

# Structured Small/Mid Cap Core Equity

Quarterly Commentary

Third Quarter 2018

## Market Commentary

During the third quarter, the U.S. domestic backdrop continued to be highly positive for small-cap equities. The economy continued to grow at a steady pace, while interest rates edged up to more historically typical levels. Earnings, employment, and future profit growth expectations remained strong.

While overall equity market performance trended positively, the drivers behind stock price performance shifted as the third quarter progressed. Within the small-cap equity universe, performance in July was driven by cyclical sectors, such as Industrials and Materials, with each posting sector returns in excess of 3% for the month. As a result, small-cap value stocks outperformed their growth counterparts, as measured by the Russell 2000 Value and Russell 2000 Growth indexes, respectively. A rise in investor sentiment in growth-oriented sectors helped drive the Russell 2000 Index for August, although absolute returns were less robust as the quarter continued. The Russell 2000 Index posted a negative absolute return for September, with Telecommunications as the only positive sector.

While growth outperformed value in a reversal from the previous quarter, it was a continuation of the trend that has persisted for nearly the last two years. Besides second quarter 2018, the last time value outperformed growth was during fourth quarter 2016. We believe growth has and will continue to lead the market on the basis of a growing economy, strong corporate earnings, and low unemployment, among other factors.

So far this year, size (i.e., market capitalization) has been a notable driver of returns. As of the end of September, on a year-to-date basis, small-cap stocks have outperformed large caps, as measured by the Russell 2000 and S&P 500 indexes, respectively, with a majority of the gains occurring during the second quarter. Large caps outperformed small caps in the third quarter, which narrowed the year-to-date gap. Within the small-cap universe, larger market-cap stocks in the index also outperformed.

Because our models favor larger-cap stocks among the overall small-cap universe, when the market favors the highest market caps of the group, this creates a tailwind for our process. The weighted average market-cap for the Structured Equity portfolios will almost always be notably higher than the Index, due to the risk constraints we place on portfolios construction related to liquidity and solvency.

Looking forward, we believe there is a strong positive outlook for consumers as we approach the tax return season. Given recent changes to the individual income tax code, leading researchers anticipate that workers may receive higher tax refunds next year. We anticipate this extra income will propel the Consumer Discretionary sector through 2019.

Additionally, the impact of tax reform is ongoing and contributing to a positive fundamental backdrop for U.S. businesses as well. Corporate earnings growth has been strong, as expected, but revenue growth has also been robust, indicating businesses are getting a boost beyond the bottom line. Notably, the National Federation of Independent Business's Small Business Optimism Index reached new highs during the quarter. In August, the index soared to 108.8, topping the July 1983 high-water mark of 108. This index, based on a survey of small and independent business owners, measures expectations for compensation, profits, sales, inventory levels, and employment, among others. Fortunately, this optimism has persisted in spite of ongoing international trade tariff disputes, which escalated further during the quarter, particularly between the U.S. and China.

We expect investors to continue to favor more growth-centric companies, such as those within the Information Technology and Consumer Discretionary sectors. Earnings dispersion, a factor measuring the variation in analyst estimates, has been one of the strongest factors over the trailing 12-month period, suggesting consensus among analysts has been a driving force behind market returns year-to-date. At this point in the business cycle, valuations have not been a driver of investor interest, a condition that we believe will persist until there is a notable shift in the market. Until we see valuation compression, we expect valuation will take a back seat to persistent trends and growth.

## STRUCTURED SMALL/MID CAP CORE EQUITY

### Performance Summary

For the quarter ended September 30, 2018, the PNC Capital Advisors Small/Mid Cap Core Equity Composite outperformed its benchmark, the Russell 2500 Index, on a gross of fees basis, returning 4.79%, but underperformed net of fees, returning 4.57%. This compares with a return of 4.70% for the Russell 2500 Index during the same period.

# Structured Small/Mid Cap Core Equity

Performance Summary as of September 30, 2018 <sup>1</sup>		3Q18	YTD	1 Year	3 Year	5 Year	10 Year
Structured Small/Mid Cap	Gross	4.79%	12.50%	19.33%	17.54%	14.93%	14.04%
Core Equity Composite	Net	4.57%	11.79%	18.32%	16.54%	13.96%	13.06%
Russell 2500 Index		4.70%	10.41%	16.19%	16.13%	11.37%	12.02%

<sup>1</sup>Data as of September 30, 2018. Source: Advent Portfolio Exchange®(APX). Performance returns are presented gross and net of fees and include the reinvestment of all income. Gross of fee performance returns do not reflect the payment of investment advisory fees and other expenses. Actual returns will be reduced by advisory fees and other expenses that may be incurred in the management of the account. Net of fee performance was calculated using the highest management fee of 0.90% for the period prior to March 1, 2016, and 0.85% thereafter, representing the maximum advisory fees charged to client accounts invested in the Structured Small/Mid Cap Core Equity Composite during the respective periods. **Past performance is no guarantee of future results.**

For information regarding the current investment advisory fees of PNC Capital Advisors, LLC, please refer to Form ADV, Part 2A, which is available at <https://pnccapitaladvisors.com>. Please refer to our GIPS®-compliant presentation, which includes additional important disclosures and is located at the end of this presentation.

