"Inflation is like taxation without legislation." — Milton Friedman

Summary

- **Micro Cap performance in 2021 was achieved largely in Q1 with the balance of the year being mostly rangebound.**

- **A shift in Fed Policy toward a more inflationary bias noted in 2020 is leading to a rotation from growth to value and should benefit small stocks.**

- **A modest rise in inflation expectations might be good, but policymakers may need to be careful because there is a much narrower acceptable bandwidth in terms of higher inflation expectations.**

- **As increased inflation leads the market into a transition from growth to value, staying in the "middle lane" with a mix of growth at a reasonable price and value should optimize performance.**

- **Changing inflation expectations should be positive for the Financial, Industrial, Materials, Energy, Real Estate, and Consumer Discretionary sectors.**

- **Insider and smart money transactions suggest that valuations remain attractive, and the business environment remains positive.**

- **The outlook for 2022 remains positive for micro-cap stocks as ample liquidity and a robust M&A environment continues strong into yearend.**

Performance In Brief

After a very strong first quarter, micro-cap stocks bounced up and down in a trading range for the remainder of the year. For the year-to-date period ending December 31, 2021, the ***preliminary estimated*** investment results for the Uniplan Micro Cap Portfolio are as follows:

	MTD	QTD	YTD
Uniplan Micro Gross	1.60%	1.72%	16.96%
Uniplan Micro Net	1.42%	1.17%	14.45%
Russell Micro	0.50%	-2.65%	19.35%
Russell 2000	2.23%	2.14%	14.82%

The huge biotech sector rally that left us behind late in Q1 and during early Q2 largely dissipated during Q3 and Q4, helping us to regain some relative performance on the benchmarks. The risk-on, risk-off trade continues to modulate across the small and micro-cap space with the earlier rise of the Delta and current rise of the Omicron variants being cause for growing concern over some aspects of the US economy and putting investor flows back into the risk-off mode. The larger cap benchmarks handily exceeded small and micro-cap performance during the quarter and year-to-date. And so, the quarter ends largely where it began, with a slight bias to the upside.

Source: IWC – iShares Micro-Cap ETF

Staying In "The Center Lane"

In our Micro Cap Flash Report for Q3 2020, we noted that the Fed was signaling a shift in policy (https://uniplanic.com/micro-cap-flash-2020-q3/) and that if enacted could cause a rotation from growth to value as a predominant market theme. Since the late 1990's, 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. ***However, 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 to 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).

Source: U.S Bureau of Economic Analysis

As can be seen in the PCE chart above, since the change in policy, inflation has moved up dramatically as compared to the past ten years. As we said in the aforementioned Flash Report, "Going forward, we anticipate that the FOMC will target for inflation somewhat above 2 percent after any periods when inflation has run persistently below 2 percent so as to average 2 percent over that period." This 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 and should facilitate a broader appetite for smaller value companies as the market broadens.

