Denali Network Value Small
1Q 2022 Commentary

- The rapid spread of the omicron variants of Covid-19 pushed US infection rates far above previous peaks in January, with death rates briefly approaching those of the prior winter, slowing the economy. Corporate profit growth stalled, but inflation mounted to 40-year highs, pushing up interest rates and setting off a swift equity market correction, in which Value held up much better than Growth. When Russia invaded Ukraine in February, US stocks incongruously surged upwards, led by large Growth stocks and the Energy sector.
- Our **Network Value Small** composite returned -3.41% in Q1 gross of fees (-3.53% net), while the Russell 2000 Value benchmark lost 2.40%. In the past year the strategy gained 7.04% (6.57% net), well ahead of the benchmark's 3.32%.
- In a reversal from the previous quarter, benchmark stocks with profits for the past year lost on average almost 4% for the quarter, while the nearly 3/8 of constituents reporting losses gained more than 2%. Our position favoring stocks with higher E/P ratios and avoiding loss makers accounted for about 85 bp of our 101 bp active shortfall.
- The smallest two quintiles by market cap had the largest losses; our underweight to these micro caps contributed 50 bp.
- Our Network Value Index*, focused on stocks with both higher earnings and lower liquidity, declined 5.49.% for Q1, trailing the Value style benchmark but 2% ahead of the broad Russell 2000.
- The stock-level Network Value forecast was modestly successful within small caps in Q1. Our Detailed Estimates model had quite good predictive performance, as did our Intrinsic Value forecast, reflecting attentiveness to expected earnings. Characteristics Trend model results were somewhat negative amid continuing factor return volatility.
- Linear attribution shows that while exposure to higher reported E/P detracted, higher forecast E/P had a large positive contribution, as did higher Sales/Price. Cash Flow/Price and B/P were also beneficial, as was exposure to dividend payers. Our higher sales/assets and current assets/liabilities ratios and lower relative liquidity were detractors.
- GICS sector allocation produced a negative impact of about 235 bp, almost all from underweighting Energy. Favoring Financials and avoiding Utilities also detracted, while a Health Care underweight helped. Selection within sectors was good, most successful in Health Care (pharma over biotech), Technology (distribution), Materials, Financials (insurance) and Industrials (transport). Only Energy had meaningful negative selection.

Market Outlook

War, pandemic and economic developments all pushed the economy and capital markets around rather roughly in the first quarter of 2022. The fast-spreading omicron variants of Covid-19 pushed US infection rates far above previous peaks in January, with death rates briefly approaching those of the prior winter. This wave burned through the population quickly, however, and by February infection rates were dropping sharply. U.S. economic growth reached 6.9% over the prior quarter in Q4, higher than expected, but the omicron wave slowed the momentum; quarterly growth is estimated at just 1.5% for Q1. Unemployment dropped further, to 3.8% in Q1. But inflation reports set successive multi-decade highs; the CPI was 8% higher than a year ago in Q1, and the Fed's preferred core measurement was estimated up 5.4%. Investors concluded that rather than winding down monetary accommodation, the Federal Reserve would need to reverse it rather sharply. Ten-year Treasury yields rose above 2% in February. Rising costs are expected to impact corporate profitability, and no quarterly earnings growth is seen in estimates for Q1. These pressures on earnings and valuations set off a swift correction in the equity market, with the Russell 3000 losing 11.7% through Feb. 23. Value stocks held up much better than Growth, outperforming by almost 11%.

Then, on Feb. 24, Russia invaded Ukraine. The reaction of the U.S. stock market was, rather incongruously, a surge upwards, led by large Growth stocks and, far and away, by the Energy sector, with oil prices spiking over $100 a barrel. The Russell 3000 gained 7.3% in the five weeks through the end of March. This seems to point up the extent to which U.S. large Growth stocks are viewed as a safe haven, in an environment where rising rates impair the ability of Treasury bonds to play that role.

The FOMC did begin raising short-term rates at their March meeting, and 10-year Treasury yields ended the quarter up 80 bp at 2.32%. For the complete quarter, the Russell 3000 index finished with a loss of 5.28%. The large cap Russell 1000 outperformed the small cap Russell 2000 for a fourth consecutive quarter, by 2.4% in Q1. Value outperformed Growth by 8.3% among large caps and 10.2% within small caps, with a good amount of the outperformance provided by Energy stocks. Volatility in the relative performance of the style indexes remained near its highest in 20 years.

We expect the heightened volatility of Value vs. Growth performance to persist, while over time we expect to see Value continue to take two steps forward and one step back vs. Growth. We are now commencing the removal of extremely accommodative monetary policy steps. Rising interest rates will continue to benefit Financials (heavily represented among both Value and small cap stocks) and pressure high valuation multiples. Inflation should be a relative benefit to producers of material goods, and not necessarily to those of virtual goods. With the tide of interest rates rising for a long time to come, it seems doubtful that the historically very high valuation differentials between Growth and Value (and between large and small cap stocks) that had persisted for several years before this recent accelerated market cycle can be maintained, and indeed they have begun to revert significantly toward normal levels. We expect to see this continue and eventually penetrate that largest cohort of “safe haven” large Growth stocks. The first quarter saw some large bumps in the road towards normalization, but we expect that process to continue, which should present a favorable environment for our valuation-oriented strategies for some time to come.