The top sector contributor to relative investment results was Healthcare, followed to a lesser extent by Energy and Consumer Staples. Stock selection within Healthcare was the primary source of positive relative performance, led by the biotechnology industry. Energy was led by the oil & gas industry and Consumer Staples was driven by specialty retail. However, this positive relative performance was more than offset by negative stock selection effects within Financials, Industrials, and Information Technology. The strategy underperformed in Financials mainly due to the overweight in banks, as the rising interest rate environment is creating a hurdle for the industry. Industrials performance was led by airlines and Information Technology by semiconductors. Overall, the positive and negative effects of stock selection effectively offset one another. As a result, the strategy's outperformance was driven by sector allocation. From a sector allocation perspective, the strategy's overweights in Healthcare and Telecommunications and underweight in Real Estate contributed the most to relative investment results, while the strategy's underweight in Information Technology and overweights in Consumer Staples and Energy were the top detractors.

As mentioned in our Market Commentary, larger-cap stocks outperformed smaller-cap stocks during the quarter. As our portfolio is typically underweight smaller-cap stocks due to portfolio construction risk and liquidity constraints, this trend was a tailwind to the strategy's performance during the quarter.

## STRUCTURED SMALL/MID CAP EQUITY STRATEGY FACTOR ANALYSIS

The Structured Small/Mid Cap Equity s are systematic and disciplined in nature, modeled after scientific evidence. All of the Structured Equity strategies utilize a multi-factor model composed of factors that are academically sound and extensively tested for robustness over long periods in the Russell small and small-to-mid cap universes.

Throughout the year so far, we have seen constant transition and flux within the small-cap market, a trend that carried through to the end of the third quarter. In fact, during the most recent quarter, we saw leading factors fluctuate from month to month—value showed slight positive strength during July, then growth in August, and finally sentiment shifted towards defensive quality midway through September. While our models were most effective during the month of September, end-of-quarter strength was not compelling enough to lead to quarterly outperformance across all Structured Small Cap Equity strategies. Indeed, this ebb and flow caused our multi-factor model to post a flat correlation of alpha scores to price return for the third quarter.

### Top Performing

#### Price Momentum

Short-term price momentum factors, such as 1-month Price Reversal, persisted as we entered the third quarter, although they fell off as September approached. These short-term factors that measure the quick month-to-month swings in price performance are not an effective alpha-generating tool for long-term investing. Positively, traditional long-term factors, such as Price to 200-day

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Moving Average, were effective during most of the quarter. These factors that look for trends over the long-term have played an important role in the Structured Small/Mid Cap Equity strategy's ability to track the index.

- Price to 200-day Moving Average
- Price-to-52-week High
- 12-Month Price Change

## Quality Factors

Particularly strong at the end of the quarter, quality factors, such as those measuring cash flow strength and low leverage, had high correlations with price return for the quarter. This signals a shift toward quality. Market participants have decided to place their funds in securities that are backed by companies with strong balance sheets and improving margins. This is a positive sign for our strategies that specifically look for quality-driven companies.

- Cash Flow-to-Assets
- Long-term Sales Growth
- Debt-to-Assets

## Bottom Performing

### Volatility & Risk Factors

Stocks that had high volatility, as measured by standard deviation of price returns, underperformed for the quarter. This is consistent with the narrative that investors flocked to stability and quality as the quarter progressed. As we potentially reach the end of the business cycle and interest rates continue to rise, investors are wary of increased risk in the market. Notably, Beta, a factor used to measure risk of a security relative to the market, posted flat correlations.

- 22-Day Standard Deviation of Price
- 1-Year Daily Price Volatility

### Price-Based Valuations Factors

Valuation-based factors have been the laggards of 2018 and the last 3-year period. Specifically, valuation factors based on price have been significantly ineffective this quarter. Earnings-to-Price posted the lowest correlations with forward price return across all factors. It was completely ineffective across all sectors except Energy. As growth-based factors continue to lead the market, we do not anticipate valuations to rebound before the end of the year.

