NO ONE SAID IT WAS GOING TO BE EASY!

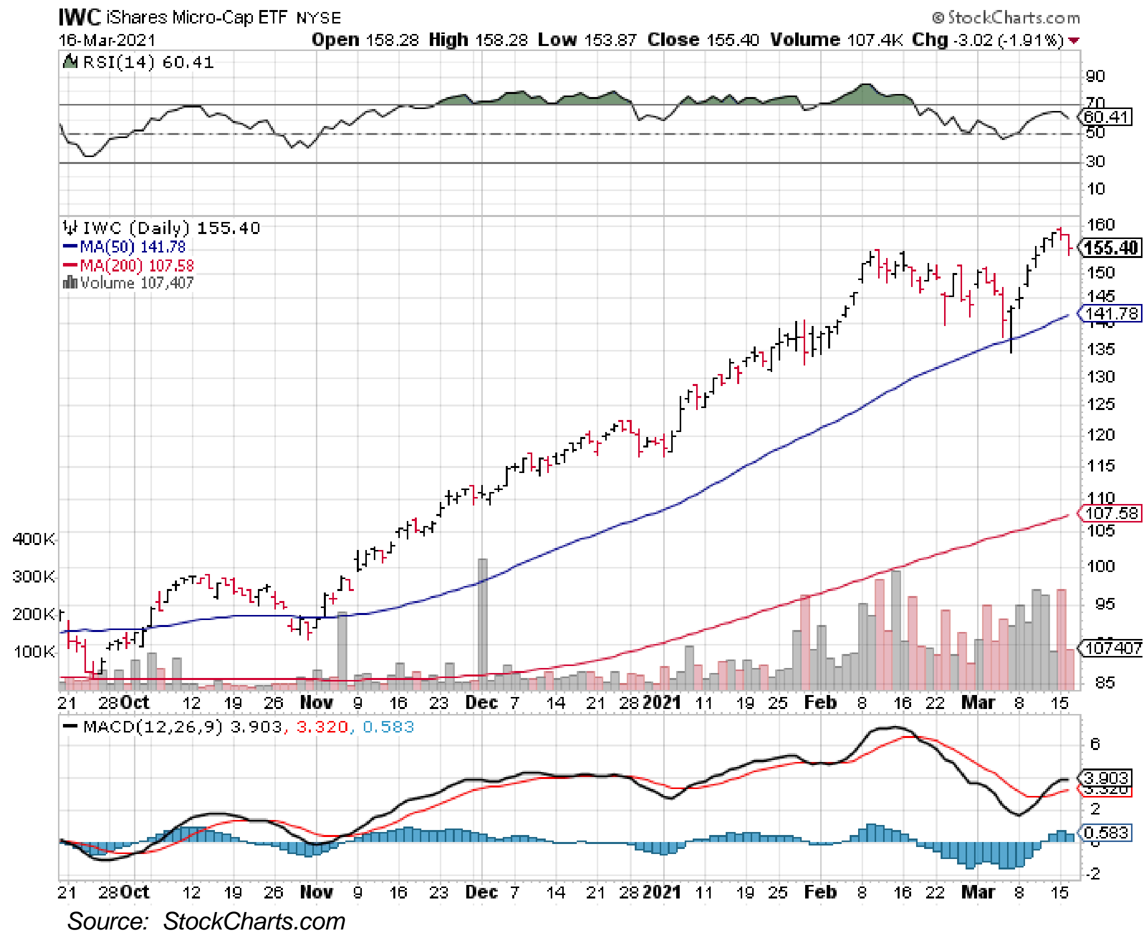
It is mid-March and we have yet to release our year-end Micro Cap Portfolio Flash Report. This is normally the edition where we would look back at the prior year and recap our portfolio and cite the “winners” and the “losers” and discuss themes and strategy for 2021. We will touch on those items in our next note. However, the present market conditions are ostensibly so unique that it seems only appropriate to address the current environment before looking back at the past year. As the market has evolved over the last few weeks, so has this report.

Last year the Uniplan Micro Cap Portfolio returned about 20%, which was consistent with the appropriate Micro Cap benchmarks. What makes this interesting is that the benchmarks were all negative for the YTD as of the end of Q3, and all the positive return for the year was posted in Q4. That is how fast things can turn, and if you are not in the market you will miss those moves.

Micro Cap Returns December 31st, 2020

	QTD	YTD
Uniplan Micro Gross	29.97%	19.61%
Uniplan Micro Net	29.32%	17.03%
Russell Micro	31.39%	20.95%

As of Friday, March 12, 2021, the broader micro cap benchmarks were up over 30% for the year-to-date! Although micro cap stocks are prone to move up and down in bigger increments than larger capitalization stocks, these types of moves are worthy of mindful examination and appropriate risk management in order to harvest returns and alpha that can easily appear and then disappear in a few ticks of the market.



