Denali Network Value Small
2Q 2021 Commentary

- Progress on Covid vaccination campaigns and economic re-opening continued to propel U.S. stocks to new highs. But the emergence of a virulent new variant pushed investor preferences away from economically sensitive companies back toward large Growth stocks and pulled down interest rates. Volatility in the relative performance of Value vs. Growth and large caps vs. small caps (Russell 2000) are both the highest since 2002, in the aftermath of the tech stock bubble.
- Our **Network Value Small** composite gained 1.39% in Q2 (gross of fees), trailing the benchmark Russell 2000 Value Index's 4.56% return.
- Among small caps, the 40% of benchmark stocks reporting losses for the past year strongly outperformed those reporting profits, in contrast to the large caps, where the 20% reporting losses underperformed, suggesting that normalization is taking longer for smaller firms. Our position favoring higher E/P quintiles and avoiding loss makers accounted for about 90% of our active shortfall.
- Our overweight in smaller cap (lower liquidity) stocks added around 20 bp to our active performance.
- Our Network Value Index, focused on stocks with both higher earnings and lower liquidity, gained 3.00% for Q2, accounting for about half of our underperformance.
- Reversing from Q1, the stock-level Network Value and Intrinsic Value forecasts had negative predictive performance, consistent with the less favorable environment for Value and high Earnings stocks. Characteristics Trend model results were slightly negative amid continuing factor return volatility. Detailed Estimates forecast results were good.
- Again this quarter, linear attribution shows exposure to higher reported E/P was the worst detractor from active return, but forecast E/P was most positive and other valuation ratios (Cash Flow, Sales, Book Value) were beneficial, as was higher ROE. Our lower average momentum, higher Current Ratio, lower relative liquidity and slightly lower beta were detractors from active performance.
- GICS sector allocation had a small negative impact; positive exposure to Financials and negative to Energy detracted, but favoring Communications and avoiding Utilities helped. Selection within sectors was most negative in Communications (no AMC), and detracted in Discretionary (recreation), Materials and Financials (banks).

Market Outlook

The course of the Covid-19 pandemic is still a main driver of the economic and investment environment. In the U.S., as vaccines reached a majority of the population by June, Covid cases and death rates fell to the lowest since the beginning of the pandemic. The U.S. economy continued to recover strongly as restrictions and risks abated; the consensus estimate compiled by Bloomberg is that GDP grew at a 9% rate in the second quarter, and is forecast to grow faster than 5% in each of the next two quarters. Government policy has somewhat slowed the decline in unemployment, but that is now predicted to fall below 5% by year end. Quarterly profits for the S&P 500 surpassed pre-pandemic highs by more than 12% in both Q1 and Q2, with a further 8% rise predicted by Q4. In response, the U.S. equity market continued its ascent to new record highs. The Russell 3000 Index gained 8.2% in Q1 and 15.1% for the year to date.

As a counterpoint, however, fewer vaccinations and the emergence of new, more contagious virus variants set back progress in much of the rest of the world, with surges in infections and deaths in South Asia and Latin America, and much of the Asia-Pacific region unable to advance in re-opening due to low vaccination rates. One result was increased safe-haven demand for U.S. Treasuries which unexpectedly drove U.S. interest rates back down, with the 10-year Treasury yield falling 30 bp to 1.45% in the quarter (and lower since). This helped push investor preferences away from Financials, economically sensitive and smaller cap stocks, back towards large Growth stocks. In fact, Growth outperformed Value in the Russell 1000 in June by 7.4%, the most in any month since 2001, and 5.3% in the Russell 2000.

We expect heightened volatility in the relative performance of Value and Growth to continue. In fact, the annualized volatility in the relative performance of the Russell 1000 style indexes is now the highest since 2001 in the aftermath of the Tech bubble. (Volatility in the relative performance of large and small caps is also now the highest since 2003). But as in that earlier era, we expect the medium term trend to strongly favor Value over Growth. Partly this is because we are seeing the beginning of the end for extreme accommodation in monetary policy. With fast economic growth running into supply constraints, inflation is becoming visible, with CPI rising at about 4% and the Fed’s preferred core measure around 3%. The FOMC will begin tapering their asset purchases in the foreseeable future, and short term interest rate increases are not many quarters away. Inflation expectations and interest rates turning up from very low levels will benefit Financials (heavily represented among both Value and small cap stocks) and pressure high valuation multiples. 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 have only just begun to revert toward normal levels. Normalizing markets have generally been friendly to valuation-oriented strategies.

Denali Network Value Small GIPS Composite Report

Performance numbers presented on pages A-1B.
Returns are presented gross and net of management fees and include the reinvestment of all income. Actual investment management fees are used to calculate net of fees returns unless otherwise noted in the composite specific disclosures. Past performance is not indicative of future results.

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, 2020. 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. 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 available upon request. The firm's list of composite 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 01, 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. 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 $5 million.

Denali Network Value Small		Composite Assets		Annual Performance Results				3-Year Annualized Standard Deviation*	
				Composite					
Year End	Total Firm Assets (millions)	US Dollars (Millions)	Accounts in composite	Gross	Net	Russell 2000 Value	Composite Dispersion	Composite	Benchmark
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.

*3-Year Annualized Standard Deviation and Composite Dispersion is calculated using gross of fees returns. N.A. means an insufficient number of portfolios or insufficient number of periods.