Slow and steady wins the race.
Aesop, The Hare and the Tortoise

Morgan Dempsey Large Cap Value Strategy
Fourth Quarter 2019

Market Commentary

Investors celebrated the end of the decade with a buying spree that drove equity indices to new highs. Investor enthusiasm appeared to be stoked by a reduction in U.S./China trade tensions and the opening of a new chapter of Federal Reserve monetary policy that flooded the markets with liquidity. This was a suitable finale for a decade of cheap money and strong equity returns that saw stock indices rise like the mythical Phoenix from the ashes of the Great Financial Crisis.

Index	Q4-2019	2019	10 Year*	20 Year*	30 Year*
S&P 500 Index	9.07%	31.49%	13.56%	6.06%	9.96%
Russell 1000 Growth Index	10.62%	36.39%	15.22%	5.18%	10.00%
Russell 1000 Value Index	7.41%	26.54%	11.80%	7.03%	9.81%
Russell 2000 Growth Index	11.39%	28.48%	13.01%	5.57%	8.15%
Russell 2000 Value Index	8.49%	22.39%	10.56%	9.41%	10.42%

*Annualized returns ending 12/31/2019
Source: Morningstar Direct

Trade negotiations between the U.S. and China took a positive turn on December 13th when the Trump Administration announced a "Phase I" deal. The scope of the agreement appeared to be limited, and the most difficult issues relegated to future discussions. This did not prevent the market from responding positively to this first step towards reducing trade tensions. While both the rumors surrounding the trade negotiations and the eventual agreement provided short-term catalysts for stocks, we believe that Federal Reserve policy played a far larger role in the outsized fourth-quarter equity returns.

The Fed reduced interest rates by .25% during its October 31st meeting. We expected this. What we didn't expected was an expansion of the Fed's repo program and the initiation of a new bond-buying initiative. The Federal Reserve's "temporary" lending program to Financial institutions through the use of repurchase agreements (repos) ballooned from approximately $105 billion in late September to nearly $256 billion by the end of the year. The Fed also introduced a program in mid-October to purchase Treasury bills at a pace of $60 billion per month until at least the second quarter of 2020 in order to try to keep short-term interest rates within the Fed's targeted range. What is interesting to us is that the Fed is once again growing its balance sheet and flooding the financial markets with liquidity at the same time that its Chairman is both extolling the strength of the economy and watching the U.S. stock market continue to reach record highs.

We have focused on the trade deal and Federal Reserve policy to try to explain the outsized fourth quarter returns because of weakness in that more traditional catalyst for market advances, corporate earnings. According to Factset, a financial database service, analysts' expectations for the S&P 500's year-over-year earning's growth during the fourth quarter of 2019 declined from +2.5% on September 30th, 2019 to -1.5% by the end of the year. If the actual reported earnings are in negative territory, the S&P 500 will have recorded four consecutive quarters of year-over-year earnings declines. The strong performance of the S&P 500 was driven not by higher earnings but almost exclusively by investors' willingness to pay more for each dollar of earnings (multiple expansion). While market participants may be expecting an earnings rebound in 2020 to justify this most recent rally, it seems to be a risky bet at this point in the economic and market cycles.

We have a hard time reconciling the extraordinary activities by the Federal Reserve with a solid economy. The Central bank's need to aggressively intervene in both the repo and T-Bill markets to meet investor demand for liquidity and control short term interest rates implies to us that the Financial markets are not functioning smoothly at their most basic level. While we don't have enough information to determine any specific reason for this problem (and we suspect that the Fed may not either), we believe there is something amiss. Although it was detrimental to our clients in terms of relative performance in 2019, we believe that it is important to remain cautious as the new year begins.

Large Cap Value Strategy

The large Cap Value Strategy (LCV) did not perform well during the fourth quarter. We maintained a defensive positioning within the portfolio with limited exposure to Cyclical and Financial names. This approach, when combined with our cash position, prevented the portfolio from participating as much as we would have liked in the significant market rally. At least for the fourth quarter, our portfolio approach was not rewarded.

We found few bright spots when we analyzed the Strategy's performance. From an allocation perspective, our underweight in Financials, overweight in Consumer Staples, and cash position all had a relevant negative contribution to the LCV's relative performance. We received minor positive contributions from our overweight in Information Technology and slight underweight in Utilities.

It was disappointing that our normally strong stock selection did not reward our clients during the quarter. Our strong relative stock selection in the Consumer Staples and Utility sectors was more than offset by the poor relative performance of our Financial, Information Technology, and Consumer Discretionary positions. Our focus on less cyclical companies with higher-yielding stocks was a detriment in a what we view as a speculative market environment.

