WHERE DO WE GO FROM HERE?

MARKET REVIEW AND OUTLOOK

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MARKET REVIEW

The U.S. equity market experienced a strong start to the year with the S&P 500® Index advancing 10.56% in the first quarter—the largest first-quarter gain for the Index since 2019. Large-cap growth stocks, as measured by the Russell 1000® Growth Index, were the best performers in the quarter, gaining 11.41%. Value stocks, as measured by the Russell 1000® Value Index, lagged growth stocks, returning 8.99% in the quarter. Small-cap stocks underperformed their larger-cap counterparts, with the Russell 2000® Index advancing 5.18%. International and emerging market stocks continued to lag U.S. markets; the MSCI EAFE® Index advanced 5.78% in the quarter while the MSCI Emerging Markets Index increased just 2.37%.

Fixed income predominantly experienced negative returns during the quarter. The Bloomberg U.S. Aggregate Bond Index declined 0.78% as the 10-year U.S. Treasury yield had a volatile quarter, starting at 3.88% and ending at 4.20%. High yield, as measured by the ICE BofA U.S. High Yield Index, was the standout fixed income performer, advancing 1.51% in the quarter. Municipal bonds also declined during the quarter, with the Bloomberg Municipal Bond Index returning -0.39%.

Given the strong (but divergent) markets and the vast amount of information (or noise) available to investors, we have narrowed our focus to three questions we believe are most important to understanding what the drivers behind performance were in the quarter.

1. WHAT IS HAPPENING WITH INTEREST RATES?

At the start of the year, the futures markets were predicting as many as six 25-basis points interest rate cuts in 2024. Since then, the economy has experienced somewhat higher-than-expected growth and inflation rates. As of its most recent meeting on March 20, the Federal Reserve (Fed) expects three rate cuts this year. However, there is wide dispersion among Fed officials regarding the trajectory of rates (see Figure 1). For 2025, four of the 19 Fed officials see the federal funds rate at 4% or above. One expects a federal funds rate just above 2.5%. The Fed's "dot plot" chart is a baseline of estimates, and we know that exogenous shocks or financial disruptions can change things quickly. This disparity, however, leads us to believe the longer-term outlook for rates is still quite uncertain, which is why we favor businesses with low leverage.

Despite the uncertainty regarding the longer-term outlook, we are seeing early signs of a less constricted interest rate environment, with lower mortgage rates (still high, but trending in the right direction) and compressed credit spreads. We believe continued rate declines would support both asset prices and better earnings growth for companies.

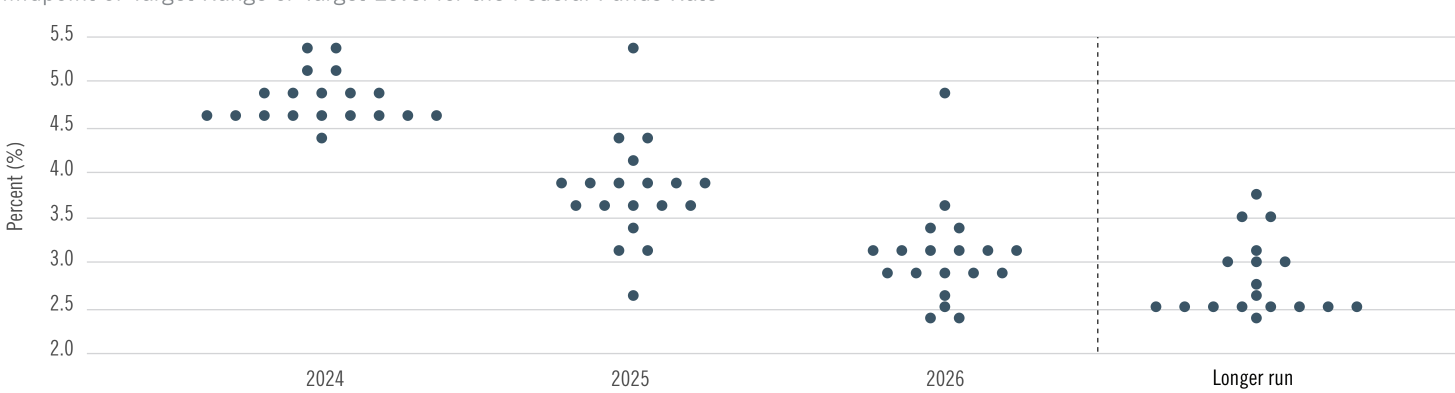
2. ARE WE WORRIED ABOUT MARKET NARROWNESS?

