TRAN CAPITAL MANAGEMENT

Partners Strategy | Third Quarter 2022

Dear Clients and Friends,

We hope you and your family are well. Persistent high inflation, rising interest rates, and slowing economic conditions continued during the past three months giving us no relief to a challenging 2022. These factors resulted in a tough quarter with the S&P 500 down 5%, bringing the market's year-to-date return to -23.9%. We know what the Federal Reserve has done, and we know what the Fed will likely continue to do. To address inflation, the Fed has raised the Federal Funds Rate by over 300 basis points, or 3%, so far this year to 3.25%. This was far greater than what market expected. At the start of this year, the market expected just one 25 bps hike in all of 2022. As shown in the table at the bottom of page, compared to the start of the year, the Fed Funds Futures implied rate for yearend 2022 has increased from 0.68% to 4.24%. With this more aggressive policy action, concerns of a hard landing and potential recession in 2023 have led to a downward revision in S&P earnings and a contraction in the market multiple. Equity and fixed income markets have responded in kind, declining materially in 3Q and through nine months this year.

Equity Benchmarks	Return (3Q 2022)	Return (YTD 2022)
S&P 500	-4.89%	-23.88%
NASDAQ Composite	-3.91%	-31.99%
Russell 2000	-2.18%	-25.11%

Fixed Income Benchmarks	Return (3Q 2022)	Return (YTD 2022)
Bloomberg U.S. Aggregate Bond Index	-4.75%	-14.61%
Bloomberg U.S. Corporate Bond Index	-5.06%	-18.72%
iShares 20+ Year Treasury Bond ETF	-10.29%	-29.92%

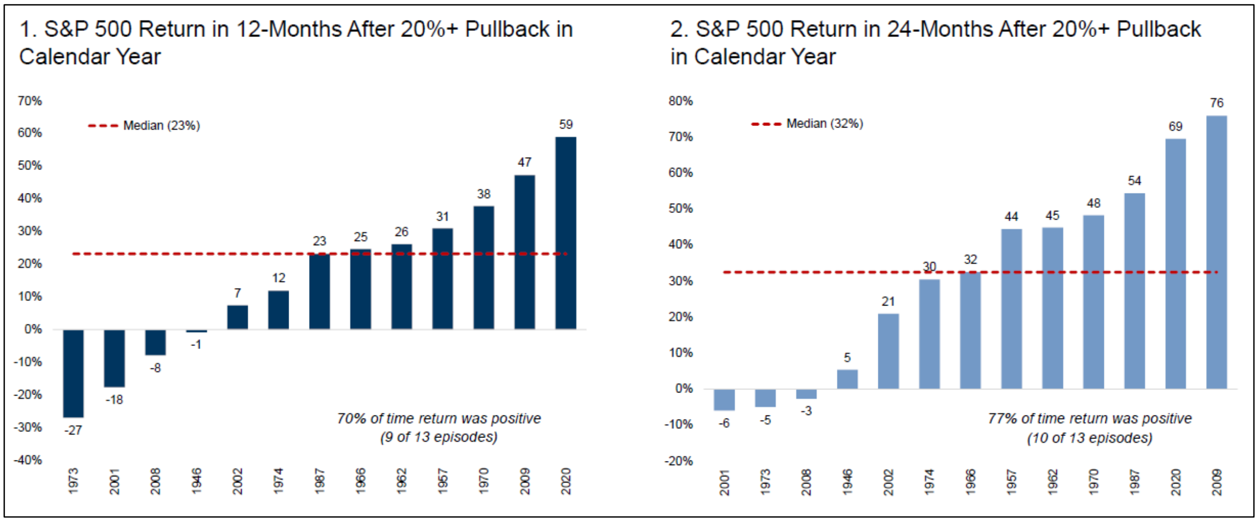
Source: Bloomberg

TCM's Partners Strategy performance was also affected by these macro headwinds. Third quarter and year-to-date returns are -9.67% and -34.62%, net of fees, respectively. This has been a very difficult market for investors as valuations declined, almost irrespective of fundamental factors.

