
Kevin E. Silverman, CFA

The stock market is making new highs, unemployment is at record low levels, and GDP has never been better. Corporate revenue and earnings are near records. Borrowing rates are low and inflation is low. It's difficult to find any data that suggests a recession is on the way. Yet everywhere we turn, pundits are bearish. Why do we hear so many economists talking about a big chance of a recession sometime in the next few years? Earnings comparisons are tougher, tariffs are terrible, they say, a weak Europe is the start of a global recession, all the benefits of the tax cuts are over, negative interest rates are bad for asset values, among other things. When pressed, though, the most common reason is that the economy has been good for too long and that can't last much longer.

This seems new. Perfectly capable economists are predicting recession simply on the basis of a recession being "due." The longevity of the current recovery is simply too long for some people to stomach, believing that the "natural cycle" of recoveries is just 3.2 years, the average of the 1854-2007 time period. So, we are "overdue by 4.5 years," according to an October 2018 Forbes article.[1] The recent market corrections in the fall of 2018 and in May 2019 both unfolded with a healthy dose of concern about near-term earnings, GDP growth, China tariffs, and the policy of the Fed, all of which together formed a mosaic of imminent recession, pundits say by late 2019, or certainly by 2020 at the latest.

Two economic metrics that are key to this discussion are real GDP and inflation. In part, it is low real GDP growth compared to past recoveries that creates concerns about the longevity of the current expansion. Inflation estimates are used to make real output estimates from nominal sales reports, which then are used to estimate real GDP. Real GDP growth estimates obviously help drive analysts' revenue and earnings growth assumptions and help to inform the Fed's policy decisions. The problem with this is that these estimates are wrong and economists know it.

The CPI is the inflation measure used in these estimates. It is created using baskets of goods in dozens of locations around the U.S. The current survey methodology ignores certain substitution behaviors, doesn't account for discounts at outlet stores, doesn't account for new products, and quite often ignores quality differences between discontinued products and those that replace them in the baskets. The CPI is known to overstate inflation by as much as 0.4% per year. The PCE is a better, lower, inflation estimate but it is not as timely and goes unused. That leads to an understating of real GDP growth, which is of course the remainder after adjusting nominal GDP by the inflation estimate. While that's a modest error in the short run it's a giant error in the long run. Not only is real GDP growth understated, but with inflation overstated, real wage gains are understated. With real GDP growth and real wage gains understated, the current economy seems more tenuous and it makes near-term recessions easier for economists to predict.

Another element to the mismeasurement thesis is the mismeasurement of GDP itself. In addition to the problem of measuring general inflation discussed above, there is also the problem of determining whether a price increase is a feature enhancement or inflation. It's likely that many feature enhancements are being misdiagnosed as inflation. There's the problem of not measuring the convenience of using OpenTable and the time it saves to do other things. This isn't captured. In fact, it's likely that a whole host of new conveniences along with productivity and lifestyle enhancers from Waze to Live Nation to Amazon Fresh are not being captured in GDP growth because the benefits are hard to measure in terms of time saved, not to mention what beneficial activity is created during that extra time.

Finally, traditional causes of recession, the mismatched timing and bad forecasting of inventory and end demand, are increasingly tamed by transparency in the supply chain. In general, the vast benefits of the instantaneous flow of information to everyone or anyone are still working their

1. "Recession Is Overdue By 4.5 Years, Here's How To Prepare." Cameron Keng, Forbes, October 23, 2018. <https://www.forbes.com/sites/cameronkeng/2018/10/23/recession-is-overdue-by-4-5-years-heres-how-to-prepare/amp/>

way through the economy, quite possibly in ways that are difficult to measure with tools originally designed to count units and weigh output. With long-term real GDP growth and living standard gains mismeasured and the full economic benefits of the internet still not fully understood, we believe there is a reasonable case that the economy is not only better than generally believed but also that real wages have risen more than believed for 30 years. If only we were using the PCE instead of the CPI.

