October 2021

Dear Clients,

The third quarter of 2021 saw the broad stock market averages take a pause compared to the strong performance in 1H21. We believe this pause is due to increased investor concerns regarding both the Covid Delta variant and the worsening supply chain shocks that have restrained the ability of many companies to meet strong demand. While the Russell 2500 Value index fell 2.09% in 3Q21, it continued to outperform the Russell 2500 Growth index which fell 3.53%. Year to date the Russell 2500 Value is up 20.11% versus a 4.83% gain in the Russell 2500 Growth index. We believe value is still in the early stage of a sustainable recovery versus growth. We are pleased with the performance of the Rewey Asset Management (RAM) small and midcap strategy versus the Russell 2500 Value index for both the quarter and on a year-to-date basis.[1]

3Q21: A Quarter Of Delays

The consistent theme of 3Q21 was delays. The nation's recovery from Covid was delayed by the Delta variant, which brought back restrictions on socializing and commerce. While the economy continued to recovery in 3Q, the pace was slower. Non-farm payroll growth slowed to 235 thousand in August compared to 962 thousand in June.[2] U.S. auto sales, which had grown to a red-hot 18.51 million rate in April, slowed to a paltry 12.18 million rate in September, driven by microchip and other supply shortages.[3] The government did not accomplish much either, with hesitancy on approving the $1 trillion infrastructure bill and the $3.5 trillion entitlement bill and a delay in legislation to raise the debt ceiling. These, and many other factors, have caused expectations for U.S. GDP growth to slow to an expected 5.5% for 3Q21 vs. 6.7% and 6.3% in 2Q and 1Q21, respectively.[4,5]

Our View Has Not Changed

Despite the hiccups of 3Q21, our view is that the economy will continue to strengthen on the back of the prior massive stimulus actions, and the accommodative stance of the Fed. Forecasts of 5.5% GDP for 3Q21 can hardly be described as weak. Data also indicates that people are finding jobs in this stronger economy, with the U-3 total unemployment rate falling to a post pandemic low of 5.2% in August.[6] Inflation clearly didn't take a break in 3Q21 either, with the Consumer Price Index (CPI) rising to 5.3% in August and the Producer Price Index (PPI) rising to a scorching 10.5% in August.[7] These strong inflation readings support continued strong demand that is limited by supply, as price increases almost never stick in weak demand environments.

As we wrote in our June 16th Market Musing blog, *The Fed Taper: When Not If* (https://www.reweyassetmanagement.com/post/the-fed-taper-when-not-if), the improving economy and the continued bloating of the Fed's balance sheet would likely lead the Fed to begin moderating its bond purchases in the near term. With the backdrop of a strong economy and a balance sheet that has swelled to over $8.4 Trillion, on September 22nd in its FOMC statement the Fed finally acknowledged that "the economy has made progress" towards its goals and indicated "that a moderation in the pace of asset purchases may soon be warranted." Most pundits translated this announcement as an indication that the Fed will likely begin tapering in November. In our view, both higher interest rates and higher pricing power, as evidenced by the PPI, bode well for smaller market cap companies.[8]

Supply Shocks Take Their Toll

Over the last few weeks of 3Q21, dozens of companies have lowered their projected earnings expectations due to supply shocks. These companies have typically cited very strong continuing demand, even record demand, for their goods and services, but blamed their earnings reductions on supply chain issues, mainly in labor shortages, logistics challenges and the availability and price of raw materials. Most of the management commentary followed the general theme that these supply chain shortages should not cause permanently lost sales, but rather push out most of the current excess demand into future quarters.

What Problem Would You Rather Have?

While we never like to see companies lower earnings estimates, we think the negative market reaction to the supply shortages is misguided. We ask the question to you: If you could have a scenario with demand that is too strong for supply, or a situation where end demand is soft and supply is in excess capacity – which would you rather have? To us, the choice is obvious - strong demand is never a bad thing.

In discussing strong, or record, current demand and a likely push out of sales into 2022, we think these management teams have provided the market with higher visibility on future sales and earnings. As supply chain kinks are worked out over the next few months, end-market demand should be filled and depleted inventories levels likely rebuilt. As we focus on a long-term investing horizon, we see the news announcements of likely sustained revenue strength as a positive.

