website at www.cambiar.com. Please read the prospectus carefully before investing.***

***Risk Disclosures***

*Mutual fund investing involves risk including loss of principal. The Fund pursues a "value style" of investing. If the Adviser's assessment of market conditions, or a company's value or prospects for meeting or exceeding earnings expectations is inaccurate, the Fund could suffer losses or produce poor performance relative to other funds or market benchmarks. In addition, "value stocks" can continue to be undervalued by the market for long periods of time, and may never achieve the Adviser's expected valuation." In addition to the normal risks associated with investing, investments in small companies typically exhibit higher volatility. A company may reduce or eliminate its dividend, causing losses to the fund. There is no guarantee the fund will achieve its stated objective. Diversification does not protect against market loss.*

*The Russell 2500™ Value Index measures the performance of the small to mid-cap value segment of the U.S. equity universe. It includes those Russell 2500™ Index companies with lower price-to-book ratios and lower forecasted growth values. Index returns do not reflect any management fees, transaction costs or expenses. The Russell 2000® Index is a float-adjusted, market capitalization weighted index that measures the performance of the 2,000 smallest companies in the Russell 3000® Index, which consists of 3,000 of the largest U.S. equities. Indexes are unmanaged and one cannot invest directly in an index. The S&P 500 Index consists of 500 stocks chosen for market size, liquidity, and industry group representation. It is a market-value weighted index, with each stock's weight in the Index proportionate to its market value. The U.S. Aggregate Bond Index is a broad base, market capitalization-weighted bond market index representing intermediate term investment grade bonds traded in the United States. The MSCI EAFE® Index (net) (Europe, Australasia, Far East) is a free float-adjusted market capitalization index that is designed to measure developed market equity performance, excluding the U.S. & Canada. The MSCI indices are compiled by Morgan Stanley Capital International. Index returns do not reflect any management fees, transaction costs or expenses. Indexes are unmanaged and one cannot invest directly in an index.*

*As of 3.31.23, the Cambiar SMID Fund had a 1.8% weighting in BOK Financial, 2.9% in Euronet, 1.9% in V.F. Corp, and 2.7% in WEX Inc. Cambiar had a 0.0% weighting in EastWest Bancorp, Signature Bank, Silicon Valley Bank, and Silvergate. Holdings subject to change. Current and future holdings subject to risk.Holdings subject to change. Current and future holdings subject to risk.*

*For characteristics and risk definitions, please visit www.cambiar.com/definitions.*

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