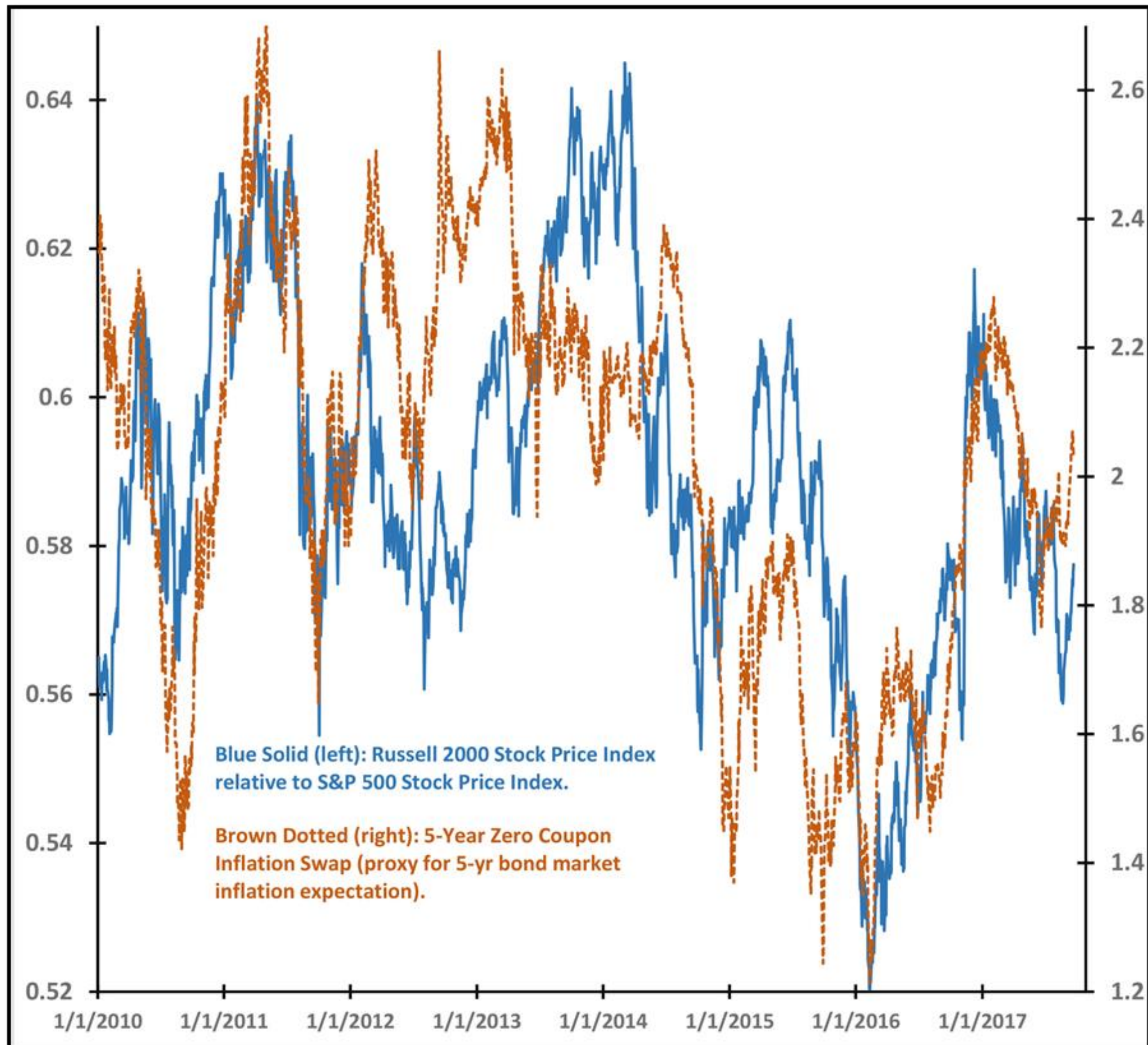
Equities Versus Bonds

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 we saw for the past decade, there generally is a positive relationship between changes in equities and inflation. This is most notable in the Materials, Energy and REIT sectors where increasing inflation from a low base is usually taken as a sign of improving growth prospects and a diminishing risk of deflation, both of which are supportive of commodity valuations and equities in general.

However, both corporate debt levels and valuations have increased as a result of such low interest rates. Companies raised a record $12.1 trillion in financing in 2021, up by 17% from the previous year, according to Financial Times calculations based on Refinitv data. The huge bond-buying program of the Federal Reserve and other central banks pushed the cost of borrowing to record lows, stimulating the rush for new loans and other types of fundraising. In the US, companies raised over $5 trillion in 2021, an all-time record. So, it takes a much smaller rise in bond yields in the current interest rate environment to propel equity valuations lower than would have been the case in periods when rates were higher. For example, when the financial crisis hit, 10-year Treasury bonds were yielding around 4%. At the time many argued that those rates 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 market along the way. A modest rise in inflation expectations might be good, but policymakers may need to be careful because there is much narrower acceptable bandwidth in terms of higher inflation expectations. Too high, which is arguably a much lower level than in the past, and we would likely see a reversion to concerns about secular stagnation. Given the sudden rise in inflation, these concerns may be emerging.

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 small cap and higher yielding value equities.

Most do not think of small caps as an inflation play, but historically, they have done best relative to the market when inflation expectations are rising. As can be seen below, the relative price performance of small cap stocks is charted against a proxy for the bond market's inflation expectation (derived from the 5-year Zero coupon inflation swap). The closeness of this correlation illustrates that Small Stocks respond well in an environment of rising inflation expectations. The 5-year inflation expectation peaked at about 2.65%. If inflation expectations begin to rise again due to the Fed's new AIT policy, small company stocks should once again outperform.



Source: Barrons

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 since the global financial crisis.

Investors are now prepared to pay more for higher expected future growth than in the past, especially for 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.

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. Clearly, strong economic growth and higher bond yields and inflation expectations would tend to reverse this, at least in part.

The bottom line is that a change in future inflation expectations should be positive for small companies in general and the Financial, Industrial, Materials, Energy, Real Estate, and Consumer Discretionary sectors in particular, which show the most relative value across the market.

The shift in sentiment from growth to value seems to be playing out as we see inflation on the rise and the yield curve steepening. This transition may in fact be playing out as we have seen a widening disparity as value has started to outperform growth since the middle of 2021. As we are in this transition period, it will be useful to stay in “the center lane” with our portfolios and maintain a balance in exposure to both value stocks in sectors that will benefit from inflation and stocks that offer growth at a reasonable price which should both perform well as inflation expectations rise.

