Phillip Cook, Michael Cook, and Tread Thompson on a research trip.

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Perspective on Shocktober

A return to volatility marked October in the capital markets, notably in the U.S. small cap and SMID cap investment universes where the benchmark Russell 2000® and Russell 2500™ indices fell approximately 10.9% and 10.2%, respectively. The majority of market sectors posted negative absolute performance in October, including health care and technology which had been the leading contributors to performance through the first nine months of the year in both the Russell 2000® and Russell 2500™. The materials and processing, producer durables and energy sectors all sold off sharply with utilities, consumer staples and financial services holding up better, relative to the others. We commented recently that a broad repricing, however painful, might motivate the market to focus on the **fundamentals and valuations** we espouse in our research process rather than the growth and momentum investment styles which we would argue have continued to support the strength of high multiple stocks in market performance, regardless of underlying business quality. We contend that October's sell off was not reflective of fundamentals reported by our portfolio companies or even corporations more broadly in the market.

Revenue growth and improved cash flow continued for our portfolio holdings in the third quarter of 2018, and we believe that management teams are optimistic as they implement strategic plans for 2019. The stock price movements we witnessed in October do not reflect the last several quarters of organic growth, margin expansion and cash flow generation in our businesses. We assert that October's market action means that the **"spring is loaded"** even more for high quality, attractively priced companies. Remember also that roughly **60%** of our portfolio companies had not yet reported by the end of October, but we have seen solid results so far and are looking forward to hearing from more of our businesses in the coming weeks.

The industrial recession of 2014-2016 provided fertile ground for several of our businesses to utilize their financial flexibility during a period of slack demand and capacity to fund new projects, and we have learned that some of these are just now moving into a position of more optimal utilization and cash flow generation. We believe that the next 12-24 months may better reveal the potential of these investments than the market's reaction to short-term conditions and uncertainty. **Darling Ingredients, Inc. (DAR)** has commented recently on the increased cash flow profiles of its renewable diesel and pet food investments. **The Brink's Co. (BCO)** has effected initiatives, since current management was hired in 2016, designed to increase the efficiency of its cash management services both inside its branches and on its armored truck routes which we believe may support higher incremental cash flows in the coming years. **Timken Co. (TKR)** continues to report on the progress of its emerging markets operations, noting directional improvement in its supply chain, distribution capabilities and customer relationships in China.

While October produced an increase in volatility and a broad repricing, these examples, amongst others, lead us to believe that this did not represent a return to fundamentals. However, we do believe that increased volatility and the cracking of the momentum trade present a real first step toward a shift to fundamentals, favoring high quality and attractive valuations. Based on our conviction in the quality of our portfolio businesses and the valuations at which they trade presently, we are optimistic regarding their potential upside following October. We remain close to the companies in which we invest and to those we are evaluating, meeting with them regularly to discuss capital allocation, growth prospects and their value creation, and look forward to continuing to report their progress to our clients.

Our research on October's performance led us to consider the broader equity markets, small caps specifically and performance across styles, sectors and valuation ranges. Several headwinds persisted for our strategies last month as outlined in Charts 1-3 below; however, we finally began to see some shifts in the growth versus value trade and momentum's leadership, which we believe will be positive for our style going forward.

A look at a broad market sampling of nearly 7,000 stocks shows that the lowest price:earnings (PE) ratio quintile of stocks had the worst performance in October 2018. Only negative earners posted poorer performance. While the market sold off, it did not favor the low multiples preferred by value investors.

CHART 1: PE RATIO AT START OF OCTOBER 2018, USING TRAILING 12 MONTH EARNINGS

PE Quintile	*Number*	*EV/EBITDA: Median*	*PE: Median*	*median(Age)*	*% Change: Oct 2018*	*% Change: YTD 2018*	*% Change: Last Year*	*% Change: Last 5 years*
Lowest PE	557	6.75	6.92	37.00	-8.76%	-13.82%	-8.39%	30.10%
2nd quintile	558	8.51	13.06	51.00	-6.86%	-5.41%	-0.01%	42.41%
3rd quintile	557	10.71	17.53	54.00	-7.99%	0.71%	5.79%	44.86%
4th quintile	558	13.03	26.03	48.00	-6.92%	-0.28%	4.17%	66.52%
Highest PE	558	18.37	58.33	34.00	-8.35%	10.99%	14.36%	90.82%
Negative Earnings	4,090	13.75		18.00	-9.58%	12.48%	19.27%	45.35%

Source: Musings on Markets blog written by Aswath Damodaran who is a Professor of Finance at New York University Stern School of Business; S&P Capital IQ

While the health care and information technology sectors sold off in October after leading market performance through the first nine months of the year, energy, industrials and materials continued as leading detractors.

