RS SMALL CAP VALUE STRATEGY QUARTERLY COMMENTARY

RS Investments®
A VICTORY CAPITAL® INVESTMENT FRANCHISE

As of June 30, 2021

Market Commentary

U.S. equity markets exhibited continued strength in the second quarter as the global economy appears to be returning to normal following the successful domestic rollout of COVID-19 vaccinations. In addition, earnings expectations and investor sentiment have been buoyed by the Federal Reserve's accommodative monetary stance, not to mention the news that an outsized infrastructure deal may finally be poised to pass after years of speculation. Interestingly, this may have positive ramifications for some value-oriented equities, including traditional industrial/materials companies, natural resources businesses and financials, to name a few. As the quarter ended, markets moved higher as some investors embraced the view that inflation concerns were perhaps a bit overblown, though the debate still rages whether the recently elevated inflation data is transitional in nature or not.

An underlying theme for U.S. equity markets has seen value-oriented cyclical stocks (loosely defined as those with fundamentals that are closely tied to short-term economic output) outperform growth-oriented secular stocks (defined as those stocks less sensitive to short-term economic output, as they typically take market share from legacy companies). This cyclical versus secular tug-of-war had also taken place within indices, as many sectors that lagged during the first 10 months of 2020 stepped up to lead markets higher in the fourth quarter of 2020 and again in early 2021. These included energy, producer durables, materials & processing, and consumer staples companies. As a result, the Russell 3000® Value Index outperformed the Russell 3000® Growth Index, rising 17.67% versus 12.71% for the first half of 2021.

All equity styles continued to perform well in absolute terms during the second quarter, with the Russell 3000® Value Index rising 5.16%. In terms of market cap performance, large companies led the way during the second quarter as the Russell 1000® Index returned 8.54%, outperforming both the Russell Midcap® Index and the Russell 2000® Index, which returned 7.50% and 4.29%, respectively.

Today, unemployment is approximately 6%, inflation is running hot above 5.0% (regardless of whether it's transitory or not), and perhaps most importantly, the S&P 500® Index is trading near 21x earnings. Given the current lofty valuations and the degree of Federal Reserve accommodation, we think that this is a market environment where stock selection will once again matter significantly. In fact, we anticipate that companies that exhibit pricing power with the ability to offset rising input, wage, and other inflationary costs may be poised to outperform, including many names in the consumer staples, industrials, and natural resources sectors. In the mid to longer term, this environment looks conducive to value-oriented investors going forward, particularly if capital flees the growth sectors when the Federal Reserve inevitably begins tapering its quantitative easing programs.

Performance Review

For the three months ended June 30, 2021, the RS Small Cap Value strategy underperformed its benchmark Russell 2000® Value Index (the "Index") and returned 4.02% net versus 4.56% for the Index.

In the second quarter, relative performance was aided by stock selection in the Materials and Energy sectors, which was offset by performance in Communication Services and Consumer Discretionary.

Investment Strategy

The RS Value Team seeks to invest in good companies, led by strong management teams, which are attractively valued. Our decision to invest in any company starts with business analysis and an understanding of the company's unit-level economics. Our work on unit-level economics helps us determine the quality and key drivers of the business. We are Return on Invested Capital (ROIC)–focused investors and seek to invest in companies that can create shareholder value due to an improvement in the returns of the existing assets or through attractive reinvestment opportunities. We are long-term investors who use our investment time horizon as a competitive advantage and are attracted to out-of-favor and/or misunderstood companies in the market.

The next step in our process is to assess the management team. Our evaluation of a company's management team is critical to our investment decision. We regularly meet with management to gauge how they think about their business: Are they focused on (and compensated for) growing earnings at any cost, or do they understand return on invested capital (ROIC) and how value is created? Additionally, we perform detailed historical analyses of management's capital decisions—looking at acquisitions, asset sales, and measures of capital stewardship. This analysis provides us with the conviction to invest with strong management teams that are able to navigate through short-term market volatility and deliver long-term shareholder value.