As our thinking evolves, we are carefully examining our top investment themes that have traditionally been the framework within which we look for companies that present as a relative value while experiencing an internal or external catalyst for positive change. Secular themes like the digitization of retail or the growth of e-commerce remain intact and have accelerated into the current environment. As such we have made more tactical changes during 2021 to the Micro-Cap portfolio than is normal as we move thematically into “the middle lane” between growth and value while being mindful of both. We will continue to make these adjustments as the available real time data evolves.

Portfolio Notes

During Q4 we continued to adjust positions and holdings at a much higher rate as the rangebound market has given us the chance to reposition for the emerging change in inflation expectations and interest rates.

We sold seven positions from the portfolio for failure to reach threshold events that were potential catalysts for revaluation of the companies. Failure of management to execute the business plan as articulated and the seeming lack of willingness to adapt in a COVID environment have been reasons in general for the underperformance of

some stocks, and in the current environment the market is not patient with lack of execution. One additional position was eliminated from the portfolio because the company was the subject of a merger agreement which was announced earlier in the year.

Two positions within the portfolio were trimmed for risk management purposes as the stocks had moved nicely higher and became overweighted within the portfolio. In one case, Alpha & Omega Semiconductor LTD (AOSL) the position was trimmed due to the strong price appreciation after running up +93% during the quarter and +156% for the year-to-date. The other position, Herc Holdings INC. (HRI), had gained 136 for the year-to-date and although we continue to like the outlook for the company, we felt it would be prudent to reduce the size of the position as a risk control measure.

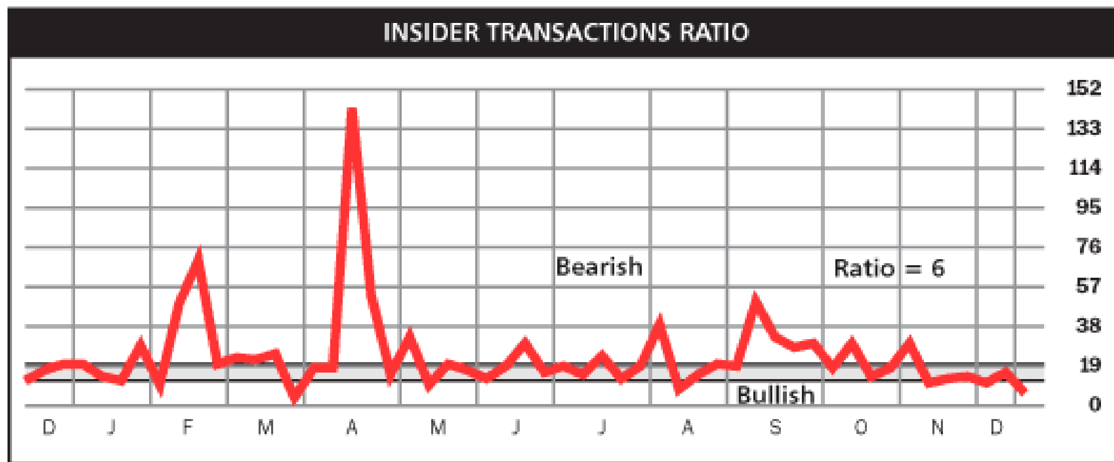
The proceeds from those sells and trims were invested across nine existing portfolio positions which had declined sharply earlier in the year and appeared to show exceptional value and solid long-term outlooks even when reviewed in the light of the Covid pandemic and other macro factors.

Finally, we added six new names to the portfolio in small increments with the intention of building out larger positions over time as the thesis for these names evolve and the opportunity unfolds as threshold events are met by the companies.

In volatile environments like today, we maintain an even more active, engaged dialogue with our portfolio companies. We are always thinking about and looking for ways to help create value by encouraging our management teams to pursue intelligent, value accretive capital allocation moves or making changes to upgrade governance, oversight, and business performance. In these times, our quiet and trusted approach to engagement is more productive and appreciated, as we often act as a sounding board for our company management partners.

Insider Activity

As our investors know, we also closely monitor insider and smart money activity across our portfolio and the micro-cap universe. Insiders at many of our portfolio companies have continued to personally buy shares in the open market this quarter, signaling confidence in their companies and the future of the business and sending the Insider Transactions Ratio into positive territory. This is generally a positive signal for current valuations and future earnings outlook.



Ratio of Insiders Sales to Buys. Readings under 12:1 are Bullish. Those over 20:1 are Bearish.
The total top 20 sales and buys are 526,916,374 and 81,080,679 respectively; Source: Thomson Reuters

Conclusion – Setting Up For a Strong 2022

The case for micro-cap exposure looks strong on a go forward basis. The sizable pool of risk-on liquidity that has fueled Special Purpose Acquisition Companies (SPACs) and many new small and micro-IPOs continues to roll through the market. This SPAC phenomenon has triggered a wave of M&A activity in the US that has totaled a record $2.2 trillion during the first three quarters of 2021 and continues strong according to REFINITIV Global. To date this has been driven by private equity firms that have done over 8,000 deals in the past year and have accounted for nearly 28% of all M&A volume according to REFINITIV. This is likely to be the first wave in a long cycle of M&A driven by liquidity in private equity and the desire for stronger growth among both public and private companies. We would argue that the private equity buyer views the micro-cap space as an attractive target list for finding potential small company investment opportunities.