Source: StockCharts.com

There is clearly a time to listen to the market, and there are times when you do not need to necessarily pay attention to what the market is saying. It seems to us that the difference between what the FOMC (Federal Open Market Committee) is saying and what the market is telling us is very wide indeed. In fact, it seems it is as wide as we have ever seen. Investors are hearing a clear message from the FOMC, and that message is that the FOMC is not blinking or hiking or tapering any time soon. The FOMC will eventually hike. Eventually, they will taper. But the message is clear that it is not now. Because of that message, equities in general will continue to rise, and likely continue to make new highs.

If you have read our Flash Reports over the last year, you are aware of our thesis on the Fed and inflation and rotation in the equity markets. For new readers, I will recap it here. Since the late 1990s, the Federal Reserve has supported the idea that a long-term target of 2% inflation is the correct amount of inflation. This target is not just a one-year goal, but rather a permanent, long-term target. The Fed's favorite measure of inflation, the PCE deflator, has averaged 1.5% over the past decade. The Fed now says it could let inflation in the future run high so that the long-run average rises to 2%. This suggests that the Fed could be willing to have inflation run at 2.5% for the next ten or fifteen years so that the 20-year

average trends upward to 2%. At least, this is what they seemed to conclude at the annual Jackson Hole Symposium in August 2020, with the adoption of flexible average inflation targeting (AIT).

Going forward, we anticipate that the FOMC will target inflation somewhat above 2% after any periods when inflation has run persistently below 2%, so as to average 2% over that period. We suggest that this potential rise in inflation expectations could lead to significant rotations in leadership across equity markets, with a notable shift from growth to value companies over time.

In a world of deflation, equities generally suffer while government bonds, even at very low yields, tend to perform well. A very low bond yield can be good for equities because it tends to push the P/E higher for equities as the discount rate falls. The correlation between equities and inflation varies according to the level of inflation. In a low inflation period, like today, we generally see a positive relationship between changes in equities and inflation.

But, both corporate debt levels and valuations have increased as a result of low interest rates, so it takes a much smaller rise in bond yields in the current interest rate environment to force equity valuations lower than would have been typical in periods when rates were higher. For example, when the financial crisis hit, 10-year Treasury yields were around 4%. At the time many argued that these were too low. It seems inconceivable now that we could see a rise in bond yields to those sorts of levels without inflicting significant damage on the economy and the stock markets along the way. A rise in inflation expectations would be good, but policymakers may need to be careful because there is a much narrower acceptable bandwidth in terms of higher inflation expectations. Too high, which is arguably much lower than in the past, and we would likely see a reversion to concerns about secular stagnation.

In the current environment, rising bond yields from extremely low levels should be a positive for equities as it would reflect a positive growth signal and would likely go along with a decline in the equity risk premium. Rising inflation expectations would also support owning inflation-protected assets such as higher-yielding value equities.

In a macro context, growth has outperformed value because the scarcity of growth has benefited a narrow range of particular stocks – The FAANGs as they are called. These stocks have, in recent years, delivered more growth in margins and earnings than most other companies. Within the US it has strongly benefited large-cap technology stocks, at least partly explaining the increased narrowness of the market leadership. But growth, in general, has outperformed significantly ever since the global financial crisis.

Investors are now prepared to pay more for higher expected future growth than in the past, especially anything that is perceived to be safe top-line growth. The

scarcity of growth means that investors are prepared to pay a big premium for stable secure growth in the few areas that offer it - but the lower levels of inflation mean both lower average levels of nominal growth in the economy and lower interest rates, which further boost the net present value of these long-duration growth companies.

The increased valuations for the highest growth areas, particularly in defensive growth such as staples and healthcare, also make sense because these stocks have the highest duration or sensitivity to bond yields. They tend to do best as bond yields fall (alongside inflation), while financials and cyclicals tend to do best when bond yields and inflation rise. This is very consistent in looking at estimates of the equity duration of various market sectors.

A meaningful rise in inflation expectations is likely to trigger a reasonable degree of rotation in leadership towards more cyclical and value-orientated companies. The shift upwards in inflation expectations and term premium in the bond market needs to be enough to change the net present value assumptions of growth companies, but not so much that it leads to an expectation of lower overall growth in the economy.

In the case of lower volatility stocks, we see another version of a similar relationship. Very low levels of bond yields and an uncertain future path for growth not only raise the value of longer-duration growth companies but also increase the attraction of companies that have a record of achieving stable and low volatility returns. In effect, their risk premium falls relative to that applied to other more volatile and cyclical companies, thereby generating a widening valuation premium. Strong economic growth, higher bond yields and inflation expectations would tend to reverse this, at least in part.