While a broadening of the market would be a welcome sign for equity investors, we do believe the narrowness of the market makes sense.

As we have all read about endlessly, the major driver of equity index performance has been the Magnificent 7 technology stocks: Apple, Amazon, Meta, Tesla, Alphabet, NVIDIA, and Microsoft. These companies have been seen as direct beneficiaries of the recent advances in artificial intelligence (AI), most notably, generative AI.

FIGURE 1: FED DOT PLOT: FOMC PARTICIPANTS' ASSESSMENTS OF APPROPRIATE MONETARY POLICY

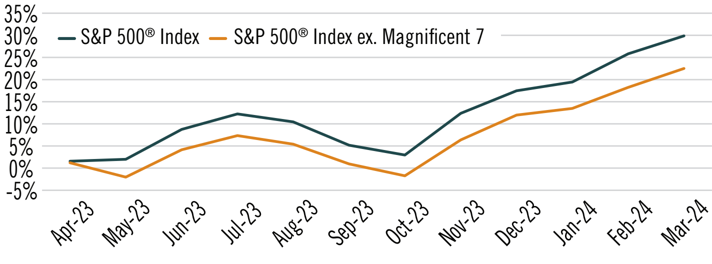
Midpoint of Target Range or Target Level for the Federal Funds Rate



Data as of March 20, 2024. Data is obtained from the FOMC and assumed to be reliable. Each shaded circle indicates the value (rounded to the nearest 1/8 percentage point) of an individual participant's judgment of the midpoint of the appropriate target range for the federal funds rate or the appropriate target level for the federal funds rate at the end of the specified calendar year or over the longer run. One participant did not submit longer-run projections for the federal funds rate.

The magnitude of the outperformance of these AI-fueled names has distorted market metrics. If we exclude the Magnificent 7 from the S&P 500, we see that stock performance in the last year has been much more uneven.

FIGURE 2: S&P 500® VS. S&P 500® EX MAGNIFICENT 7



Past performance is no guarantee of future results. Data is for the 12 months ending March 31, 2024, obtained from FactSet, and assumed to be reliable. The Magnificent 7 stocks include Alphabet, Amazon, Apple, Meta Platforms, Microsoft, NVIDIA, and Tesla.

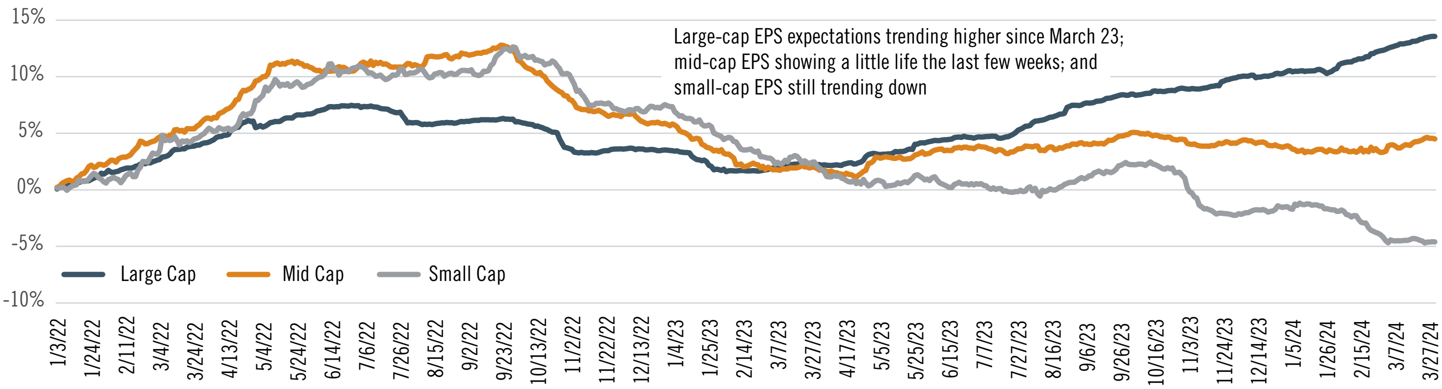
But we do not believe this rally is wholly unjustified. Investors are simply going where the earnings are growing.