Portfolio Highlights

We believe our portfolio is well positioned for continuing economic strength, rising rates and rising inflation, while also very attractive from a valuation perspective. Four holdings are trading under book value, six additional holdings are trading at less than 1.6x book, and our composite portfolio is trading at an average of 1.94x book value.[9] It is also worth highlighting that four of our holdings have no sell-side coverage, and nine others have five or fewer covering analysts.[10] We believe this anonymity provides us with the opportunity to identify companies that pass under the radar for other investors, and help secure positions at attractive valuations.

At quarter-end, our cash level was a higher than normal 9.8%.[11] In the last two weeks of the quarter, we sold one position to zero and substantially trimmed back two others post strong gains. Our cash levels will fluctuate as part of our investment process, and our quarter ending cash level should not be seen as a defensive tilt. We continue to find new ideas for our work-in-process lists, and have never held the view that there are no actionable, individual ideas to be found in the market. We continue to be opportunistic to invest in new and existing positions and to harvest from those approaching our Assessed Fair Value (AFV) price targets.[11]

Lincoln National (LNC) was our top contributor in the quarter, and became our largest position on price strength as shares rose to a high of $72.90 September 28th, vs. a June 30th close of $62.84. While shares were likely helped by the strong performance of most financials post the Fed's announcement on tapering, Lincoln delivered tangible progress on many of its self-help goals in the quarter. While the life insurance industry has struggled with higher deaths from Covid and the negative impact of lower interest rates, Lincoln has taken the offensive with operational cost cuts, as well as redesigned and repriced product offerings. They have also invested heavily in digital distribution initiatives. Lincoln has taken the correct view, in our opinion, not to chase market share in a low-return environment and instead, has deployed capital aggressively to repurchase shares. Over the last 10-years, Lincoln has reduced its share count through repurchases from 307 million in 2011 to 192.2 million at June 30th. On September 17th, LNC announced another large reinsurance transaction with Resolution Life, which will free up an additional $1.2 billion of capital, $900 of which will be directed towards share repurchases over the next twelve months, approximately 7% of its market cap. We think the waning impact of Covid, the newly introduced insurance product offerings and the rising interest rate environment will all benefit LNC over the next 3-5 years. Further, we applaud the aggressive approach to share repurchases, as LNC still is trading significantly under its June 30th book value of $115 per share. Lincoln remains a top holding, despite our trimming back the position on strength late in the quarter.[12]

Heritage Insurance Holdings (HRTG) was our weakest performer in the quarter, as shares fell to $6.81 on September 30th vs. a June 30th close of $8.58. With only a $187 million market cap and only four sell-side firms covering HRTG, we believe the shares suffer from investor neglect. As discussed in our 2Q21 letter, Heritage has been aggressively raising insurance prices, along with the industry, to overcome lower interest rates and recently high levels of storm losses. Further, legislative changes in Heritage's largest market, Florida, should greatly reduce the high levels of fraud losses the industry has faced over the last three years. While there was no specific news that drove down shares in the quarter, we believe investors in general, were nervous about the approaching hurricane season. We feel this risk is misunderstood at HRTG, as it has installed caps through reinsurance that would limit its losses, even in a worst-case scenario. We continue to see compelling value in Heritage, due to a strong balance sheet, and an improved pricing and regulatory environment. HRTG is likely to resume its share repurchase activity this fall, which we see as a compelling use of capital as it is trading at only 44.8% of its $15.20 book value. In the meantime, we are paid to wait, as Heritage offers a compelling 3.5% dividend yield.[13]

Miller Industries (MLR)

Miller Industries (MLR) is the world's largest manufacturer of towing recovery equipment (wreckers, car carriers and hydraulic booms). Miller is based in Ooltewah, TN and has four manufacturing facilities in the U.S. and two in Europe. Miller sells its products under ten brand names and its R&D focused organic growth initiatives have led the industry in innovations since its formation in 1990. We see Miller as an undiscovered gem, with investor neglect stemming from having no large public competitors and no sell-side coverage.

Shares of Miller fell in 3Q21 after warning about supply chain shortages that are impacting its operations, in labor shortages and in receiving the delivery of chassis. Miller manufactures the bodies of wreckers and car carriers and installs them on truck chassis purchased from automotive companies, where production is strained due shortages of microchips. In its 2Q21 release, Miller noted that these pressures impacted margins by 240 basis points, and that it saw these pressures continuing into 3Q21. The market took this news poorly and Miller closed 3Q21 at $34.04, down from its April 6th high of $47.57.