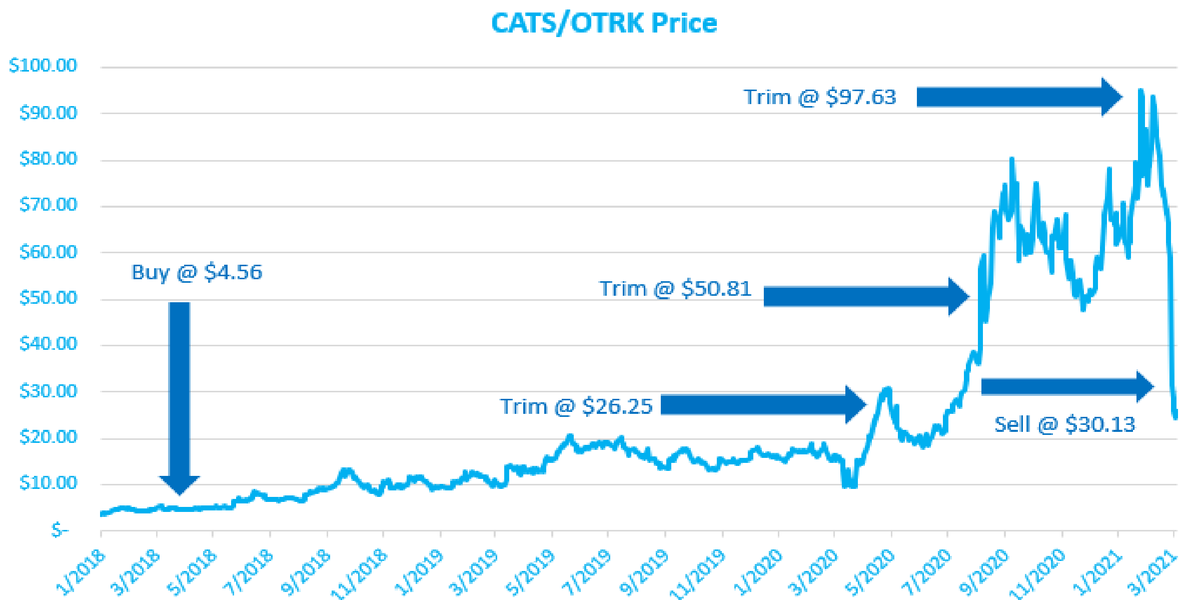
The recent (Q1 to date) sell-off in growth may have been too far too fast. It was the source of funds for the beginning of a repositioning into value and growth at a reasonable price while also prompting some market players to use the growth stock source of funds to reduce or manage risk. While it is possible that we may see a reversal over the next month or two, where growth again outperforms, it seems likely, given the steepening yield curve, that we will get back to a longer-term rotation out of growth and into cyclicals and value. That is the upcoming rotational phase of this new investment cycle. Carefully making that transition from growth to value will be the key to keeping up with the surging market benchmarks. To that end, managing the market risk and volatility will be a key factor to maintaining good relative returns. It is not going to be easy, but to get the returns investors must manage the rotation and stay in the game.

Managing Risk in a Rotational Environment

One of the hallmarks of the Uniplan Micro Cap Portfolio style is to run a fairly concentrated portfolio of high conviction names. This also means that as portfolio managers we must think about how to prudently manage the concentration risk – particularly in a highly volatile and rotational environment.

The following is a case study of a recent micro cap portfolio investment in a company called Catasys – CATS (eventually renamed OnTrak - OTRK). The chronology is as follows:

In March of 2018, we established a 1% portfolio position in CATS at an average cost basis of $4.56. The company executed well and displayed good execution of the business plan which they had laid out for investors. By March of 2020, two years later, the stock had moved up to $26 per share and the position represented a portfolio holding of over 4%. We trimmed the position back to 3% at an average price of $26.25. The stock retreated into the teens and then, on a series of positive announcements by the company, moved back up to over $50 per share. Again, we trimmed the position back to 3% at an average price of about $51. By March of 2021, three years after our initial purchase of the name, the stock was trading at over $90 per share and was nearly 5% of the portfolio. We trimmed the position back to 2.5 % at an average price of $97.63. Shortly after that sale, the company announced that they had lost one of their largest customers and the stock plunged to about $22. Upon the negative announcement, the micro cap team decided to exit the position and sold the balance of the remaining stock at about $30 per share.



Source: Bloomberg
Please Note: These prices are based on Uniplan's average execution across all micro cap accounts. Individual clients may have received a different execution price and/or timing of the trade(s) due to platform and account restrictions.

When you do the final math, our average cost basis was $4.56 while the average selling price was $45.78 for an average return of over 10x on the three-year life of the investment. This example is about the qualitative management of risk within the micro cap landscape. Returns of this nature are not uncommon in the micro cap space, but as can be seen in the chart above, they can be volatile and temporal. Our plan is to help manage and mitigate those risks while providing a competitive return for our clients. This must be done in the context of the macro-environment, which can change in an instant.