The final step in our analysis is valuation. To the RS Value Team, value investing is buying a business at a discount to what we believe it is actually worth. We determine what a company is worth by assessing a company's current share price versus its future cash flow streams or long-term net asset value based upon the management team's plan for value creation. ROIC is the lens through which we analyze that value creation. Our research has shown that, over time, stock price performance has a higher correlation to improving ROIC as opposed to traditional valuation measurements like price to earnings (P/E). We seek to invest in companies that can create shareholder value due to an improvement in the returns of the existing assets or through attractive reinvestment opportunities. We pay close attention to a company's financial strength, scrutinizing financial statements, and we run various financial models to understand our downside. This quantitative analysis gives us confidence in our investment thesis and helps us determine at what stock price we are comfortable investing.

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Select Position Review

Below, we review two businesses in an effort to use tangible examples to highlight our investment process.

Cognate Software (CGNT) provides security analytics software to enterprises, police forces and governments. The software fuses, analyzes and visualizes disparate data sets to help identify, track and connect relationships of bad actors. CGNT was spun out of our portfolio company Verint Systems in February. We have been encouraging Verint management for years to spin out this asset because it is fundamentally different than Verint's core call center software and are excited that it has finally happened.

Often small spin-out companies initially trade down because certain shareholders of the parent company either can't (due to market cap restrictions) or don't (due to a lack of understanding of the non-core business) hold the new shares and indiscriminately sell them after the spinoff. This happened to CGNT as the stock price fell as much as 25% in the 5 months since its spin out. Since we know the business well and are bullish on its prospects, we used this opportunity to meaningfully increase our ownership of CGNT.

Meritor (MTOR) is a provider of drivetrain, braking, aftermarket and electric powertrain solutions for the commercial truck and industrial markets. Over the past few years, the company has been investing in electric powertrain solutions as its customers start to transition to electric vehicles while continuing to provide advanced powertrain components for new internal combustion trucks that are still used by transport and logistics companies today. The company has focused on improving its balance sheet and reducing its pension liabilities such that much more of its excess cash flow will now go to shareholders or value-enhancing acquisitions. MTOR continues to progress toward its 2022 goals of higher margins and better capital efficiency, and we believe the company will outperform the market as it executes on its strategy and provides higher return on invested capital (ROIC) over the next few years.

Recently, Meritor has underperformed the market as investors have become concerned over rising steel prices and the duration of the commercial truck cycle. As the world economy has started to emerge from the pandemic, many commodities, including steel, have risen dramatically. Steel is an important component of Meritor's products and, while the company has mechanisms to pass along most of the price increases, there is a lag between the increase in the price of the raw material and when Meritor recoups the excess cost. Consequently, the company's anticipated margin increases are being pushed out by a couple of quarters. Additionally, the market is concerned over how long the strong demand for commercial trucks will last. With orders already very healthy, the market is anticipating we are at peak levels and is expecting growth to slow. However, we believe that with supply-chain shortages and a robust consumer and industrial environment, there can be an extended cycle of truck orders over the next couple of years. Looking beyond the market's immediate concerns, Meritor has positioned itself well to capitalize on the transition to electric vehicles, winning content on OEM developments in this space. Meritor should continue to show solid margins and improving returns on capital over the next few years, and we believe the company will prove to be a profitable investment.

Outlook

The first half of 2021 provided a more optimistic outlook as the rollout of the COVID-19 vaccines hit full stride, further fiscal stimulus was injected into the economy, and the expectation for continued low interest rates and an infrastructure bill increased confidence that an economic normalization was taking hold. We are clearly in the early stages of a new economic cycle, following the pandemic-led recession of 2020. The progress on vaccinations has allowed the U.S. economy to reopen and begin to return to normalcy with dining out, air travel, and large group gatherings. The U.S. elections are behind us, and although they were hotly contested and resulted in a change in administration, the narrow margins in Congress should temper any radical changes.