We believe this negative reaction is overdone. In immediate response to these issues, Miller announced that it has raised prices twice to offset higher costs, and expects only a short-term 4-5 month lag on realizing these price increases as its backlog converts to sales. Further, Miller has notified its dealers that it will implement an additional immediate price surcharge if conditions warrant, and with strong end market demand these price increases are sticking. Further, Miller has broadened its supply network for its own production, and continues to help its dealer network source truck chassis. We believe this commitment to supporting its dealers, of which 85% distribute only Miller brands, is another tangible positive that highlights Miller's market strength.

We see a compelling investment opportunity in MLR both in the near term, as supply chain issues normalize, and over the longer term as it continues to execute on its organic growth opportunities.

From a financial perspective, Miller has a rock-solid balance sheet, which provides us with the visibility and confidence to invest with a long-term horizon. At June 30th, Miller had no debt and $53.9 in cash, or

$4.73 per share, representing 13.9% of its September 30th market cap. Miller also has an undrawn $50 million revolving line of credit with First Horizon Bank through May of 2027. Miller has no pension and no significant legal or environmental liabilities saddling its balance sheet.

Miller's book value per share is $25.38, and has grown at an astounding CAGR of 9.8% over the last 5-years, inclusive of the years 2020 and 2021 which have been impacted by Covid and supply chain issues. Despite operating in a cyclical industry, Miller has paid a consistent dividend since 2010, and now pays $0.72 per year, for a 2.1% yield. Looking forward, management has indicated it is not interested in large M&A, but prefers to invest for organic growth and perhaps small bolt-on technology driven acquisitions.

We believe that as supply chain issues normalize, Miller can exceed the record level of sales and earnings it achieved in 2019, due to new product introductions, global growth, its recently completed capital investment program and margin improvements from operating leverage and its I.T. systems upgrade.

Over the period of 2016-2020, Miller invested a whopping $97 million in capital into its facilities, focused on capacity expansion, automation and environmental initiatives. This staggering investment level is notable not only because it is roughly $8.51 per share, or 25% of its total market cap, but more importantly that the investment is finished, and it retains a net cash position of $4.73 per share post this program. Miller invested $29 million into its Pennsylvania facility and $25 million into its two Tennessee facilities to not only increase capacity, but to install sophisticated robotic production systems to decrease labor intensity and streamline production. Miller also scores highly on this investment from an ESG perspective, installing energy efficient LED lighting and new ventilation systems to improve workplace quality.

In 2019, Miller opened its free-standing R&D facility in Chattanooga, TN, supporting its commitment to organic sales growth. In fact, in late 2019, MLR introduced the M100, the world's largest tow truck. Miller sees continued investment opportunities to grow revenues in both domestic and global military markets as well.

In 1Q21, Miller completed its initial upgrade of its Enterprise Resource Planning (ERP) system, and noted in its 2Q21 release that it was already beginning to see the benefits of this system. We believe that with increased capacity, strong end-market demand, increased pricing, new product introductions and an upgraded ERP system, MLR has a highly visible path to margin improvement as well as sales growth.

The negative impacts of Covid and supply chain issues have clearly impacted Miller's sales and revenues in 2021, but have not, in our view, dampened the long-term investment case. Despite forecast sales in 2021 of approximately $650 million, well below 2018's peak of $818 million, we believe Miller's growth initiatives will allow it to exceed its peak sales level once supply chain kinks normalize. In its 2Q21 release and earnings call, Miller noted that despite its supply issues, it continued to see improved industry dynamics and healthy customer demand.

Our near-term Appraised Fair Value (AFV) price target of $46.50, which is below MLR's April high, represents 10x our 2021 EBITDA forecast, which is depressed vs. prior years. This AFV represents 36.6% upside to its September 30th close, plus an additional 2.1% dividend yield. Longer term, with a recovered supply chain likely in mid-2022, we see Miller's AFV at $52.50, which is still conservative at only 9x its 2019 EBITDA level. While Miller has not repurchased shares since 2011, we have urged management to aggressively buyback shares at these valuation levels, as management has indicated that has no alternative large calls on its cash balance or future cash flow.