Conclusion in Brief

Fed Chairman Powell and the FOMC members have been very clear that we are NOT anywhere near tapering and that they will be very clear when they plan on doing so. In the Fed's analysis, we are nowhere near the policy-mandated full employment we need, and that policy goal could take a long time. They see no signals indicating that the disinflationary pressures are subsiding, or that there are inflationary pressures building to the upside. Additionally, they are not concerned with the move in the markets or treasury yields. Conversely, the market is pricing in some rate hikes sooner rather than later. Clearly, someone is wrong, and our thesis is that it is NOT the FOMC. If one reads the Fed commentary carefully, Chairman Powell and his committee have been very coordinated in their message: We are not near Full Employment. Disinflation is of greater concern than inflation. We are not near Tapering. It is a unified and singular message.

So, if you run the game film forward, what happens? Rates will eventually move higher, and inflation will creep up. But the inflationary metrics that the FOMC is looking at have not yet moved into an area of concern and even if it does, its 'long term average inflation' target (AIT) will be the focus and we need to get to Full Employment. So, it stands to reason that the Fed will not hike as aggressively as the markets seem to be predicting and equities will likely continue to benefit from engineered central bank liquidity. The real trick will be correctly migrating into the rotation from growth to value, while managing the risks of volatility related to the changing market environment. But, most importantly, you must stay in the game to make the returns. No one said it was going to be easy!

Rick Imperiale
Chief Investment Officer
March 2021

The Uniplan Micro Cap Portfolio is a low-turnover high-conviction micro cap strategy designed to offer investors a quality alternative to private equity having a similar unlevered return while providing daily liquidity. The core investment thesis is focused on companies trading at a low multiple of cash flow or EBITDA, with little or no balances sheet debt and having meaningful smart money activity in the form of insider buying, or 13G/13D activity along with identifiable macro or company level catalysts.

Important Information: 1. Uniplan Investment Counsel is a boutique investment firm, with roots dating back to 1984, that manages a variety of portfolios primarily for US clients. Uniplan maintains a complete list and description of composites that is available upon request. 2. The composite was created August 1, 1999. Performance is calculated in US dollars utilizing a time-weighted total rate of return. Total return for the composite is represented by the asset-weighted returns of the portfolios within the composite. Trade-date valuation is used. 3. Performance is net of all transaction costs and net performance is net of transaction costs and (maximum allowable total) investment management fee, but before any custodial fees (that may be incurred separately by the client). 4. The benchmark for the composite is the Wilshire US Micro-Cap Index that represents a float-adjusted, market capitalization-weighted portfolio of all stocks below the 2,500th rank by market capitalization in the Wilshire 5000 on March 31 and December 31 of each year. The index is used to measure small stocks and is adjusted to reflect the reinvestment of dividends, when applicable. 5. The Russell Micro Index may be used as an alternative benchmark. The Russell Microcap Index is an unmanaged total return index of the smallest 1,000 securities in the small cap Russell 2000 Index and the next smallest 1,000 companies based on a ranking of U.S. equities by market capitalization. 6. It is not possible to invest directly in an index. The index figures do not reflect any deduction for fees, expenses or taxes. 7. The dispersion of annual returns is measured by the standard deviation of asset-weighted portfolio returns represented within the composite for the full year. The standard deviation of the annual returns for the period August 1, 1999 to December 31, 2020 is 20.85% for the composite and 26.66% for the Wilshire Micro-Cap Index. 8. The composite does not have a minimum size criterion for composite membership. All fee-paying discretionary accounts with similar investment objectives are included. Leverage is not used in this composite as a means to generate higher returns. There may be non-fee-paying portfolios in the composite. Individual account holdings may vary depending on numerous factors including the size of an account, cash flows, and account restrictions. 9. There have been no changes in the personnel responsible for the management of this composite. 10. The composite contains both traditional and wrap fee portfolios. Uniplan has a flexible and negotiable fee schedule reflecting the differences in size, composition and servicing needs of clients' accounts. A complete description of investment advisory fees is contained in Uniplan's Form ADV and is available upon request. 11. Uniplan Investment Counsel does not claim GIPS Compliance. The performance has been verified by an independent source as of 1/1/2006 – 12/31/2019. Individual account performance may vary from the results shown because of differences in inception date, restrictions and other factors. 12. Investors should understand that micro-cap stocks are subject to a higher degree of risk than other equity investments due to the small size of the companies and the limited trading volume inherent in micro-cap stocks. 13. This information is not an offer to buy or sell a security nor does it constitute investment advice or an offer to provide investment advisory or other services. All information is subject to correction or change. **Past performance is no guarantee of future results. Investment involves a risk of loss.**

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