Earnings expectations for large-cap stocks (with outsized representation of the Magnificent 7, which account for 18% of S&P 500 earnings) are clearly well ahead of mid- and small caps. Expectations in mid-caps have found their footing, while small-cap earnings are still challenged. This has translated to stock valuations directly.

What is notable is that the increase in small-cap valuations is not being driven by higher stock prices, but rather weaker earnings. Until earnings bottom, we would expect valuations awarded to small-capitalization companies to remain pressured.

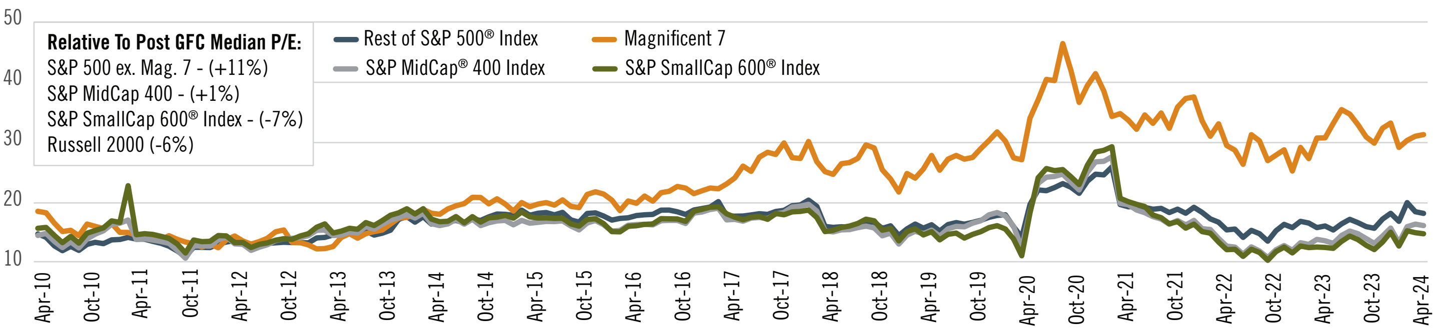
Given the large-cap bias in the market, we continue to believe that the small-cap universe has many high-quality businesses that are now trading at attractive valuations. Thus, we maintain that active management within small caps makes sense in avoiding the 42% of the small-cap benchmark Russell 2000 Index that does not generate earnings.

FIGURE 3: CONSENSUS EARNINGS PER SHARE (NEXT 12 MONTHS) Indexed to December 31, 2021



Past performance is no guarantee of future results. Data as of March 27, 2024, obtained from FactSet and Raymond James, and assumed to be reliable. Large Cap = S&P 500 Index, Mid Cap = S&P MidCap 400 Index; Small Cap = Russell 2000 Index.

FIGURE 4: PRICE-TO-EARNINGS RATIO OF MAGNIFICENT 7 VS. REST OF S&P 500, MID-, AND SMALL-CAP INDEXES
GAAP, Current Year



Past performance is no guarantee of future results. Data as of March 31, 2024. Data is obtained from FactSetand Raymond James and is assumed to be reliable. Magnificent 7 stocks include Alphabet, Amazon, Apple, Meta Platforms, Microsoft, NVIDIA, and Tesla. The Russell 2000 Index excludes companies with negative earnings.

continued

3. HOW MUCH GROWTH IS DUE TO EXOGENOUS FACTORS?

One large challenge coming out of the pandemic is trying to parse the underlying strength in the U.S. economy. Our supply chains were whipsawed, our employment patterns changed dramatically, and we saw unprecedented monetary and fiscal support. Given these factors, it is hard to gauge how much of our economic strength is due to fundamentals versus other exogenous effects.