Last, although not part of our investment case, we see Miller as activist/take-over vulnerable. While the Founder Bill Miller, 74, remains chairman and his son, Bill Miller Jr., 42 is Co-CEO, Miller management and directors in total own only a paltry 3.65% of the shares outstanding. There is no large option overhang for MLR either, as basic shares of 11.4 million match the diluted share count. With what we see as a strong investment outlook, completely renovated manufacturing facilities and a strong net cash position, Miller could be an attractive takeover target for a strategic or private equity buyer.[14]

Looking Forward

Despite the relatively flat market returns in 3Q21, we see a compelling argument for stronger performance for the small/mid value sector into 4Q21. The strengthening economic recovery and the likely increase in interest rates due to Fed tapering, bode well for both the relatively high industrial and financial weightings in the small cap universe. Additionally, we believe our concentrated portfolio offers compelling valuation opportunities over both a short and long-term horizon.

In our view, the market has an extremely short-term investment horizon due to the rapid growth of hedge funds, quantitative strategies and new armies of day traders. We see these styles as increasing market volatility, as they react to short-term data points that we believe are relatively meaningless over a longer-term horizon. We believe our long-term value focus can not only identify companies that are likely to prosper over the next three to five years, but can also take advantage of price volatility that can be caused by the rapid trading actions of these short-term strategies. Over the next few months, the economy is likely to continue to strengthen and interest rates are likely to rise due to the dual impact of inflation and Fed tapering. Most importantly, we do not need to be exactly right on when this will happen. Time is our ally, and to us the question is when, not if. We like the setup of risking time instead of capital, and we see the potential return profile of our portfolio heavily skewed to the upside vs. downside risk level.

Thank you for your continued trust and support. Stay safe and healthy. Please do not hesitate to contact us for client service, to discuss our commentary or to simply opine on the market and stocks.

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1 Russell 2500 Value and Russell 2500 Growth Index performance levels are sourced from Bloomberg. The Russell 2500 Value and Russell 2500 Growth indicies are an unmanaged group of securities considered to be representative of the small and mid-cap stock market in general. Indexes are unmanaged and do not incur management fees, costs, or expenses. It is not possible to invest directly in an index.

2 Change in June non-farm payrolls from U.S. Bureau of Labor Statistics

3 U.S. SAAR monthly auto sales rates sourced from Wards Automotive, via Bloomberg.

4 US Q/Q GDP growth rate for 2Q21 sourced from the U.S. Bureau of Economic Analysis, via Bloomberg.

5 5.5% estimated 3Q21 GDP sourced from The Conference Board https://www.conference-board.org/research/us-forecast

6 U-3 US Unemployment rate sourced from U.S. Bureau of Labor Statistics

7 U.S. CPI Urban Consumers year-over-year reported by Bureau of Labor Statistics. U.S. PPI Final Demand Y/Y SA reported by Bureau of Labor Statistics, both sourced via Bloomberg.

8 Federal Reserve Balance Sheet sourced from https://www.federalreserve.gov/monetarypolicy/bst_recenttrends.htm. Federal Reserve 9/22/21 statement https://www.federalreserve.gov/newsevents/pressreleases/monetary20210922a.htm

9,11 All portfolio discussion is based off our model RAM Smid portfolio. Company financial estimates sourced from Rewey Asset Management proprietary analysis, and Bloomberg BEST company estimates. Historical pricing and company financial data sourced from company 10Q and 10K filings, and Bloomberg. Individual portfolios may hold slight deviations in position sizes and names held. Book value portfolio estimates exclude Graftech International, due to a negative equity position that would distort the comparison by lowering the value of the portfolio multiple.

10 Covering active sell-side analyst data sourced from Bloomberg.

12 LNC quarterly performance information sourced from Black Diamond/ASN performance reports. Other LNC commentary sourced from company earnings releases, 10Q, 10K filings, company presentations, Bloomberg and Rewey Asset Management proprietary analysis.

13 HRTG quarterly performance information sourced from Black Diamond/ASN performance reports. Other HRTG commentary sourced from company earnings releases, 10Q, 10K filings, company presentations, Bloomberg and Rewey Asset Management proprietary analysis.

14 All financial ratios, statistics, and projections discussed in the Miller Industries (MLR) commentary are sourced from MLR's 10-K and 10Q filings, company press releases, company public conference calls and webcasts, company slide presentations, MLR company webpage, RAM discussions with MLR management and Rewey Asset Management proprietary financial analysis and Rewey Asset Management industry due diligence. Historical share price information sourced from Bloomberg.

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