Over the years, we have argued that investing in micro-cap stocks can offer excess returns because of the inefficient information flow regarding the thousands of small companies which populate the space. Do your homework, be mindful of valuation and actively manage risk; that is the path to adding alpha in a micro-cap portfolio. This thesis is supported in part by the fact that very few micro-cap companies have any formal sell side research analyst coverage. As a result, doing primary source research can often lead to gaining insights and finding opportunities long before the investing public discovers these facts.

While some investors may try to gain exposure via the index or ETF in an effort to time and capture market beta, we would argue that this is a less effective way to play small and micro-cap opportunities. In a post Covid-19, world there will be bigger differences between winners and losers on an individual security basis in a market segment where careful fundamental research can still result in an information advantage. Our rigorously screened bottom-up work on business, management, and valuation along with our thematic macro framework helps us distinguish real businesses trading at attractive relative valuations.

We are excited for the long-term prospects of our portfolio and continue to find interesting opportunities with high quality small companies offering compelling values. For the patient long-term investor, micro-cap stocks offer better return opportunities than any domestic equity class. In looking back at the history of micro-cap securities, they are often punctuated with periods of extreme volatility. It's easy to argue that we are in one of those periods of volatility. As such, we often look to those periods to reposition and evolve the portfolio and we continue to evolve our thinking to adjust for the new environment**.** For these reasons we believe now more than ever, micro-cap stocks have a meaningful place in the portfolios of individual investors.

While we have discussed here at length the investment opportunity that the market disruption has created, we are deeply saddened by the devastating loss of life and dangerous health impact the Covid-19 pandemic has had for so many globally. The health and safety of our employees, their families, our clients, and the community around us remain our top priority.

###

Richard Imperiale
Chief Investment Officer

January 2022

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 at 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 Microcap 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. The Russell 2000 Index is used for comparison purposes and doesn't serve as a benchmark. The Russell 2000 Index measures the performance of the small-cap segment of the US equity universe. The Russell 2000 Index is a subset of the Russell 3000 Index representing approximately 10% of

the total market capitalization of that index. It includes approximately 2,000 of the smallest securities based on a combination of their market cap and current index membership. 7. It is not possible to invest directly in an index. The index figures do not reflect any deduction for fees, expenses or taxes. 8. The strategy principally invests in Micro Cap stocks, including those companies that show growth. Uniplan typically views companies, at time of investment, to be considered a micro capitalization company if the market capitalization falls below the larger of $500 million or the market capitalization of the largest company in the Russell Microcap Index. 9. 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, 2021 is 20.72% for the composite and 26.74% for the Wilshire Micro Cap Index. 10. 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. 11. There have been no changes in the personnel responsible for the management of this composite. 12. 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. 13. Uniplan Investment Counsel does not claim GIPS Compliance. The performance has been verified by an independent source as of 1/01/2006 – 12/31/2020. Individual account performance may vary from the results shown because of differences in inception date, restrictions and other factors. 14. 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. 15. 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.**

All investments carry a certain degree of risk, including possible loss of principal. REITs are subject to illiquidity, credit and interest rate risks, as well as risks associated with small and mid-cap investments. It is important to review your investment objectives; risk tolerance and liquidity needs before choosing an investment style. Value style investing presents the risk that the holdings or securities may never reach their full market value because the market fails to recognize what the portfolio management team considers the true business value or because the portfolio management team has misjudged those values. In addition, value style investing may fall out of favor and underperform growth or other style investing during given periods.

Uniplan Investment Counsel is a registered investment advisor. The views expressed contain certain forward-looking statements which can be speculative in nature. Uniplan Investment Counsel believes these forward-looking statements to be reasonable, although they are forecasts and actual results may be meaningfully different. This material represents an assessment of the market at a particular time and is not a guarantee of future results. This information should not be relied upon by the reader as research or investment advice regarding any particular security and is subject to change without notice. Past performance does not guarantee future results. Prices, quotes, and other statistics have been obtained from sources we believe to be reliable, but Uniplan Investment Counsel cannot guarantee their accuracy or completeness. All expressions of opinion are subject to change without notice. It should not be assumed that recommendations made in the future will be profitable or will equal the performance of this security. A list of securities purchased and sold in the portfolio during the past year, including the purchase or sale price and the current market price, is available upon request by calling 262-534-3000.