While the Federal Reserve's actions to date have caught the market by surprise, market participants have since adjusted their expectations to be more in line with the Fed's intentions – that they will keep hiking until there's clear line of sight to lower inflation and reduced aggregate demand. The market now expects an additional 100 bps, or 1%, of hikes between now and year end. Given the sharp revision in rate expectations, we believe it is likely that much of the Fed's future rate hikes are now priced into the market and adequately reflected in today's expectations. **If the Fed raises rates within these expectations, we believe equity prices will recover, especially for companies with strong competitive advantages whose businesses continue to grow.** While the past is never a perfect indication of the future, we are nevertheless encouraged by the fact that the S&P 500 has not only risen every year after a mid-term election since WWII but also

	Fed Fund Futures			S&P 500			S&P 500			
Date	Implied FFR YE 2022	% Δ vs. YE 2021	Δ bps m/m	Est. EPS 2022	% Δ vs. at YE 2021	% Δ m/m	Price	% Δ vs. at YE 2021	% Δ m/m	P/E
12/31/21	0.68%	0.0	-	209.9	0.0%	-	4,766	0%	-	22.7x
1/31/22	0.82%	14.2	14.2	221.5	5.5%	5.5%	4,516	(5%)	(5%)	20.4x
2/28/22	1.32%	64.0	49.8	223.2	6.3%	0.8%	4,374	(8%)	(3%)	19.6x
3/31/22	1.42%	74.5	10.5	225.8	7.6%	1.2%	4,530	(5%)	4%	20.1x
4/29/22	2.40%	171.7	97.2	226.7	8.0%	0.4%	4,132	(13%)	(9%)	18.2x
5/31/22	2.86%	218.2	46.5	227.7	8.5%	0.4%	4,132	(13%)	0%	18.1x
6/30/22	2.74%	206.0	(12.2)	227.9	8.6%	0.1%	3,785	(21%)	(8%)	16.6x
7/29/22	3.38%	269.7	63.7	226.7	8.0%	(0.6%)	4,130	(13%)	9%	18.2x
8/31/22	3.75%	306.7	37.0	226.9	8.1%	0.1%	3,955	(17%)	(4%)	17.4x
9/30/22	4.24%	356.0	49.3	223.9	6.6%	(1.3%)	3,586	(25%)	(9%)	16.0x

Source: Bloomberg



Source: Goldman Sachs Investment Strategy Group, October 2022

averaged a 1-year return of 15%.[1] Moreover, following periods where equity markets declined 20% or more, the S&P 500 has posted strong performance in the 1- and 2-years thereafter with median returns of 23% and 32%, respectively.[2]

With some storm clouds still on the horizon, including the risk of the Fed oversteering, we are not quite ready to call this the bottom. However, we do believe that sentiment is overwhelmingly negative and that we are likely closer to the bottom than the market realizes. Markets are forward-looking and typically bottom 6-9 months before earnings reach a recessionary trough. As volatility increases, investor time horizons tend to decrease. **For long-term investors, it is precisely during these trying periods that high-quality companies can be purchased at attractive prices.** While difficult, this strategy has rewarded us in the past. With strong stock picking, we believe we can navigate these uncertain times and outperform in the years ahead.

Is Inflation Peaking?