Denali Network Value Small GIPS Composite Disclosures

Denali Advisors, LLC claims compliance with the Global Investment Performance Standards (GIPS®) and has prepared and presented this report in compliance with the GIPS standards. Denali Advisors has been independently verified for the periods April 1, 2007, through December 31, 2021. The verification report is available upon request. A firm that claims compliance with the GIPS standards must establish policies and procedures for complying with all the applicable requirements of the GIPS standards. Verification provides assurance on whether the firm's policies and procedures related to composite and pooled fund maintenance, as well as the calculation, presentation, and distribution of performance, have been designed in compliance with the GIPS standards and have been implemented on a firm-wide basis. Verification does not provide assurance on the accuracy of any specific performance report. The Denali Network Value Small composites has had a performance examination for the periods June 30, 2021, through December 31, 2021. The performance examination report is available upon request. Denali is an independent registered investment advisor. Results are based on fully discretionary accounts under management, including those accounts no longer with the firm. Denali was established in 2001 and manages equity and alternative assets for primarily institutional clients. The U.S. dollar is the currency used to express performance. The annual composite dispersion presented is an asset-weighted standard deviation calculated for the accounts in the composite the entire year. Leverage is not used. Additional information regarding Denali’s policies and procedures for valuing portfolios, calculating performance and preparing GIPS Reports is available upon request. The firm’s list of composite and pooled fund descriptions is available upon request. Please contact Anne Erickson at Anne@DenaliAdvisors.com.

Denali Network Value Small: Composite consists of fully discretionary small cap portfolios. Results are compared against the Russell 2000 Value and intend to outperform that benchmark while maintaining similar sector, industry and security characteristics. The Denali Network Value Small Composite inception and creation date is June 1, 2013. As of February 18, 2016, the secondary benchmark Russell 2000 was removed as it is no longer representative of the strategy. The NV Small portfolio construction is based on the analysis of earnings, liquidity and other characteristics of selected companies from the Russell 2000 index. Returns are presented gross and net of management fees and include the reinvestment of all income. The composite was comprised of 100% non-fee-paying accounts for periods presented through March 31, 2019, net returns were calculated by reducing gross monthly returns by a model management fee of 1%. As of April 1, 2019, the net returns have been calculated using actual management fees. The management fee for this product is 1.00%. Client returns will be reduced by advisory and other expenses the client may incur. There is a marketing minimum of $1 million. Past performance is not indicative of future results.

***Network Value Small Index**: The results presented reflect research returns of a historical simulation of the construction process for the Denali Network Value Large index beginning at the end of December 1994 and tested through April 2013, combined with the results of index portfolios constructed contemporaneously each month from May 2013 through the most recent month-end. Index portfolios were rebalanced as of the end of each month of the historical period using historical data available at the time as input to Denali's proprietary Network Value index construction process. The security selection universe was the membership of the Russell 2000 index, which is meant to represent the investable small cap stock universe in the United States. Data used in the historical simulation was sourced from Compustat, and the Barra U.S. Equity model was used for performance calculation. Real time performance presented for periods since May 2013 is without the benefit of hindsight in model development. This Index is not offered as an investment vehicle and like all indexes is not directly investable; the returns do not account for any transaction costs of rebalancing.

Denali Network Value Small		Composite Assets		Annual Performance Results				3-Year Annualized Standard Deviation*	
Year End	Total Firm Assets (millions)	US Dollars (Millions)	Accounts in composite	Composite Gross	Composite Net	Russell 2000 Value	Composite Dispersion	Composite	Benchmark
2021	426	227	Five or Fewer	34.70%	34.15%	28.27%	N.A	25.50%	25.35%
2020	729	197	Five or Fewer	3.60%	3.19%	4.63%	N.A.	25.65%	26.49%
2019	1,338	116	Five or Fewer	24.01%	23.42%	22.39%	N.A.	15.16%	15.90%
2018	1,401	Less than a million	Five or Fewer	-5.89%	-6.85%	-12.86%	N.A.	14.93%	15.98%
2017	1,311	Less than a million	Five or Fewer	5.83%	4.79%	7.84%	N.A.	14.67%	14.17%
2016	762	Less than a million	Five or Fewer	28.85%	27.64%	31.74%	N.A.	16.48%	15.72%
2015	476	Less than a million	Five or fewer	-2.58%	-3.56%	-7.47%	N.A.	N.A.	N.A.
2014	357	Less than a million	Five or Fewer	8.53%	7.47%	4.22%	N.A	N.A	N.A
6/01/2013 - 12/31/2013	323	Less than a million	Five or Fewer	24.60%	23.94%	17.12%	N.A.	N.A.	N.A.