Westwood®

Westwood **Quality SmallCap Fund (WHGSX)**

Commentary

4Q **2023**

Performance Highlights

- Small- and mid-cap stocks finally benefited from positive investor sentiment as a broad-based market rally pushed stocks higher to close the year. In this environment, the Westwood Quality SmallCap Fund performed in line with the benchmark Russell 2000 Value® Index. The Fund gained 15.02% in the fourth quarter, compared with 15.26% for the benchmark.
- The quarter began with a market pullback after a series of dispiriting economic releases that solidified the "higher for longer" interest rate trajectory caused markets to sink. The subsequent rally was sparked by a combination of strong earnings from bellwether companies, further confirmation that inflation was subsiding, and statements from the Federal Reserve that seemed to indicate that the rate hike regime had come to an end. The "Powell Pivot" took full effect, and the S&P 500 rallied 6.5% over the next eight trading days, finishing the calendar year within a small margin of all-time highs. The rally off the bottom was encouraging in that it spread beyond the Magnificent Seven, the large-cap stocks that had dominated the market performance for much of the year. Small- and mid-cap stocks participated, and value outperformed growth for the last two months of the year.
- Bonds also rallied, and the 10-year Treasury rates peaked at 4.98% on Oct. 19, then fell over 100 basis points to close at 3.88% in December, the same place they started the year. Market expectations changed quickly, moving from rate cuts in late 2024 to nearly even odds that the Fed would cut rates in March 2024. High-yield and investment-grade credit did particularly well in the fourth quarter, as investors see benign credit conditions tempering credit risk.
- Both asset allocation and security selection were positive factors in the quarter, with the combination of allocation and security selection — the interaction effect — being a negative contributor. Security selection was a positive factor in the **Industrials** and **Communication Services** sectors, while it was detrimental in the **Health Care** sector.
- The best-performing sector on a relative basis for the Fund were the **Industrials** and **Energy** sectors; for Industrials, stock selection was paramount, while our underweight position in Energy was beneficial. **Health Care** and **Consumer Staples** were the largest detractors in the quarter, mainly due to stock selection.

Performance Drivers

- On an absolute return basis, all but one of the 10 sectors posted positive returns in the quarter. Leading the pack in terms of absolute contribution were the **Financials** sector, followed by the **Communication Services** and **Consumer Discretionary** sectors. The only sector with a negative return was Energy, where we were underweight the benchmark.
- **Academy Sports and Outdoors Inc. (ASO)** was the leader for the quarter, gaining nearly 40% despite announcing lower earnings in the third quarter. Management was optimistic about the holiday shopping season, giving the stock a boost into December. Elsewhere, aerospace and defense contractor **Moog Inc. (MOG)** rallied on strong earnings, increased margins and enhanced 2024 guidance. Lumber and wallboard manufacturer **Boise Cascade Co. (BCC)** concluded a strong year by gaining more than 30%; the stock continued to soar on strong earnings and expectations of a resilient housing market.
- **First Bancorp (FBNC)** and **Seacoast Banking Corp. of Florida (SBCF)** were two of the top contributors in the quarter, among several banks making double-digit gains in our portfolio. Regional banks rebounded strongly in anticipation of the end of the Federal Reserve's rate hike campaign.

- Oil and gas production companies were among the top detractors in the quarter. The leading detractor was **Enerplus Corporation (ERF)**, an oil and gas production company with acreage in Canada. Also among the detractors were **SM Energy Company (SM)**, with production in the Midland Basin and South Texas, as well as **Northern Oil & Gas (NOG)**, which owns production in the Rocky Mountain regions. Energy stocks declined overall largely due to lower commodity prices, providing an attractive entry point for several companies that we own.
- **Livent Corp (LTHM)** also declined, as lithium prices have fallen due to inventory buildup in China and perceived weakening demand in battery-powered electric vehicles. Finally, **Masonite International Corp. (DOOR)** was a detractor in the quarter; the company's stock price soared 20% in mid-December, and then promptly came back to earth after a planned acquisition of PGT Innovations, a window manufacturer, ran into some controversy.

