Mid Cap Value
Portfolio Commentary
As of September 30, 2022

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Market Review

In our opinion, we are, and will continue to be, in a new investment regime with higher levels of inflation and higher interest rates for the foreseeable future, signaling a rotation from growth to value in the market similar to what we saw in the early 2000's. For the last several years we saw massive amounts of money flowing into venture capital,[i] biotechnology,[ii] and cryptocurrencies,[iii] all of which are in the process of unwinding. In response, investors are moving money into more traditional value sectors, such as energy and natural resources. While the transition period from growth to value in the early 2000's was volatile, value outperformed expectations for the next several years.[iv]

U.S. Equity Markets

Every sector of the U.S. equity market sold off during the second quarter with the S&P 500 and Nasdaq indices firmly in bear market territory (defined as a greater than 20% drawdown) for the year.[v] The value indices are also down but have fared better than the core and growth indices.[vi] The primary reason, in our opinion, is the rotation from growth to value, with the expectation of benefiting from value's defensive characteristics through a rising rate environment. Coming into this year, growth areas of the market were overvalued relative to history and have benefited from the low interest rate environment over the last decade.[vii] As interest rates increased significantly this year to combat high inflation, we have seen large stock price decreases and valuation re-ratings in the technology, consumer discretionary, and communication services sectors.[viii] Meanwhile energy, consumer staples, healthcare, and utilities sectors have been less negative and behaved defensively in the market sell off.[ix]

Even with the markets being down there are some major undercurrents across sectors. The Covid-19 pandemic and associated government policies distorted consumer spending. Consumers had extra money either from savings or stimulus and used those dollars to buy goods.[x] Retailers responded by ordering more goods, which were delayed by supply chain issues and finally arrived this year.[xi] This led to a surplus of goods and increase in discounted items, increasing losses for this sector. We are now seeing a normalization back to pre-pandemic levels on the goods side and a shift in consumer spending.[xii] Furthermore, the cost of essentials like food, rent, and oil have gone up considerably, which impacts the consumer and their spending.[xiii] The shift happened so fast that it caught many companies by surprise and has made it difficult to forecast spending patterns and costs.[xiv] We expect the second quarter earnings season to be challenging given the rapid economic shifts. Currently, the expectations are for the S&P 500 earnings growth to be up 6% for 2022,[xv] but that prediction may be revised downward as the year progresses.

Inflation

The inflation picture has not eased as evidenced by the 8.6% annualized CPI growth in May.[xvi] This has been a year of sustained high inflation numbers due to various factors, including higher oil, food, and rent prices, as well as increases in wages and supply chain issues.[xvii] While some of the supply chain issues are getting better, we expect inflation to peak in the second half of 2022 and that it will remain elevated for some time.

Between government regulations and underinvestment in energy and natural resources, prices are likely to remain elevated. The forecast for inflation over the next three years is in the 3.5% to 4% range,[xviii] which is much higher than we have seen in the last 20 years. The Federal Reserve is trying to tame inflation by raising interest rates. However, high inflation on its own can be enough to reduce demand and slow growth, which is what we are seeing now. The question remains whether the combination of high inflation and increased interest rates will push the economy into a recession.

Federal Reserve and Interest Rates

Since the beginning of the year, the bond market has been proactively increasing the interest rates on government bonds. In the second quarter, the yield on the 10-year Treasury bond moved from 2.3% to 3.1%,[xix] which is a significant move in a short period of time. The front end of the yield curve steepened, while the back end flattened,[xx] resulting in a slight inversion of the curve.[xxi] We believe the bond market changes indicate that the Federal Reserve was late to act. Even Chairman Powell has acknowledged the need to be more aggressive in raising interest rates. The Fed started raising rates in March with more increases in May and June bringing the Fed fund rates to a 1.5%-1.75% range.[xxii] The market expects the Fed to raise rates at least three more times in 2022 to bring the Fed funds rate closer to the current yields on the 10-year Treasury bond.[xxiii]

Oil

The energy markets have continued to rally with tight supplies and continued pressure from the Russia/Ukraine war. The price of oil has gone from $100/barrel at the beginning of the quarter up to over $120/barrel and back down now to $103/barrel.[xxiv] We expect that energy prices will remain somewhat elevated but are now seeing some demand destruction from the high oil prices. We are just starting to see consumers adjust their driving plans to reflect the higher oil prices.[xxv]

U.S. Economy

Despite the inflation picture and broader macro concerns, the U.S. economy has been fairly resilient. Employment has been strong with unemployment levels continuing to stay at 3.6%.[xxvi] Manufacturing numbers as seen with the Purchasing Managers Index (PMI) has stayed above 50, in expansion territory.[xxvii] Many consumers continue to have a high level of savings relative to historic data.[xxviii] However, we are starting to see cracks in the economy. First quarter GDP growth decreased 1.5%.[xxix] Additionally, 30-year mortgage rates have reached over 6% and high housing prices have caused the housing market and mortgage applications to cool.[xxx] Retail sales for May declined by 0.3%.[xxxi] Finally, the University of Michigan Consumer Sentiment has reached extremely low levels.[xxxii]

Performance Overview

The Anchor Mid Cap Value Portfolio returned outperformed the Russell Mid Cap Value Index for the quarter. On a relative basis, the Portfolio benefited the most from security selection in the Consumer Staples sector as well as an overweight allocation to Industrials and an underweight allocation to Real Estate. Security selection in Energy, Real Estate and Utilities were the greatest detractors from relative performance.[xxxiii]

Quarterly Attribution Highlights[xxxv]