Not surprising then that we remain positive on the economy and that we believe our portfolios are well positioned for good results ahead. By identifying companies with good balance sheets that offer products or services that are better, cheaper, or faster than the competition, our portfolio companies stand to thrive no matter how the predictions of economists turn out. Our strategies performed well in 2Q 2019, with our Small-Cap Value Focus concentrated strategy earning a 5.9% return net of fees and our Small-Cap Value Diversified strategy earning a 4.02% return net of fees versus the 1.37% return of our Russell 2000 Value Index benchmark. Details on our results are discussed later in this commentary.

Thank you for your interest in Sterling Partners Equity Advisors.

Kevin E. Silverman, CFA
Chief Investment Officer
Sterling Partners Equity Advisors
312-465-7096
ksilverman@sterlingpartnersequityadvisors.com

Sterling Small-Cap Value Focus
2Q 2019 Summary

Highest Performers	Lowest Performers
L. B. Foster Co.	Armstrong Flooring, Inc.
Skyline Corp.	Lions Gate Entertainment Corp.
Winnebago Industries, Inc.	Criteo SA
U.S. Concrete, Inc.	Glu Mobile, Inc.
Fox Factory Holding Corp.	Hurco Companies, Inc.

Sterling Small-Cap Value Diversified
2Q 2019 Summary

Highest Performers	Lowest Performers
L. B. Foster Co.	EnscoRowan plc
Skyline Corp.	Armstrong Flooring, Inc.
Winnebago Industries, Inc.	Criteo SA
The Ensign Group, Inc.	MasterCraft Boat Hldgs, Inc.
U.S. Concrete, Inc.	Hurco Companies, Inc.

L. B. Foster Company (FSTR)

Highest 5 Performing Security:
Sterling Small-Cap Value Focus
Sterling Small-Cap Value Diversified

L.B. Foster is a manufacturer and distributor of transportation and energy infrastructure products and services with locations in North America and Europe. Management indicated that spending in transit rail infrastructure in North America and Europe drove the 31.4% increase in backlog. In addition, the company continued reduction of total debt positions to lower borrowing costs for future growth initiatives.

We believe that the company's strong product will gain market share over the long run as infrastructure spending both in transportation and energy will drive stable growth. We expect management will use free cash flow to reduce debt, helping grow the EBITDA margin and ROI. At the current price, we believe FSTR offers an attractive long-term return.

Skyline Champion Corp. (SKY)

Highest 5 Performing Security:
Sterling Small-Cap Value Focus
Sterling Small-Cap Value Diversified

Skyline Champion is one of the largest factory-built housing companies in North America, with a leading portfolio of manufactured and modular homes, park-models and modular buildings for the multi-family, hospitality, senior and workforce sectors. Skyline also operates a factory-direct retail business, Titan Factory Direct, with 21 retail locations in the southern United States.

Management indicated that during the quarter they made progress realizing the recent merger synergies, which led to a 23% increase in sales and 13% increase in homes sold for the quarter year-over-year. During the quarter, the company completed the expansion of a facility and made progress on a new manufacturing facility. Our thesis on Skyline Champion is that it is a low-cost producer in manufacturing shelter for individuals and families in areas in which land is not the major cost and traditional home affordability is a concern.

Winnebago Industries, Inc. (WGO)

Highest 5 Performing Security:
Sterling Small-Cap Value Focus
Sterling Small-Cap Value Diversified

Winnebago Industries is a manufacturer of recreation vehicles under the Winnebago, Grand Design and Chris-Craft brands, primarily used in the leisure travel and outdoor recreation activities. We see WGO as a beneficiary of entrenched favorable trends in recreational vehicles, including the recent addition of Chris-Craft brand recreational boats to the product mix.

Winnebago continued to perform well during the quarter after hitting some lows at the end of 2018. Management continues to indicate continued margin expansion and positive market share gains particularly by the strength of the Grand Design brand.

U.S. Concrete, Inc. (USCR)

Highest 5 Performing Security:
Sterling Small-Cap Value Focus
Sterling Small-Cap Value Diversified

U.S. Concrete is a leading supplier of concrete and aggregates for large-scale commercial, residential and infrastructure projects across the country. The company holds leading market positions in the metropolitan markets of New York, San Francisco, Dallas Fort Worth and Washington D.C.