Interest and mortgage rates continue near historically low levels and inflation remains in check, although there are signs that this may be changing. We remain very watchful of inflation, particularly as a result of the size and speed of the monetary and fiscal response to the pandemic. The Federal Reserve (as well as many economists) is forecasting a rise of ~2.5% in the Consumer Price Index; many believe the spike is temporary, suggesting that markets reflect that level of comfort. The risk, therefore, is that it is not temporary, and that Treasury yields could begin to reflect a very different assumption. We are reminded of 2013 and what happens when markets adjust to a surprising new outlook, as we saw the 10-year U.S. Treasury yield rise by more than 100 bps that year.

Equity valuations are in the top decile compared to historical levels, in part due to depressed earnings resulting from the COVID-19 pandemic, but also as a result of multiple expansion in the six largest mega-cap stocks in the S&P 500. Excluding the six largest mega-cap stocks, valuations are more reasonable, particularly if compared to the 10-year U.S. Treasury yield. Recovery in aggregate earnings will be tempered, as certain industries such as hospitality, entertainment, banking, and travel will take longer to return to pre-coronavirus levels. However, equities continue to look attractive when compared to Treasuries and high-grade corporate bonds after the flight to safety rally during the crisis. In any case, we feel the values inherent in your portfolio should attract other investors and acquirers over time.

We thank you, as always, for your support.

Sincerely,

RS Value Team

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Top Contributors (Representative Account)
As of June 30, 2021

Holding	% Contribution to Return
NCR Corporation	0.63
PDC Energy, Inc.	0.61
Magnolia Oil & Gas Corp. Class A	0.53
Summit Materials, Inc. Class A	0.43
Constellium SE Class A	0.33

Top Detractors (Representative Account)
As of June 30, 2021

Holding	% Contribution to Return
Meritor, Inc.	-0.32
Taylor Morrison Home Corporation	-0.20
Brinker International, Inc.	-0.19
SkyWest, Inc.	-0.17
ArcBest Corporation	-0.14

Performance quoted represents past performance and does not guarantee future results. Investing involves risk, including the possible loss of principal and fluctuation of value. There is no assurance the investment process will lead to successful investing.

Returns are expressed in U.S. dollars. Composite returns are net of transaction costs and net of non-reclaimable withholding taxes, if any, and reflect the reinvestment of dividends and other earnings.

Gross-of-fees returns are presented before management and custodial fees but after all trading expenses. Net-of-fees returns are calculated by deducting one-twelfth of the highest tier of the standard fee schedule in effect for the period noted (the model fee). The composite model fee for each period is either the highest tier of the current fee schedule or a higher value, whichever is required to ensure the model composite net-of-fee return is lower than or equal to the composite net-of-fee return calculated using actual fees. Actual fees may vary depending on, among other things, the applicable fee schedule and portfolio size. The firm's fees are available on request and may be found on Part II of its Form ADV.

Index returns are provided to represent the investment environment during the periods shown. The index is fully invested, including the reinvestment of dividends and capital gains. Index returns do not include transaction costs, management fees or other costs. Non-U.S. indices are net of withholding taxes, if any.

The opinions are those of the authors as of the time of this writing and are subject to change at any time due to changes in market or economic conditions. The comments should not be construed as a recommendation of individual holdings or market sectors, but as an illustration of broader themes.

Portfolio holdings are subject to change and should not be considered a recommendation to buy or sell individual securities. A complete list of all recommendations of security selection is available by request for the previous 12 months. Victory Capital Management Inc., and its affiliates, as agents for their clients, and any of its officers or employees, may have a beneficial interest or position in any of the securities mentioned, which may be contrary to any opinion or projection expressed in this report. This information should not be relied upon as research or investment advice regarding any security in particular.

The RS Small Cap Value Strategy primarily invests in a diversified portfolio of small-cap companies.

Information relating to portfolio holdings is based on the representative account in the composite and may vary for other accounts in the strategy due to asset size, client guidelines, and other factors. The representative account is believed to most closely reflect the current portfolio management style.

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