The Essex Exchange

ESSEX INVESTMENT MANAGEMENT COMPANY, LLC

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Please see our website www.essexinvest.com for updated insights from our portfolio management and research team.

Shifting Sands

By: Robert J. Uek - Co - CEO & Senior Portfolio Manager

The bad news finally overwhelmed the optimism of US investors during the first quarter of 2022 with the S&P 500 Stock Index declining 4.6%. Remarkably, this was only the fourth quarterly decline in the broad stock market averages in the past five years and the seventh such quarterly decline in the last 40 quarters. Much worse than expected inflation, hawkish comments from the Federal Reserve, fears of slowing economic growth coupled with the Russian invasion of Ukraine all managed to dampen investor expectations. Although the broader market indices (which are dominated by mega-cap stocks) have held up well over the past year, this relative strength masks some underlying market turbulence: smaller cap stocks and high-growth stocks have been significant underperformers for several quarters, signaling investor concern around valuations, interest rates and slowing growth. Continuing a trend over the past few quarters, the Russell 2000 Growth Index (which is more representative of smaller company stocks) and the NASDAQ (more representative of growth stocks) both performed worse than the S&P 500 Index during the first quarter of 2022 with declines of 12.6% and 9.1% respectively. The average stock in the S&P 500 Index is 20% off its high.

Although the market's near-term focus is consumed by debate around the number of potential Fed Fund rate hikes, analyses of yield curve inversions, the probability of stagflation, assessing the rapidly changing geo-political landscape and handicapping the potential outcomes of the upcoming mid-term elections, we would highlight some of the longer-term implications of recent developments.

Shifting Sands

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We would posit that we are in the midst of a major shift in the underlying investment landscape that has longer lasting implications. Three major investment truisms that have been the basis of most key investment decisions over the past forty years are arguably no longer true. Globalization is dead. Inflation is an issue. Interest rates are rising. We first highlighted the possibility of a "regime change" in the investment arena on these pages in our Q3 2021 letter to investors when we started to sense the whisps of changes to our key investment underpinnings. Events over the past six months have reinforced our conviction in these changes.

- Globalization since the end of the Cold War has been instrumental in spurring growth in the emerging economies while providing cheap goods for the developed world – in essence allowing for the importation of deflationary forces.

- Interest rates have been in a downward trend since then-Fed Chairman Paul Volcker tamed inflation in the early 1980's. The nearly continuous forty-year decline in interest rates spurred growth in cheap financing underpinning corporate borrowings, growth in the housing market, and huge inflows into bond funds.

- Inflation has not been a major worry for the Fed in several decades. This has had important effects on consumption patterns, wage expectations and corporate working capital decisions.

Erosion in these tenets seemed to take root a few years ago with the fraying of international relations following trade disputes and the adoption of tariffs targeting Chinese manufactured goods. These trade frictions caused increased costs in both finished goods and key component supplies causing businesses to start to re-assess their manufacturing and sourcing strategies. The on-set of COVID 19 and the associated lock-downs and worker shortages caused further strains on costs and supply chain efficiencies. And most recently, Russia's invasion of Ukraine and the resulting economic sanctions has caused severe disruptions in the supply of energy and key commodities to the global economy. And international relations have broken down to the point where it appears we are re-entering a Cold War like period again.

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Investors have begun to react and adjust to this new regime. Asset allocation models need to reflect the new reality. Valuations of stocks and bonds are being re-assessed in an inflationary and rising interest rate environment. Corporations are adjusting to the new business risks with re-onshoring of manufacturing facilities, de-emphasis of just-in-time inventory strategies to increase inventory buffers and increasing working capital levels. And finally, governments are focused on economic security by providing incentives to build out domestic supply chains and security of raw material sourcing in an increasingly hostile trade environment.

But despite the near-term negativity and shifting sands, all is not lost and we don't think the answer is to abandon stocks. To highlight a favorite quote of ours from Nelson Rockefeller, "Wherever we look upon this earth, the opportunities take shape within the problems." Indeed, we believe that the next few years will offer great growth opportunities for companies that can adapt to this new investment and economic landscape. Valuations are important and the days of casually valuing emerging, pre-revenue growth stocks at 20+ times projected revenues are most likely over. In our opinion, we see opportunities in the following secular growth areas:

- Re-onshoring of domestic manufacturing
- Flexible factories
- Security of domestic materials sourcing
- Domestic stocks as "safe havens"
- Agriculture productivity and food shortage solutions
- Improved healthcare diagnostics and cost efficiencies
- Infrastructure improvements
- Technology or services that help businesses reduce inflationary input costs (ie, energy efficiency)

As investors digest the turmoil in Ukraine, higher interest rates, etc., we believe it will be a more discerning stock market with returns driven by earnings growth as opposed to the ever-increasing earnings multiples that investors have been willing to pay over the past couple of years. We believe that in the near term, we are in a "stock pickers" market where there are select stock opportunities at attractive valuations where earnings growth and revenue growth can exceed expectations. Over the longer-run, there are important underlying changes to the market dynamics that will create interesting secular growth opportunities.

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Essex Strategies

LONG EQUITY STRATEGIES

Micro Cap, Small Cap and SMID Cap Equity Growth Strategies are managed by our all-women investment team based in Evanston, Illinois, which is focused exclusively on long-only growth equity strategies and has worked together for more than 15 years. The team manages three equity strategies that each share a common investment philosophy and process:

Micro Cap Growth Strategy: We look for under-followed, under-owned, under-appreciated companies & industries in early stages of acceleration.

Small Cap Growth Strategy: The strategy focuses on identifying companies in an inefficient sector of the market at an inflection point where their growth rate is improving.

Small/Mid (SMID) Cap Growth Strategy: Our approach is to execute a systematic, fundamental process to find companies whose future growth prospects are not fully reflected in the price of the stock.

Essex Research Strategy is managed by a team of investment professionals seeking growth equity opportunities across an all-cap universe. By employing fundamental top down economic and sector analysis with bottom-up stock picking skills, the strategy provides the investment team a wide framework in which to identify growth candidates regardless of market capitalization restraint. Individual client portfolios are offered in two risk profiles: aggressive growth or growth and income.

Essex Global Environmental Opportunities Strategy (GEOS) is a thematic, all-cap global stock strategy that invests in clean technology and clean energy companies that help solve the world's environmental problems. The Strategy is focused on nine environmental technology themes and invests with a long investment horizon, typically holding about 40 companies. GEOS is clean technology and energy infrastructure-focused, with companies that exhibit generally high growth rates. ***This strategy is available as both a separate account and mutual fund.***

LIMITED PARTNERSHIP HEDGE FUNDS

Essex Performance Fund is an ultra-aggressive equity strategy which primarily aims to uncover small and mid-sized companies that exhibit the potential for meaningful growth over time. Seeks to maximize returns by utilizing both fundamental and technical analysis with an emphasis on thematic investing and tactical market positioning. The strategy will use leverage to enhance returns.

Essex Evolution Long/Short strategy is a hedged equity strategy that aims to provide competitive risk-adjusted returns by utilizing both fundamental and technical analysis with an emphasis on thematic investing and tactical market positioning. Specifically, we aim to understand key themes within dynamic sectors to capture the growth in those trends and utilize short positions to both hedge portfolio risk and exploit specific mispriced stock opportunities. The fund generally has an equity exposure less than that of the overall market.

Please refer to our firm's website at www.essexinvest.com for more information about Essex, the strategies we manage and important disclosures.