Sector - Top 3 Contributors	Sector - Bottom 3 Detractors
Consumer Staples	Real Estate
Health Care	Utilities
Energy	Technology

Security - Top 5 Contributors	Avg. Weight %	Contribution %	Security - Bottom 5 Detractors	Avg. Weight %	Contribution %
Hubbell Incorporated (HUBB)	1.87%	0.38%	Liberty Broadband Corp. Class C (LBRDK)	1.61%	-0.59%
M&T Bank Corporation (MTB)	2.66%	0.23%	CarGurus, Inc. Class A (CARG)	1.71%	-0.53%
EPAM Systems, Inc. (EPAM)	1.22%	0.21%	Vontier Corp (VNT)	1.48%	-0.39%
Ubiquiti Inc. (UI)	1.31%	0.19%	Waters Corporation (WAT)	1.96%	-0.34%
Gartner, Inc. (IT)	1.57%	0.17%	Sun Communities, Inc. (SUI)	2.30%	-0.33%

Quarterly Transactions

Purchased	Sold
LKQ Corporation (LKQ)	GXO Logistics Inc (GXO)
Trane Technologies PLC (TT)	Zimmer Biomet Holdings Inc (ZBH)
Alexandria Real Estate Equities Inc (ARE)	Burlington Stores Inc (BURL)

Purchases

LKQ Corporation (LKQ) is a leading distributor of collision repair parts in North America and mechanical repair parts in Europe. LKQ distributes aftermarket products, recycle products, and remanufactured products to collision and mechanical repair shops. The company has grown from a $330 million revenue recycled products company in 2003 to a $13.5 billion revenue aftermarket distribution business. It is 30x in size to its nearest peer in the US and 10x its nearest peer in Europe. The company has a large moat thanks to its distribution network, fast fill times, fill rates and technology and has an outlook of 2% to 3% growth on top of inflation. LKQ is undervalued relative to specialty distribution peers and its long-term valuation. It is a market leader, has an above market ROA, strong FCF generation and should grow for years to come.

LKQ is an ESG oriented company. They have a goal to reduce emissions by 30% from 2021 to 2030 and be net zero emissions across the company by 2050. The company has a sustainability report which shows that they create a circular economy by selling used parts with their operation recovering more than 90% of the vehicle in recycling/remanufacturing parts. They have recycled over 2.1 million tires, 1.4 million catalytic converts, and over 740,000 batteries in 2021. The company also added an ESG component to management's long term cash incentives awares beginning with the 2021 to 2023 performance period.

Trane Technologies PLC (TT) is a global provider of climate solutions to buildings, homes and transportation. It is a pure play provider of commercial heating and colling systems. Trane has had higher growth that competitors and has been growing market share. They are dominant in the service space as they sell the service while selling the initial systems. We continue to see growth in this market globally and with changes in regulation many people are looking to replace their heating and colling systems to more efficient models. The stock pulled back with concerns over housing, but we found it as an attractive entry point.

Alexandria Real Estate Equities Inc (ARE) is a U.S. real estate investment trust (REIT) that owns and operates life science and technology properties. Alexandria's strategy has been to build clusters of properties in innovation centers like Boston and San Francisco. They tend to focus on high quality tenants such as larger, well established pharmaceutical and biotechnology companies. Occupancy has stayed at 95% over the last ten years. 90% of leases are with existing clients. Alexandria is excellent at recycling capital and rents have a 3% annual escalator. Generally, the stock trades at a premium in the market, but investors sold the stock on fears of a pullback in biotechnology market and higher interest rates. It presented Anchor an opportunity to buy a high-quality REIT that behaves defensively.

Sales

GXO Logistics Inc (GXO) provides outsourced warehouse and supply chain logistics for companies. It has successfully acquired new customers and improved margins. We sold out of the stock due to concerns about future volumes in e-commerce and postponement of new contracts.

Zimmer Biomet Holdings Inc (ZBH) is a medical device company that specializes in robots and instrumentation for hip and knee replacements. The company benefits from the tailwinds in the market but has lagged peers given it was behind in releasing a robot and has lost market share.

Burlington Stores Inc (BURL) is a U.S. off-priced retailer. They sell clothing, shoes, home goods, and toys at prices 20% to 70% less than department and specialty stores. Off priced retailers have been gaining market share as consumers have shifted their spending.

Consumers enjoy the treasure hunt experience and getting a value. Also, consumers have traded down to off-priced retailers in challenging economic conditions. Given the high inflationary environment consumers are focused on basic goods and not spending on discretionary goods. Given the macro environment we chose to sell ROST for better opportunities.

Anchor's Positioning

Since the beginning of the year Anchor has been defensively positioned across all strategies.[xxxvi] We reduced our exposure to higher growth and fully valued companies and sectors that are more likely to be impacted by higher interest rates and rotated into less expensive, more defensive companies and sectors. Certain health care, defense, insurance, utilities, and core consumer companies behaved defensively and performed better during the market sell-off and were positive contributors. We have also brought up cash levels across all strategies, which contributed to performance. We focused our efforts on downside protection and that has played out during the quarter, as we waited to see how inflation and interest rates played out. We believe that much of the excess over the last few years needs to be purged. On the fixed income side, we remain shorter duration, higher cash and defensively positioned to weather through the rates increases. We are being patient, and the investment team is working hard to uncover value-oriented opportunities that we can put to work once we see a bottoming process in the markets.

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[xxxvi] FactSet financial data and analytics

For a complete listing of all strategies contact Anchor Capital Advisors LLC (617) 338-3800.