Management indicated positive indicators for continued growth and reported strong aggregate product sale revenue increased 25.4% and sales volume increased of 17% compared to the prior year quarter.

We have a long history of owning cement and concrete companies on the evidence that owners enjoy a bit of local monopoly as a result of transportation costs limiting the physical area that can be served from any particular quarry. We believe USCR is a low-cost producer in its market area. Our thesis includes the view that both commercial and residential construction activity will benefit from the current strong economy and employment.

Fox Factory Holding Corp. (FOXF)

Highest 5 Performing Security:
Sterling Small-Cap Value Focus

Fox Factory Holdings designs and manufactures performance ride dynamics products primarily for bicycles, on-road and off-road vehicles and trucks, side-by-side vehicles, all-terrain vehicles, snowmobiles, specialty vehicles and motorcycles.

Once again, Fox Factory reported sales and profitability above expectations. In May 2019, FOXF acquired RideTech, a manufacturer of suspension systems to enhance the handling and ride quality of muscle cars. This acquisition is in line with previous statements that they plan on expanding into new categories.

We have owned FOXF for many years around the thesis that leisure activities will continue to gain share of GDP and we like that FOX operates in the luxury end of their market niche. Management has exhibited much skill in making accretive bolt-on acquisitions and optimizing ROA for years. We anticipate these trends will continue.

The Ensign Group, Inc. (ENSG)

Highest 5 Performing Security:
Sterling Small-Cap Value Diversified

The Ensign Group provides a broad spectrum of skilled nursing and assisted living services, physical, occupational and speech therapies, home health and hospice services and other rehabilitative and healthcare services at 253 healthcare facilities, 26 hospice agencies, 25 home health agencies and 9 home care businesses across the United States. Ensign's business model includes acquiring complimentary businesses and improving the cost structure. They continued to execute on this strategy for the quarter.

This business benefits from the aging demographics of the U.S. population, a thesis in which we have a strong conviction. The business capitalizes on this trend by providing a broad spectrum of skilled nursing and assisted living services, physical, occupational and speech therapies, home health and hospice services and other rehabilitative and healthcare services. Ensign's business model includes acquiring complimentary businesses and improving the cost structure.

Armstrong Flooring, Inc. (AFI)

Lowest 5 Performing Security:
Sterling Small-Cap Value Focus
Sterling Small-Cap Value Diversified

Armstrong Flooring is a leader in the design and manufacture of resilient and wood flooring products across North America, spun out from Armstrong World Industries just a few years ago. We believe AFI will emerge as the low-cost producer in the space, and as a result we expect some share gain. If management can achieve its cash flow targets for 2019 and 2020, as capacity and capital spending are rationalized, we think that will lead to a revaluation of the company.

Management acknowledged the headwinds of the business but are confident for its future. During the quarter, AFI announced and finished a $50 million share repurchase.

Criteo SA (CRTO)

Lowest 5 Performing Security:
Sterling Small-Cap Value Focus
Sterling Small-Cap Value Diversified

Criteo is an advertising platform designed to deliver advertising across all channels. Our thesis is that advertising spending will continue to migrate to online and mobile from TV, and Criteo is positioned to benefit from that continuing migration.

With speculation on a negative impact on a large business segment still hanging over Criteo, management indicated that it would take more time to yield benefits from any new capabilities that are being executed on in 2019. We believe in CRTO's multi-solution platform for advertising and believe CRTO will overcome these hurdles by moving into new markets. Once again, CRTO ended the quarter with a strong balance sheet with $396 million in cash.

Hurco Companies, Inc. (HURC)

Lowest 5 Performing Security:
Sterling Small-Cap Value Focus
Sterling Small-Cap Value Diversified

Hurco Companies is an international industrial technology company that sells its three brands, Hurco, Milltronics, and Takumi, of computer numeric control (CNC) machine tools to the worldwide metal cutting and metal forming industry.

Hurco saw a 22% decline in revenue in the quarter year-over-year from their Asia Pacific segment. In addition, a 20% year-over-year decline from their European segment. We like that Hurco has historically had a healthy balance sheet and their long-term outlook to advance their products and services globally. Our thesis is that investments in productivity increases for manufacturing will be made over the long-term and Hurco will take advantage of these global capital investments with their product lines.