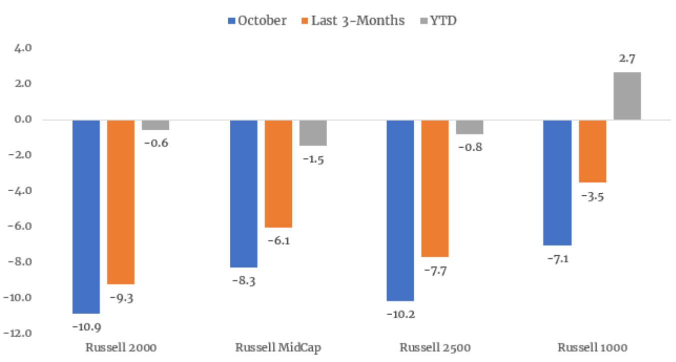
CHART 2: U.S. SECTOR MARKET CAP CHANGE

Primary Sector	Number	median(EV/EBITDA)	median(PE)	median(Age)	% Change: Oct 2018	% Change: YTD 2018	% Change: Last Year	% Change: Last 5 years
Communication Services	400	10.37	14.10	20.00	-6.58%	1.51%	8.15%	85.54%
Consumer Discretionary	713	9.84	17.12	32.00	-9.22%	7.02%	16.34%	61.25%
Consumer Staples	345	12.30	20.55	25.00	1.30%	-3.61%	2.83%	29.66%
Energy	552	9.24	13.20	17.00	-11.37%	-1.14%	7.40%	-7.01%
Financials	1,170	12.01	15.84	44.00	-7.75%	-8.13%	-4.08%	45.75%
Health Care	1,207	15.73	30.34	18.00	-8.28%	7.48%	9.90%	72.03%
Industrials	875	10.68	17.83	35.00	-12.25%	-8.68%	-4.37%	34.45%
Information Technology	979	14.30	27.87	24.00	-8.76%	13.06%	17.36%	109.90%
Materials	420	8.39	15.09	23.00	-12.58%	-16.57%	-14.65%	40.33%
Real Estate	87	18.55	17.86	25.00	-6.48%	1.82%	17.93%	103.35%
Utilities	114	11.98	21.36	69.00	2.91%	7.01%	3.63%	55.82%
All firms	**6,862**	**11.14**	**17.53**	**25.00**	**-8.01%**	**1.37%**	**6.29%**	**55.50%**

Source: Musings on Markets blog written by Aswath Damodaran who is a Professor of Finance at New York University Stern School of Business; S&P Capital IQ

Negative performance was notable for small capitalization U.S. equities versus their large cap counterparts, as the Russell 2000, Russell MidCap and Russell 2500 indices each underperformed the Russell 1000.

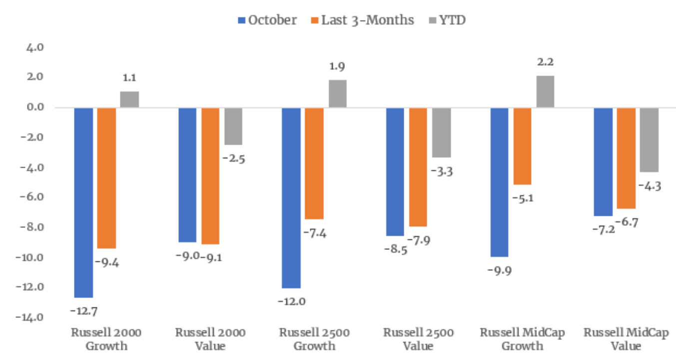
CHART 3: AWFUL MONTH ESPECIALLY FOR SMALL CAPS; WORST SINCE SEPTEMBER 2011



Source: Jefferies Equity Note written by Steven DeSanctis, November 1, 2018; Factset; FTSE Russell; Evestment

But, after leading in performance versus value for much of the year, growth underperformed during the month.

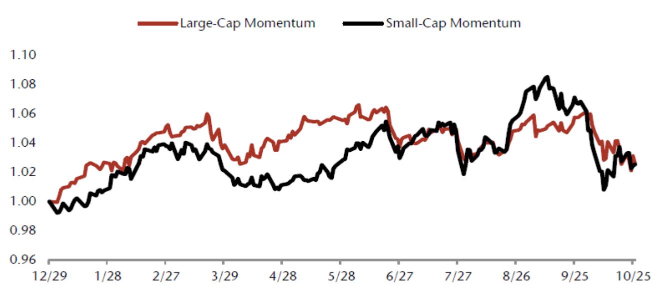
CHART 4: FINALLY, GROWTH TOOK IT ON THE CHIN



Source: Jefferies Equity Note written by Steven DeSanctis, November 1, 2018; Factset; FTSE Russell; Evestment

And, momentum's performance slowed following a strong first nine months.

CHART 5: ...AND WE SAW MOMENTUM CRACK



Source: Jefferies Equity Note written by Steven DeSanctis, November 1, 2018; Factset; FTSE Russell

Important Disclosures:
The portfolio holdings discussed in this commentary are in the top 5 largest holdings as of October month-end for the SMID Cap Composite and the Small Cap Strategy Composite and were selected as relevant examples of companies that are optimizing utilization and cash generation. No performance-based criteria was used in the selection of these holdings.

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