- Forward and Trailing Earnings-to-Price
- Book-to-Price
- Sales-to-Price

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## MANAGEMENT TEAM

**Hitesh C. Patel, Ph.D.**  
Managing Director,  
Portfolio Manager

**Paul Kleinaitis, CFA**  
Senior Portfolio Manager

**Chen Chen, Ph.D.**  
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**Jonathan J. Toerber Jr.**  
Senior Quantitative Analyst

# Structured Small/Mid Cap Core Equity

**Firm Description:** As of September 29, 2009, PNC Capital Advisors, Inc. and its affiliate Allegiant Asset Management Company each merged into and with PNC Capital Advisors, LLC (“PNC Capital Advisors” or “the Firm”). PNC Capital Advisors, a registered investment adviser and direct wholly owned subsidiary of The PNC Financial Services Group, Inc. (“PNC”), provides investment advice with respect to equity and fixed income securities for a variety of clients, including institutional accounts and registered investment companies.

For Global Investment Performance Standards (GIPS®) purposes, PNC Capital Advisors, LLC includes:

- 1) Assets under management of PNC Bank, N.A. that were previously attributed to a predecessor firm, Mercantile, which prior to September 14, 2007 was defined to include the assets of Mercantile-Safe Deposit and Trust Company and its subsidiary, Mercantile Capital Advisors, Inc. Effective September 14, 2007, Mercantile-Safe Deposit and Trust Company was merged into PNC Bank, N.A., and in conjunction with such merger, PNC Capital Advisors, Inc. became a subsidiary of PNC Bank, N.A. PNC Capital Advisors, Inc. commenced serving as subadvisor to certain clients of PNC Bank, N.A. effective February 11, 2008.
- 2) Assets under management of PNC Municipal Investment Group, formerly a part of PNC Bank, N.A., now a business unit of PNC Capital Advisors.
- 3) Assets under management of the Advantage Equity Portfolio Management Team, formerly a part of PNC Institutional Investment Group (PNC IIG”), a part of PNC Bank, N.A., now a business unit of PNC Capital Advisors.
- 4) Wrap program assets managed by Allegiant Advisory Services, formerly a part of Allegiant Asset Management Company.
- 5) Assets under management of Allegiant Asset Management Company (excluding Allegiant Advisory Services), formerly a wholly owned subsidiary of National City Corporation, now an institutional subsidiary of the PNC Financial Services Group, Inc. and part of PNC Capital Advisors.

PNC Capital Advisors Structured Small/Mid Cap Core Equity Composite									
Composite Inception Date: April 30, 2005					Composite Creation Date: April 30, 2005				
Year	Gross of Fees Return %	Net of Fees Return %	3 Yr Ex-Post Std Dev Comp %	Benchmark Return %	3 Yr Ex-Post Std Dev Benchmark %	Number of Portfolios (Year-end)	Composite Dispersion (Std Dev %)	Composite Assets (\$ millions)	Firm Assets (\$ millions)
2017	19.30	18.28	10.43	16.81	12.13	2	N/A	27.0	50,300
2016	14.81	13.78	12.48	17.59	13.67	2	N/A	28.6	48,659
2015	5.47	4.53	12.34	(2.90)	12.42	1	N/A	20.3	41,592
2014	9.62	8.64	11.69	7.07	11.67	1	N/A	19.2	41,062
2013	43.58	42.27	14.60	36.80	15.63	1	N/A	24.1	36,882
2012	18.95	17.90	17.15	17.88	18.97	1	N/A	21.5	34,425
2011	(0.80)	(1.69)	18.77	(2.51)	23.40	1	N/A	26.6	35,113
2010	23.46	22.37		26.71		1	N/A	25.1	33,318
2009	25.32	24.22		34.39		1	N/A	19.3	32,318
2008	(32.45)	(33.07)		(36.79)		2	N/A	19.4	27,606

**Compliance Statement:** PNC Capital Advisors, LLC claims compliance with the Global Investment Performance Standards (GIPS®) and has prepared and presented this report in compliance with the GIPS standards. PNC Capital Advisors, LLC has been independently verified for the period beginning September 29, 2009 through December 31, 2016 by Ashland Partners and Company, LLP, and for the periods January 1, 2017 through December 31, 2017 by ACA Performance Services, LLC. Verification assesses whether (1) the firm has complied with all the composite construction requirements of the GIPS standards on a firm-wide basis and (2) the firm’s policies and procedures are designed to calculate and present performance in compliance with the GIPS standards. The Structured Small /Mid Cap Core Equity Composite has been examined by Ashland Partners & Company LLP for the period January 1, 2008 through December 31, 2016, and for the periods January 1, 2017 through December 31, 2017 by ACA Performance Services, LLC. The verification and performance examination reports are available upon request.