Money Supply & CPI

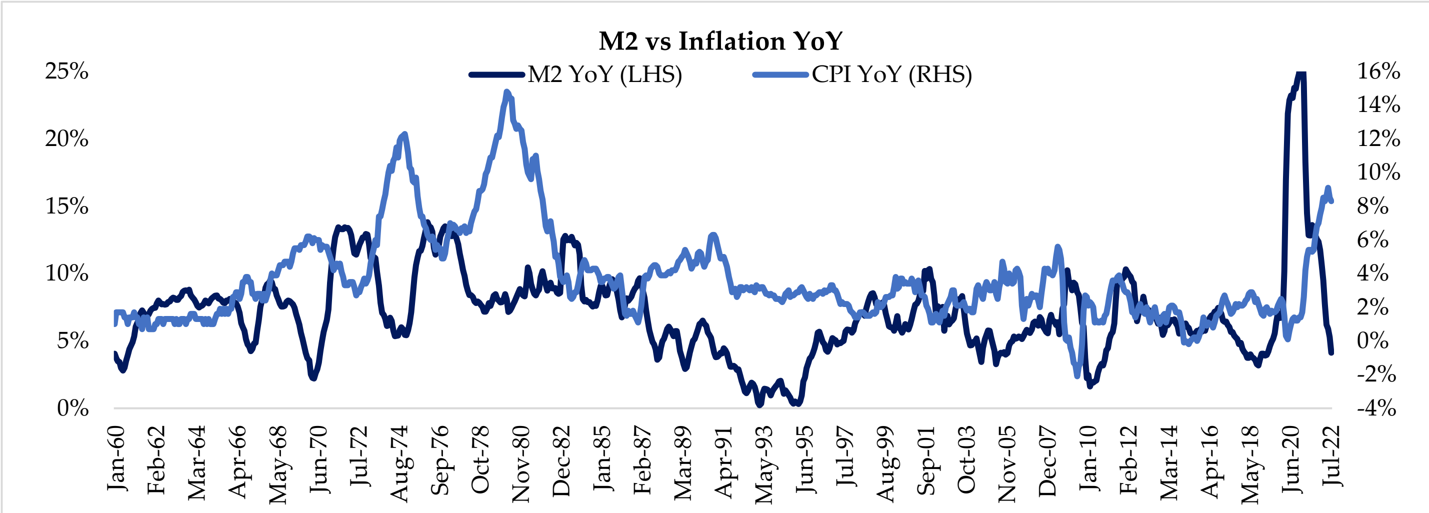
M2 is a broad measure of the money supply in the economy. Consumer Price Index (CPI) measures the monthly changes in prices paid by consumers for a representative basket of goods and services. As money supply increases, if the supply of goods and services remains constant, then prices increase – and similarly vice-versa, as money supply decreases, then prices consumers pay decline, all else equal. Through the pandemic, this relationship had been exacerbated by supply disruptions, which led to declines in the supply of goods right when the money supply increased.

We believe that with M2 falling and supply chains unwinding, a reversal in the CPI is likely on the way. This doesn't happen immediately, but over time. As shown in the chart on the next page, which compares year-over-year changes in the M2 against the CPI from 1960 to today, changes in M2 can be a leading indicator of changes in CPI. Growth of M2 peaked in Feb 2021 at 27% and has decelerated to 4% as of August 2022. We believe this deceleration will lead to a deceleration in the CPI. You can see this relationship in prior cycles.

Supply & Demand

Inflation is the result of more demand than supply. Persistent inflation is very damaging to households. In past letters, we've shared that households amassed over $2 trillion of excess savings through the pandemic. However, with high inflation over the past year for everything from gasoline to groceries, consumers are tapping into these excess savings from the pandemic.

[1] Wall Street Journal, October 2022
[2] Goldman Sachs Investment Strategy Group, October 2022



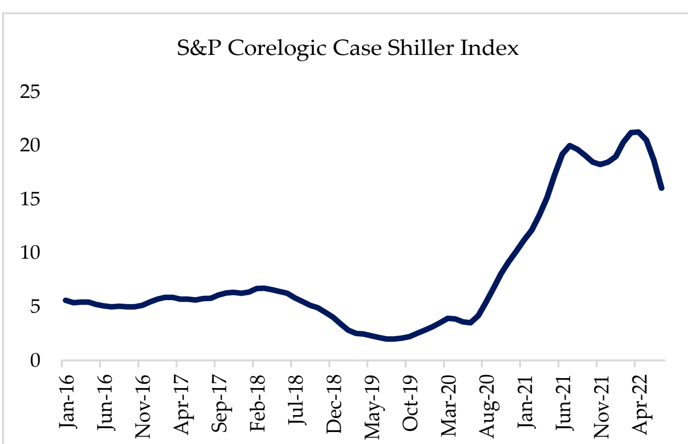
Source: Federal Reserve Bank of St. Louis

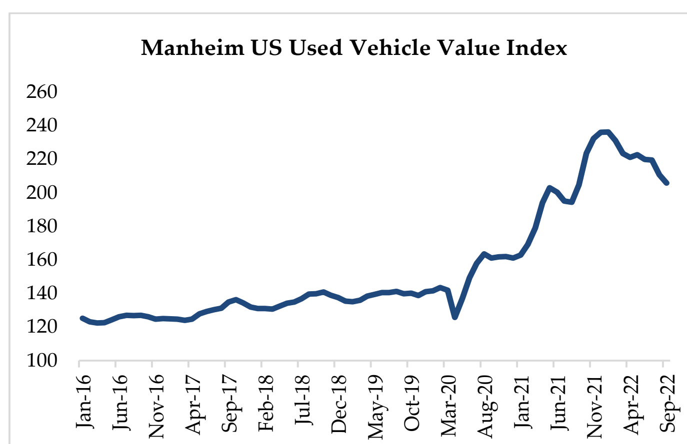
By raising interest rates, the Fed expects to diminish demand. This policy tool, in combination with supply chain improvements and a deceleration in the money supply should bring down inflation. While there is a lagged effect to raising interest rates, we are seeing an increasing body of evidence that inflation is moderating. Here are a few data points to consider:

Housing – the housing industry makes up about 16% of U.S. GDP.[3] With higher interest rates, 30-year mortgage applications have declined over 80% y/y.[4] With lower demand, home prices have begun to fall. As shown in the chart below, the S&P/Case-Shiller U.S. National Home Price Index, which tracks the price of single-family homes, has continued to soften.

Automobiles – with supply chain shortages, new and used vehicle prices spiked to record levels during the pandemic. However, with higher interest rates (which reduces affordability) and improving supply chains, vehicle prices are declining. As shown below, the Manheim Used Vehicle Value Index, which captures used vehicle pricing trends, has begun declining over the past several months.

Employment – the U.S. unemployment remains low, measuring in at 3.7% in August. Meanwhile, job openings remain over 10 million. Ironically, a strong employment environment is contributing to the Fed's aggressive monetary policy. With higher interest rates curtailing demand across the economy, we suspect that the unemployment rate will soon increase as companies look to cut costs.





Source: Bloomberg

[3] National Association of Home Builders, January 2022
[4] Mortgage Bankers Association via Mortgage News Daily, October 2022

We believe it's a matter of *when* not *if* inflation cools off, which would result in the Fed pausing its tightening policy. Therefore, we continue to focus our investments on high-quality companies that provide essential goods and services to their customers. At the margin, we reduced some of our more consumer discretionary exposed investments while adding to many of our core positions. Additionally, we started two new positions, one of which we've owned before.

Portfolio Positioning

During the quarter, we sold our positions in **Lithia Motors (LAD)**, **Aptiv (APTV)**, and **Scotts Miracle-Gro (SMG)**. We admire each of these business models but wanted to reduce our exposure to companies dependent on consumer discretionary spending.

Lithia Motors is a leading auto dealer that has been selectively consolidating the industry. With auto retail prices elevated because of supply chain shortages, auto dealers in general have been over-earning on new and used vehicle sales. We suspect that as supply chains improve and economic conditions tighten, retail prices will revert to historic levels, which would impact Lithia's margins. We wanted to step aside before that happens.

Aptiv is a leading supplier of advanced safety and electrical architecture solutions to all the leading global auto manufacturers. We like Aptiv's position as a beneficiary from the secular trends of electric vehicles and autonomous driving. However, about a third of Aptiv's revenue is derived from Europe. With Russia's ongoing war against Ukraine and the resulting energy disruptions in Europe, we believe that vehicle production schedules in Germany and the rest of Europe are at risk. This can manifest itself in rolling production schedules that would impact the entire auto supply chain's revenue and profits, Aptiv included. We would like to repurchase Aptiv once the industry is clear of this risk as we are confident in the company's ability to grow 8-10% above industry over the long term.

Scotts Miracle-Gro is a leading lawn and garden company in the U.S. We originally thought that the business enjoyed consistent demand with strong pricing power. Unfortunately, we've observed that while some of our thesis is true, other factors, including a surprise reduction in restocking at big box home improvement stores, has really disrupted Scott's operations. As such, we decided to exit our position.

We reallocated the proceeds from these sells to some of our core positions, including **Sherwin Williams (SHW)**, **Ball Corp (BALL)**, and **SVB Financial (SIVB)**. While these stock prices may be down, we believe the intrinsic value over the next 3-5 years remains attractive. We also used some of the proceeds to start new positions in **Progressive (PGR)** and **Entegris (ENTG)**.

As you may remember, we've owned **Progressive** in the past. Progressive is the 3rd largest personal auto insurer in the U.S. and has been growing its presence in homeowner's insurance to offer bundled home & auto policies to higher value customers. We believe Progressive is advantaged relative to other auto insurers due to its ability to use data for better customer segmentation, effectively pushing less profitable customers to competition over time. This is exhibited by the insurer's industry leading underwriting profitability and returns on equity. This data has also allowed Progressive to push through pricing changes earlier than peers.