The portfolio had a number of stocks that made a significant positive contribution to the Strategy's return during the quarter. These included Target Corporation, Altria Group, and Emerson Electric. Target Corporation owns and operates the Target general merchandise stores across the United States. Target executed at a high level, producing strong comparable store growth, higher-than-expected margins and strong digital sales growth. Store remodels and private label products continue to be a positive differentiator for the company. Altria Group manufactures and sells tobacco products and wine in the U.S. market. Altria beat analyst estimates for the quarter primarily because of strong pricing. While the company did write down its investment in JUUL, the e-cigarette manufacturer, Altria's launch of Philip Morris International's heat-not-burn product IQOS in the U.S. and its investment in the nicotine pouch business are two positive factors that should help catalyze the company's long-term growth. Emerson Electric primarily designs, manufactures and sells industrial valves & equipment, process control systems, and tools & HVAC solutions to industrial, commercial and consumer markets. While Emerson is struggling to grow its top line, the company's management continues an ongoing restructuring program that generates cost savings and contributes to bottom-line growth. Emerson expects to become more aggressive in pursuing bolt-on acquisitions if organic growth falters. The company also was the beneficiary of general strength in the industrial sector.

The portfolio also had a number of stocks that made a significant negative contribution to the Strategy's performance during the quarter. These included W.P. Carey, Six Flags Entertainment, and McDonald's Corporation. W.P. Carey is a REIT that focuses on the ownership of industrial, office and retail properties that are leased back to tenants using triple net leases. The company had lower-than-expected investment activity in the quarter primarily because it had difficulty finding attractive deals in an increasingly competitive environment. This contributed to its slightly reduced guidance for Adjusted Funds From Operation, a metric similar to Free Cash Flow, for full-year 2019. The stock price also was hurt by the relatively weak performance of REITs during the quarter. Six Flags Entertainment operates theme parks under the brand name Six Flags. Six Flags generated less cash flow than expected primarily due to slowing active pass growth and lower spending by park visitors. Six's international business also continued to disappoint investors. McDonald's operates and franchises the eponymously-named restaurants. McDonald's earnings per share for the quarter missed expectations primarily due to both weaker franchise margins and higher expenses driven by remodeling and technology investments. A slowdown in U.S. store traffic also was a negative during the quarter. While the lower U.S. traffic is troubling, the company's investments to upgrade its restaurants and technology should be a long-term positive for both the company and the stock.

We were disappointed, but not surprised, by the LCV's weak relative performance during the fourth quarter. The Strategy's philosophy of focusing on less cyclical companies with the potential to consistently grow dividends is generally detrimental during euphoric market rallies that are skewed towards cyclically oriented companies. Unfortunately, this was just such a period.

While the LCV's fourth quarter performance was disappointing, its 2019 calendar year performance up-capture in a very strong market was 76%. This is in-line with the Strategy's long-term historical characteristics. Since the LCV's inception, the up-capture ratio relative to the Russell 1000 Value Index has averaged 79.2% on a rolling 1-year basis and since the end of the Financial Crisis (March 2009), the up-capture ratio has averaged 71% on a rolling 1-year basis.

We believe that reviewing historical performance within various market return conditions can provide a better understanding of the strategy and provide a guide for expected relative performance. We have categorized the Russell 1000 Value Index rolling 1-year returns into five different total return ranges and have calculated the corresponding 1-year average return within each range for the Strategy and Russell 1000 Value Index in the chart below.

Range of Returns Russell 1000 Value Index	Number of 1-Year Rolling Periods	MDCM-Large Value Average Return	Russell 1000 Value Average Return
Greater Than 20%	43	24.91%	27.76%
10% To 20%	76	17.39%	15.42%
0 to 10%	42	10.84%	5.57%
-10% to 0%	18	.85%	-4.47%
Less Than -10%	17	-15.34%	-28.55%

Note: Time period measured October 2002 – December 2019; returns are gross of fees. Past performance is not indicative of future results.
Data source: Morningstar Direct. 1-year rolling returns with a 1-month shift: 196 return observations

We suspect that it will be difficult for U.S. large-cap stocks to generate above average returns over the next three to five years because earnings will need to catch up to their current valuation levels. This would mean that the one-year Russell 1000 Value returns will likely come in below the 20% range over that time period. If we are correct and the historical performance pattern holds, the Strategy should provide good relative performance for our clients.

We believed that it made sense to maintain a conservative portfolio positioning during a period of declining earnings growth and heightened geopolitical uncertainty with equity markets trading at all-time highs. We still do. What we didn't anticipate was massive intervention by the Federal Reserve in both the repo and T-Bill markets that provided significant fuel for a value-insensitive rush into risk assets, particularly equities.

We are not willing to chase the current market rally. While we know that the Strategy's limited participation in the fourth quarter's explosive stock returns was painful for our clients, we won't deviate from our investment approach to try to capture more upside during the later stages of what we believe to be a Fed inspired market melt-up. It makes even more sense to us to continue to play defense at this time.

111 Heritage Reserve Suite 200 Menomonee Falls, Wisconsin 53051 414-319-1080 Fax 414-319-1087

www.morgandempsey.com