Performance Update

As of December 31, 2023

Trailing Years Performance

	4Q23	YTD	1 Year	3 Year*	5 Year*	10 Year*	Since Inception*
Westwood Quality SmallCap Fund	15.02%	17.17%	17.17%	9.48%	11.25%	7.72%	7.86%
Russell 2000 Value Index	15.26%	14.65%	14.65%	7.94%	10.00%	6.76%	6.17%

*Annualized

Calendar Year Returns

	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023
Westwood Quality SmallCap Fund	-32.11%	20.42%	23.23%	-1.40%	18.13%	49.39%	6.05%	-5.94%	28.33%	12.36%	-14.16%	27.13%	2.16%	27.93%	-12.46%	17.17%
Russell 2000 Value Index	-28.92%	20.58%	24.50%	-5.50%	18.05%	34.52%	4.22%	-7.47%	31.74%	7.84%	-12.86%	22.39%	4.63%	28.27%	-14.48%	14.65%

Inception date is 4/2/2007. High short-term performance of the fund is unusual and investors should not expect such performance to be repeated. **The performance data quoted represents past performance. Past performance is not indicative of future results. The investment return and principal value will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their 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 877.FUND.WHG.**Expense ratio for the fund is 1.04% (gross) and 0.92% (net). The Advisor has contractually agreed to waive fees and reimburse expense until March 1, 2024. In the absence of current fee waivers total return and yield would be reduced.

Potential Risks

Mutual fund investing involves risk, including possible loss of principal. There can be no assurance that the Fund will achieve its stated objectives. There are specific risks inherent in small cap investing such as greater share price volatility as compared to other funds that invest in stocks of companies with larger and potentially more stable market capitalizations.

Top 10 Holdings as of 12/31/2023

Alamo Group Inc.	Papa John's International Inc.
First Bancorp	Masonite International Corp.
Encore Wire Corp.	Albany International Corp.
Atlantic Union Bankshares Corp.	Seacoast Banking Corp. of Florida
Triumph Financial Inc.	Academy Sports and Outdoors Inc.

Top 10 Holdings represents 21.10% of the total portfolio and represents the ten largest portfolio positions by market value in the Fund as of the period end date. Each quarter, The Westwood Funds use this same objective, non-performance based criteria to select the ten largest holdings. Holdings are subject to change. Current and future portfolio holdings are subject to risk.

Fund Positioning and Trade Rationale

Positions were initiated in the following companies:

- **Constellium SE (CSTM),** a downstream aluminum producer, was added based on favorable demand trends of sustainability and reducing weight in larger machines, as well as a rising aerospace contribution to revenue and earnings.
- **SM Energy (SM)** is expected to leverage their technical staff to extract strong production growth from an underappreciated asset base, driving free cash flow and returns higher for shareholders.
- **Cogent Communications (CCOI)** was added after the company purchased Sprint's wireline business. The acquisition should provide cost savings and synergies that are underappreciated by the market.
- Western wear store **Boot Barn (BOOT)** was added to the portfolio as this category-killer has a long runway of growth and business has fully recovered post-pandemic.
- Car dealer **Sonic Automotive (SAH)**, best known for their EchoPark used vehicle segment, was added as the post-pandemic wholesale vehicle price spike has moderated, allowing the business to return to growth and profitability.

The following positions were sold from the portfolio:

- **Livent Corp. (LTHM)** was sold due to concerns about declining battery-electric vehicle demand and excess supply in the lithium market.
- **Avid Technology (AVID)**, a software and hardware manufacturer for video and audio content creation, was sold after the company agreed to be acquired by Symphony Technology Group for more than 10% over the current share price.
- **Skyward Specialty Insurance Group (SKWD)** was sold after the stock price eclipsed the analyst's price target, and the risk/reward profile became less attractive. The stock was sold to increase our allocation to other, more attractive positions.

Market Review

Despite mixed economic signals internationally and marginally positive economic data stateside, U.S. debt and equity investors clicked the buy button across the board with a few exceptions. U.S. consumers and the labor market remain resilient and healthy by most metrics, but there are hints of potential strain such as surging credit card debt, relatively low sentiment (which got a bump in December), and a still pricey and "stuck" housing market. The quarter certainly seemed to bring an end to the broad "higher for longer" interest rate concerns, but investors could be getting a bit ahead of themselves already pricing in six cuts for the Federal Reserve in 2024.

Reversals in both Treasury yields and the abrupt about-face in Fed speak around the timing of rate cuts fueled a nine-week rally of consecutive gains beginning in November. The rally pushed the S&P to a 26.29% return for the year with the index finishing within shouting range of its record high. The S&P 500 ended up 11.69% in the fourth quarter; November's gain of 9.13% was the largest monthly jump since May 1985.

