

Focusing on High-Quality Companies with Sustainable Growth Trends

Strategy Overview

Actively managed small cap core strategy driven by bottom-up fundamental research seeking high-quality companies with strong balance sheets and cash flow characteristics that are beneficiaries of sustainable growth trends.

You should consider the investment objectives, risks, and charges and expenses of the variable product and its underlying fund options; or mutual funds offered through a retirement plan, carefully before investing. The prospectuses/prospectus summaries/information booklets contain this and other information, which can be obtained by contacting your local representative or by calling (800) 992-0180. Please read the information carefully before investing.

Key Takeaways

- For the quarter, the strategy underperformed the Russell 2000 index
- Stock selection within the retail and health care equipment and services sectors detracted the most from performance
- Selection within the semiconductors and software and services sectors contributed the most to performance
- As long-term, disciplined investors, we remain focused on high-quality companies with strong free-cash-flow and solid balance sheets
- We believe the strategy is well positioned as investors begin to focus on company fundamentals due to ongoing economic uncertainty

Current Strategy and Outlook

Significant progress in vaccination programs, states reopening, still highly accommodative government policy and the release of massive pent-up demand from excess consumer savings should drive economic growth well above trend throughout 2021. The prolongation of zero-bound interest rate policies from global central banks and virtually unrestrained fiscal expansion, including the latest \$1.9 trillion COVID-19 aid package, certainly raise the specter of inflation and fast rising bond yields. Whether, how much and how fast prices rise are debatable. We believe increases in both inflation and yields will be gradual enough, and the levels low enough, to not drastically tighten financial conditions.

The economic tailwinds forming have led to much better than expected 4Q20 earnings growth and should improve visibility going forward. Last year's equity market returns were largely driven by defensive, pandemic protected businesses and earnings multiple expansion. This year, we anticipate higher corporate profits, particularly from the cyclical areas of the market, which should benefit from reopening and deployment of large amounts of cash on the sidelines.

As long-term, disciplined investors we remain committed to our investment approach of focusing on high-quality companies with strong free cash flow and solid balance sheets. Going forward, we believe the strategy is well positioned, as we think that investors will begin to focus on companies' fundamentals due to ongoing economic uncertainty.

Portfolio Review

The Portfolio underperformed the Russell 2000 index for the quarter ending March 31, 2021 due to stock selection effects. Namely, stock selection within the retail and health care equipment and services sectors detracted the most from performance. Our strategic underweight allocation to the pharmaceutical and biotechnology sector proved to be a tailwind during the period. Stock selection within the semiconductors and software and services sectors also contributed the most to performance.

Key detractors from performance were GameStop Corp., Ontrak, Inc. and Q2 Holdings, Inc.

Not owning GameStop Corp. (GME) was a headwind during the quarter. As the well-publicized poster child of the short squeeze in late January and March, GME shares advanced along with other secularly challenged companies, as retail investors piled into stocks based on a thread on Reddit called “WallStreetBets”.

Owning an overweight position at the end of the period in Ontrak, Inc. (OTRK), a company that provides data analytics-based behavioral health management and integrated treatment services to health plans, detracted from results during the quarter. Shares traded off at the beginning of the month following its preannounced 4Q20 earnings report, during which management noted the contract loss of its largest customer, Aetna, effective June 26, 2021. While earnings results came in ahead of expectations, this news weighed on the stock given the implied impact the loss will have on 2021 guidance.

An overweight position in Q2 Holdings, Inc. (Q TWO), a software and services company that provides banking solutions, proved unfavorable during the quarter. The stock traded off along with its peers as investors rotated out of the higher growth technology stocks. We believe the weakness to be short-term in nature and anticipate continued demand for its superior solutions which should drive upside in the longer term.

The main individual contributors to performance were Signature Bank, FuelCell Energy, Inc. and U.S. Concrete, Inc.

Owning a non-benchmark position in New York City-based commercial bank, Signature Bank (SBNY), added value during the period. In addition to a well-received 4Q20 earnings report, which cited strong deposit and loan growth and continued momentum in its payment platform, Signet, shares advanced following an announced \$3.5 million capital raise, which gave investors greater confidence in the company’s deposit growth prospects moving forward.

An overweight position at the beginning of the period in FuelCell Energy, Inc. (FCEL), an environmentally responsible power generation solutions company, added value during the quarter. After completing two equity raises and having paid down corporate debt, investors rewarded FCEL for its steady turnaround and healthier balance sheet. This progress fueled greater confidence in the company’s ability to grow and become a viable player within the industry.

An overweight position in U.S. Concrete, Inc. (USCR) added value during the month. Shares advanced on positive sentiment regarding a broader economic recovery and the Biden administration’s forthcoming infrastructure stimulus

Holdings Detail

Companies mentioned in this report – percentage of portfolio investments, as of 03/31/21: GameStop Corp. 0.00%, Ontrak, Inc. 0.34%, Q2 Holdings, Inc. 0.91%, Signature Bank 0.71%, FuelCell Energy, Inc. 0.00%, U.S. Concrete, Inc. 0.66%; 0.00% indicates that the security is no longer in the portfolio. Portfolio holdings are subject to change on a daily basis.

The Russell 2000 Index is an unmanaged index that measures the performance of securities of small U.S. companies. The Index does not reflect fees, brokerage commissions, taxes or other expenses of investing. **Investors cannot invest directly in an index.**

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The strategy employs a quantitative model to execute the strategy. Data imprecision, software or other technology malfunctions, programming inaccuracies and similar circumstances may impair the performance of these systems, which may negatively affect performance. Furthermore, there can be no assurance that the quantitative models used in managing the strategy will perform as anticipated or enable the strategy to achieve its objective.

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