**Verification:** Compliance with the GIPS standards for the predecessor firm (Allegiant Asset Management Company) was verified by Ashland Partners & Company LLC for the period January 1, 2008 through September 29, 2009 and by a previous verifier for the period January 1, 1998 through December 31, 2007. In addition, a performance examination was conducted on the Structured Small /Mid Cap Core Equity Composite by Ashland Partners & Company LLC for the period May 1, 2005 through December 31, 2007 by a previous verifier. Copies of the verification reports as well as policies for valuing portfolios, calculating performance, and preparing compliant presentations are available upon request. A list of composite descriptions is also available upon request.

**Composite Description:** The investment objective of the Structured Small/Mid Cap Core Equity Composite is to provide capital appreciation by investing in a diversified portfolio of small to mid-capitalization securities, as represented by the Russell 2500 Index. Results from all accounts have been continuous from the first full month under management to present or last full month under management. The Structured Small/Mid Cap Core Equity Composite was created April 30, 2005.

**Benchmark:** The benchmark for the composite is the Russell 2500® Index. The Russell 2500® Index measures the performance of the small-cap segment of the U.S. equity universe. It includes approximately 2500 of the smallest securities based on a combination of their market cap and current index membership and is constructed to provide a comprehensive and unbiased small-cap barometer.

**Minimum Account Size:** All discretionary accounts in excess of \$2 million have been included in the composite. Effective July 1, 2010, the minimum account size is \$100,000.

**Calculation of Results:** Accounts are valued using trade date accounting and are denominated in U.S. dollars. Performance results reflect the reinvestment of interest, dividends and realized capital gains, and include cash, cash equivalents, convertible securities, and preferred securities, if applicable. Dividends and interest are recorded on an accrual basis and are gross of all applicable foreign withholding taxes, if any.

Performance results are presented on a gross and net basis. The net results reflect a deduction of 0.85%, representing the maximum advisory fee charged to client accounts in the Structured Small/Mid Cap Core Equity Composite. Prior to March 1, 2016 net results reflected a deduction of 0.90%. The actual fees paid by a client may vary based on assets under management and other factors. **Past performance is no guarantee of future results.**

**Dispersion:** The dispersion of annual return is measured by the standard deviation across asset-weighted portfolio returns represented within the composite for a full year. Prior to 2007, the dispersion of annual return was calculated across equal-weighted portfolio returns. For periods where five or fewer accounts were included in the composite for a full year, standard deviation is not disclosed, as it is not considered meaningful.

**Fee Schedule:** The management fee schedule is as follows: 0.85% on amounts up to \$25 million; 0.75% on next \$25 million; and 0.65% on amounts over \$50 million. Prior to March 1, 2016, the fee schedule was as follows: 0.90% on amounts up to \$25 million; 0.80% on next \$25 million; and 0.70% on amounts over \$50 million. The actual fees paid by a client may vary based on assets under management and other factors.

# Structured Small/Mid Cap Core Equity

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## Definitions

**1-Month and 1-Year Price Momentum:** The rate of change on price movements for a particular stock.

**TSTATV:** A statistical measure of correlation to a consistent upward trend line adjusted by price volatility, used to gauge the momentum in price behavior.

**Price to 52-week high:** Compares a stock's price to its 52-week high.

**EPS Growth:** Year over year growth of a company's profit allocated to each outstanding share of common stock.

**Debt to Asset Ratio:** A leverage ratio that measures the amount of total assets that are financed by creditors instead of investors.

**Free Cash Flow to Total Assets:** Measure of valuation based on a free cash flow relative to a company's total assets.

**Stable Growth:** A ratio of a stock's five-year growth rate in price to its five-year earnings stability rate.

**Debt to Equity Ratio:** A ratio indicating the relative proportion of a shareholders' equity and debt.

**Earnings to Price:** A factor based on the earnings per share of a company relative to its price, used in valuation.

**Book to Price:** A factor based on the book value of a company relative to its price, used in valuation.

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The **Russell 2500 Index** is an unmanaged index that includes the smallest 2,500 companies covered in the Russell 3000 universe of United States-based listed equities.

The **Russell 2000 Growth Index** measures the performance of the small-cap growth segment of the U.S. equity universe. It includes those Russell 2000 Index companies with higher price-to-value ratios and higher forecasted growth values.

The **Russell 2000 Value Index** measures the performance of small-cap value segment of the U.S. equity universe. It includes those Russell 2000 Index companies with lower price-to-book ratios and lower forecasted growth values. The Russell 2000 Value Index is constructed to provide a comprehensive and unbiased barometer for the small-cap value segment.

The **S&P 500 Index** is an unmanaged cap-weighted index of 500 publicly traded stocks generally representative of the large-cap U.S. stock market performance and includes a representative sample of leading companies in leading industries. An investor cannot invest in the S&P 500 Index.

The **National Federation of Independent Business (NFIB) Small Business Optimism Index** is compiled from a survey that is conducted each month by the NFIB of its members.

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