The strongest quarter of performance for the year was also the broadest. Both the cyclically oriented Dow Jones Index and the tech-heavy Nasdaq outperformed the S&P and small-cap stocks finally outperformed large-cap stocks. Large-cap value continued to trail growth as the Russell 1000 Value Index gained 9.50% compared to 14.16% for the Russell 1000 Growth Index. Small-cap stocks finally rebounded with a strong quarter, as the Russell 2000 Index added 14.03%; in the small-cap world, value stocks 15.26% outgained growth names 12.75%.

Within the economy, CPI readings fell to the 3% range as the year closed, showing the slowest rate of increase since 2021 and leading to hope that the inflation monster may have finally been slain. Consumer sentiment continued to decline, though spending in the critical holiday season seemed to be elevated over previous years. Consumer debt levels remain elevated, though, and high interest rates on that consumer debt could spell trouble for this critical component of the economy.

The "Powell Pivot" sent bonds on a furious rally to close out the year. Bonds were looking to log a third consecutive year of negative returns until the end of October, when the Treasury decided to issue more short-term T-Bills, as opposed to longer-dated bonds. This, followed by Fed Chairman Powell's statements on Nov. 1 that were interpreted as dovish — moving their stance from "higher for longer" to a more accommodative position — caused the bond market to rally to the end of the year.

After advancing to nearly a 5% yield in late October, 10-year Treasury bond yields turned sharply lower during the fourth quarter and finished 2023 in roughly the same place as they began, at 3.88%. Two-year Treasuries fell nearly as much, as they had reached a peak of 5.19% in mid-October, falling to 4.23% to end the year. For the quarter, most of the Treasury curve rallied with the 2-year yield. The substantial decline in real yields — the inflation-adjusted cost of borrowing — drove most of the steep drop in nominal yields, largely due to investor expectations for future Fed easing.

Corporate credit also advanced in the fourth quarter, as investment-grade bonds added 8.15%, while high-yield bonds gained 7.17%. The spread between corporate and Treasury yields declined in the quarter, indicating optimism about defaults and continued economic gains into the new year. Overall, the broad market Bloomberg U.S. Aggregate Index gained 6.82% for the quarter, ending the year with a positive return of 5.53%.

As the year closed, the idea of a "soft landing" or perhaps no recession at all gained momentum, with the consensus assuming a rate cut in March or May of 2024. The broad-based rally to close 2023 certainly indicated that investor sentiment had shifted to positive territory, as volatility fell and many stocks — not just the megacap growth Magnificent Seven — achieved new highs. With 2023 firmly in the rearview mirror, we now have S&P 500 annualized returns for the past five years at 15.69%, well in excess of historical norms.

Outlook

An increasingly accommodative Fed rate trajectory can certainly be considered a bullish tailwind for 2024. Interest rates have plateaued and easing financial conditions are making their way into the markets. Core inflation can continue to push lower, with prices for shelter/housing and energy falling while U.S. production ramps up and global demand softens. But from a valuation perspective, interest rate cuts have thus far been telegraphed by the Federal Open Market Committee and are priced into the market.

Overall, consumers seem optimistic, but many have depleted savings and are increasingly levered with high-rate credit card debt. And while easing inflation is good for consumers, it reduces pricing power and margin growth for companies.

Earnings growth should accelerate in 2024 — coming off a low base in 2023 — and economic growth has been stronger than expected, driven by better real income growth and still-low unemployment. With ongoing concerns about employment and wage growth, however, the result may mean slower GDP growth overall in 2024 and 2025.

Another important milestone to note is that the S&P hit its all-time high almost two years ago, in early January 2022 (which technically marked the starting point of that year's bear market). Two years is a long time to remain below the previous all-time high unless we are in recession. Looking at all bear markets historically, stocks have taken a median of 48 months (about four years) to travel back to their preceding peak. But bear markets that do not include a recession like we experienced in 2022 have historically taken only 11 months to recover.

We will maintain our focus on the intersection of quality and value, seeking select businesses trading at an attractive valuation. These basic rules form a strong investment foundation that applies across the market capitalization spectrum. We feel that high-caliber, high-demand businesses with sustainable competitive advantages, strong cash flows, attractive dividends and a history of execution can be resilient in uncertain economic environments like we see today. Overall, we remain cautiously optimistic, the same sentiment noted as we entered 2023, but current opportunities are obviously far different.

Important Information

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