Progressive started pushing insurance policy rate increases through to its customer base in 3Q 2021 in response to an increase in losses sparked by rising auto part and auto replacement costs along with a return to normal driving frequency. This earlier than peer action led to a slowdown in premium growth, which we believe is on the cusp of inflecting as competitor rate hikes set in. Additionally, Progressive invests policyholder premiums to earn interest income, making it a positive interest rate play. Approximately 20% of Progressive's pretax profits in 2021 came from investment income. In a higher interest rate environment, we believe the insurer will invest in securities with higher returns, resulting in an acceleration in investment income.

Entegris is a leading supplier to the semiconductor industry. Specifically, Entegris manufactures and supplies micro-contamination control products, specialty chemicals, and advanced materials handling solutions. The company sells products to all the major semiconductor manufacturers in the world. Approximately 80% of Entegris' revenue comes from consumables that are more recurring nature, a characteristic we seek in many of our holdings. We believe that as the complexity of semiconductor manufacturing increases, Entegris will benefit from increasing materials content per wafer and can sell more product and services to customers. In fact, 40-55% of Entegris' revenue is associated with leading edge nodes manufacturing, which generate above-industry growth.

Recently, the U.S. passed the bipartisan $50 billion CHIPS for the America program, which will support new manufacturing capacity and strengthen research and development for semiconductors in the U.S. Simultaneously, we observe that there are several new semiconductor manufacturing plants being built in the U.S. These include Samsung's $17 billion investment in Tyler, Texas; Intel's $20 billion factory in New Albany, Ohio; and Taiwan Semiconductor's $12 billion plant in Phoenix, Arizona. Entegris is an essential supplier into the critical semiconductor industry. Not surprisingly, the company traded at over 35x P/E in 2020 and 2021. With the market pullback, Entegris now is trading at 18x 2023 earnings. We believe that Entegris' earnings will compound at a mid-teens rate over the next several years and are happy to be shareholders at these more reasonable valuations.

Looking Forward

This has been one of the most difficult markets in which to invest. **We are reminded that time in the market is more important than timing the market.** While that discipline is true, we want to acknowledge how difficult it is to be disciplined. We have managed through global macro scares and market drawdowns in the past and are confident that we will manage through this current environment as well. We also take comfort in only investing in high-quality companies that have sustainable competitive advantages. We believe that by focusing on these opportunities, we can construct a portfolio that will grow revenue and earnings faster than the market and earn higher returns on capital, while also being purchased at reasonable valuations. At quarter end, our portfolio's characteristics compared to the market are as follows:

	P/E Ratio			EPS Growth			Sales Growth			ROE	Market Cap
	2021	2022	2023	2021	2022	2023	2021	2022	2023	TTM	$B
Partners Strategy	16.3x	17.1x	14.0x	237.1%	3.2%	28.6%	24.1%	18.0%	11.4%	25.1%	$307
S&P 500	18.0x	16.4x	15.2x	56.0%	16.2%	8.0%	14.2%	12.3%	4.2%	20.6%	$472

If you have any questions, please do not hesitate to contact us at (415) 461-3800. Thank you for support. We will continue to work hard to navigate these markets.

Sincerely,

Quoc K. Tran
Chairman & CIO

Michael Im
Co-Portfolio Manager & Director of Research

Eric A. Winterhalter
President

Important Disclosure

Performance is provided as supplemental information and is based on the Partners Strategy Composite. Performance results reflect all income, gains and losses and the reinvestment of interest and other income. All rates of return are reported "NET" of fees. Additional information regarding the policies for calculating and reporting returns is available upon request. A complete listing and description of all TCM composites and performance results is available upon request.

The 1-year, 3-year and 5-year net of fees returns of the Partners Strategy Composite as of September 30, 2022 are -30.65, 4.95 and 7.82 respectively. The 1-year, 3-year and 5-year returns of the S&P 500® Index as of September 30, 2022 are -15.46, 8.17 and 9.24 respectively. 3-year and 5-year performance figures are annualized.

The S&P 500® is an unmanaged stock market index and is not available for direct investment. The S&P 500® Index represents the stocks of 500 leading U.S. publicly-traded companies from a broad range of industries. The performance of an unmanaged index reflects no deductions for fees, expenses or taxes which would affect performance of actively managed assets. The volatility of the S&P 500® Index may be greater or less than the volatility of the portfolios in the composite.

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