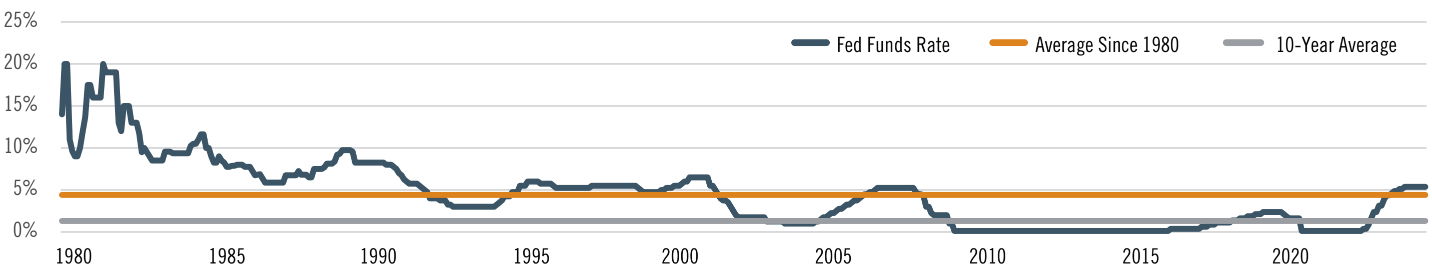
What we do know is that we have a very large federal deficit and that while interest rates may have peaked, they are unlikely to return in the near term to the basement rates we enjoyed during the pandemic. So, despite rates having increased materially in a short period of time, they are only modestly restrictive compared to the long-run average.

As a result of the low interest rates and strong government support during the pandemic, we believe the tide lifted all companies and made it easier for everyone to prosper. However, without this assistance, we expect that more fundamental factors will drive corporate profits and thus equity performance going forward. We see this already in the Magnificent 7.

Assuming less exogenous support, we believe companies that are competitively advantaged with better profitability, cash flow, and lower leverage will be able to better distinguish themselves going forward. We will continue to focus on finding quality companies with durable competitive advantages for our clients despite the ever-shifting macroeconomic environment.

FIGURE 5: INTEREST RATES ARE NOT THAT HIGH RELATIVE TO HISTORY

Fed Funds Rate Above the 10-Year Average but Near the Long-Term Historical Average



Data as of March 31, 2024, obtained from the Federal Reserve Bank of St. Louis and FactSet, and assumed to be reliable.

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Kayne Anderson Rudnick (KAR) believes that superior risk-adjusted returns may be achieved through investment in high-quality companies with market dominance, excellent management, financial strength, and consistent growth, purchased at reasonable prices.

Index definitions: The S&P 500® Index is a market capitalization-weighted index that includes 500 of the largest U.S. companies. The **Russell 1000® Growth Index** is a market capitalization-weighted index of growth-oriented stocks of the 1,000 largest companies in the Russell Universe, which comprises the 3,000 largest U.S. companies. The **Russell 1000® Value Index** is a market capitalization-weighted index of value-oriented stocks of the 1,000 largest companies in the Russell Universe. The **Russell 2000® Index** is a market capitalization-weighted index of the 2,000 smallest companies in the Russell universe, which comprises the 3,000 largest U.S. companies. The **MSCI EAFE® Index** measures developed foreign market equity performance, excluding the U.S. and Canada. The **MSCI Emerging Markets Index** is a free float-adjusted market capitalization index tracking the equity performance of global emerging markets. The **Bloomberg U.S. Aggregate Bond Index** is a market value-weighted index that tracks the daily price, coupon, pay downs, and total return performance of fixed-rate, publicly placed, dollar-denominated and non-convertible investment grade debt issues with at least $250 million par amount outstanding with at least one year to final maturity. The **ICE BofA U.S. High Yield Index** tracks the performance of U.S. dollar denominated below-investment-grade corporate debt publicly issued in the U.S. domestic market. The **Bloomberg Municipal Bond Index** is a market capitalization-weighted index that measures the USD-denominated long-term tax-exempt bond market. The **S&P MidCap 400® Index** is a free-float market-cap weighted index of 400 mid-cap U.S. companies. The **S&P SmallCap 600® Index** is a free-float market-cap weighted index of 600 small-cap U.S. companies. The indexes are unmanaged, their returns do not reflect any fees, expenses, or sales charges, and they are not available for direct investment.

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Past performance is no guarantee of future results.

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