EnscoRowan plc (ESV)

Lowest 5 Performing Security:
Sterling Small-Cap Value Diversified

Ensco Rowan is a global offshore drilling services company supporting all water depths and geographies. Ensco Rowan operates a rig fleet of ultra-deepwater drill ships, versatile semisubmersibles and modern shallow-water jack-ups.

Oil prices declined for most of the quarter, which put the price under some pressure. Ensco is changing its name to Valaris (VAL) as of July 31st. VAL will participate in the future of offshore energy production, and we believe it will generate solid returns in the long term. Our thesis is that fossil fuels will remain a key component of the world energy mix for a long time; prices will need to move higher to meet demand and offshore sources will be a growing part of that mix.

Lions Gate Entertainment Corp. (LGF)

Lowest 5 Performing Security:
Sterling Small-Cap Value Focus

Lionsgate is a global content platform whose films, television series, digital products and linear and over-the-top platforms reach audiences around the world. Our thesis is that as leisure spending continues to grow, entertainment, and the content that drives it, will continue to gain share of the economy.

Declines in the Motion Picture and Television Production segments dragged Lionsgate down more during the quarter. An offer was made to acquire the Starz business but was not accepted due to the low offering price. We have patience for Lionsgate to continue adding to Starz subscribers and look forward to that segment being worth more in the future. With movie hits a bit random, we are encouraged by the strong slate of content coming out in 2019 and attractive valuation of the shares.

Glu Mobile, Inc. (GLUU)

Lowest 5 Performing Security:
Sterling Small-Cap Value Focus

Glu Mobile is a leading creator of mobile games. Their diverse portfolio of original and licensed IP titles includes Cooking DASH, Covet Fashion, Deer Hunter, Design Home and MLB Tap Sports Baseball.

As Glu was one of our best performing holdings in 2018 and the first quarter or 2019, the expectations of Glu reporting consistent positive earnings got ahead of itself. We decided to trim our position during the quarter and that worked out in our favor.

We still believe in the video game space over the long-term, but the valuation fundamental will limit our position weight as the management executes its strategy.

MasterCraft Boat Holdings, Inc. (MCFT)

Lowest 5 Performing Security:
Sterling Small-Cap Value Diversified

MasterCraft Boat Holdings is an innovator, designer, manufacturer and marketer of premium recreational powerboats through its three subsidiaries, MasterCraft, NauticStar and Crest Marine. Our thesis on MCFT is again a view that leisure is in a long cycle of gaining share of the economy.

MCFT is executing on their strategy to capture additional market share from adjacent boating categories through acquisitions. Management indicated strong retail demand for its products across the brand portfolio, including the Crest premium pontoon line. Regardless of the strong quarter, concerns about dealer inventory have the market concerned about the future. We have the patience to wait for these concerns to dissipate and look forward to strong unit volume across all boat brands, including a newly released luxury brand, Aviara.

Sterling Partners Equity Advisors
Small-Cap Strategy Performance
2Q 2019

Sterling Small-Cap Value Focus	**QTD**	**One Year**	**Three Years**	**Five Years**	**Seven Years**	**Ten Years**	**Since Incep 6-30-2001**
Sterling SCV Focus (Gross)	6.17%	0.40%	15.46%	8.03%	13.69%	16.22%	11.16%
Sterling SCV Focus (Net)	5.90%	-0.59%	14.32%	6.96%	12.57%	15.07%	10.07%
Russell 2000 Value Index	1.37%	-6.24%	9.85%	5.39%	10.33%	12.41%	8.09%

Sterling Small-Cap Value Diversified	**QTD**	**One Year**	**Three Years**	**Five Years**	**Seven Years**	**Ten Years**	**Since Incep 12-31-2006**
Sterling SCV Diversified (Gross)	4.28%	-0.41%	17.33%	9.97%	14.46%	15.36%	8.68%
Sterling SCV Diversified (Net)	4.02%	-1.39%	16.17%	8.89%	13.33%	14.23%	7.60%
Russell 2000 Value Index	1.37%	-6.24%	9.85%	5.39%	10.33%	12.41%	5.53%

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