

It's a Small World After All?

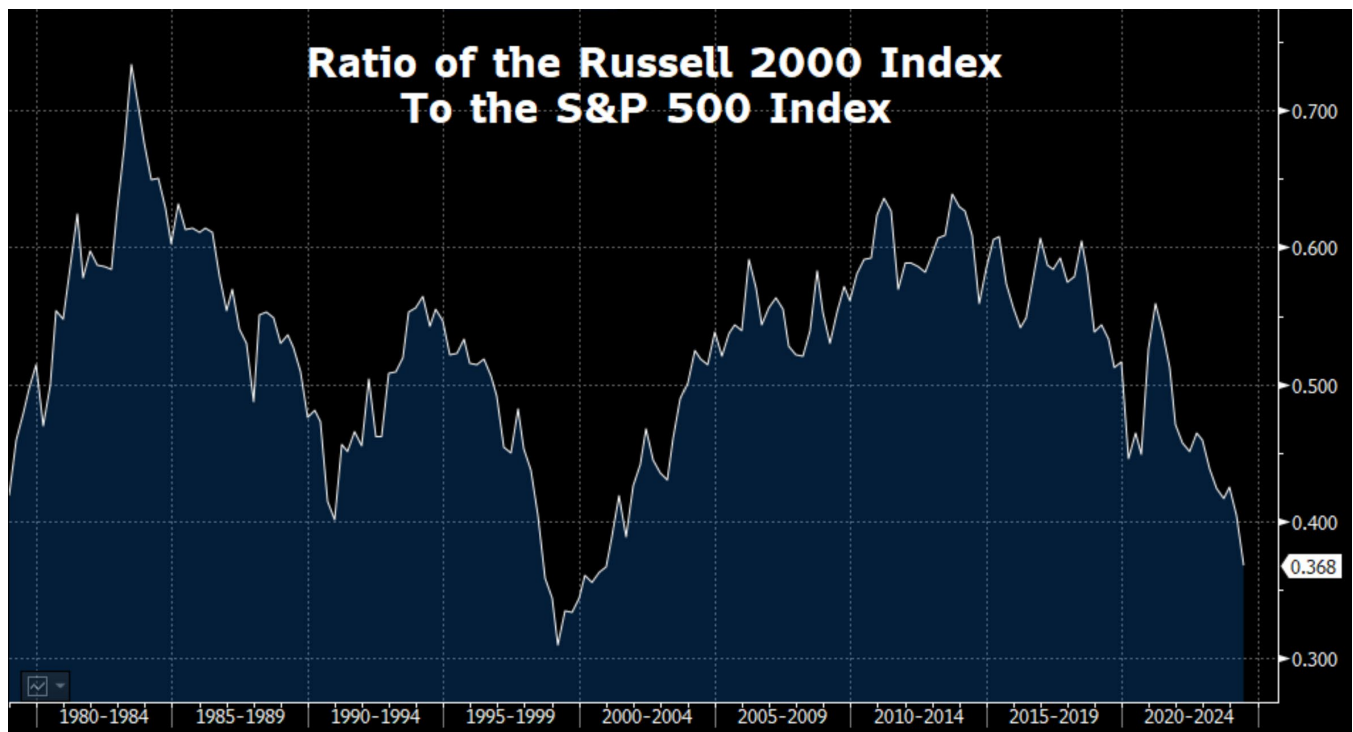
If you have ever been to Disney World, you are probably familiar with the “Small World” ride, on which you cruise around cheerful and whimsical replicas of various nations to the catchy tune of a “jubilant chorus of children from around the globe.”¹

*It's a world of laughter,
A world of tears.
It's a world of hopes,
And a world of fears.
There's so much that we share
That it's time we're aware,
It's a small world after all.*

*It's a small world after all.
It's a small world after all.
It's a small world after all.
It's a small, small world.*



If you are invested in small-cap stocks, however, it has been a “world of tears...And a world of fears.” The U.S. stock market is emphatically **not** a small world after all. The ratio of the Russell 2000 Index (of small-cap firms) to the S&P 500 Index (of large-cap firms) is plummeting close to all-time lows last seen during the run-up in the 1990s tech bubble.² Over the last decade the Russell 2000 Index has returned 6.97% annually to the S&P 500's 12.9%, with the Russell flat on the year vs. S&P's 15% rise. And over the last three years, the small-cap index is down 10%. This underperformance begs several questions: (1) Are there any opportunities; (2) Why the underperformance; and (3) Does it matter?

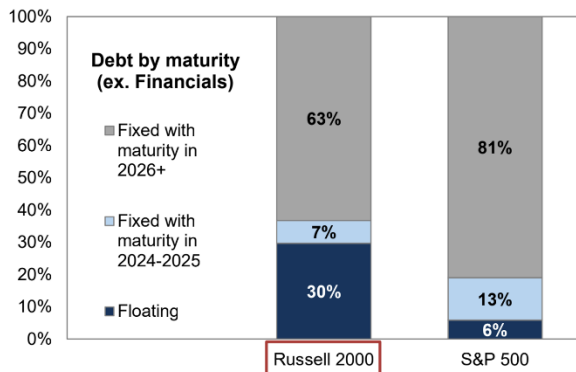


First, are there opportunities? Yes, but it depends upon your timeline and desire to invest with the crowd. Many small-cap industries and companies are irrationally cheap. While one can look at small-cap ETFs, we prefer investing in firms with solid balance sheets and strong valuation anchors (tied to earnings and cash flows). We have shied away in recent years from small-cap holdings, as the returns do not usually compensate for the additional risk and added headache of potentially elevated and seemingly random volatility.

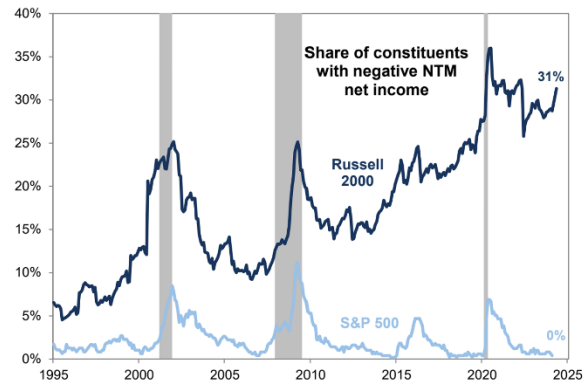
Flywheel and network effects have propelled Big Tech earnings and stock prices, something of which is not present in small-cap firms. Lastly, most people prefer investing in well-known companies (such as Apple Inc which has a \$3.3 trillion market cap and makes your iPhone) rather than in lesser or even unknown firms (such as Apple Hospitality REIT Inc which has a \$3.5 billion market cap and invests in hotels). That said, we would be happy to discuss potential investment candidates if interested and have included the results of a small-cap value screen in the appendix.

On to the question of underperformance. To start, there is the qualitative difference between the average Russell 2000 and S&P 500 stock.³ Small-cap firms are generally more capital markets dependent than large-cap firms when it comes to financing their operations. With the rise in short-term interest rates to over 5% from 0%, the cost of borrowing for small-cap firms has increased precipitously – especially for firms with floating rate debt (of which 30% of Russell 2000 firms carry). This higher cost of capital is reflected in the depressed valuations for small-caps.

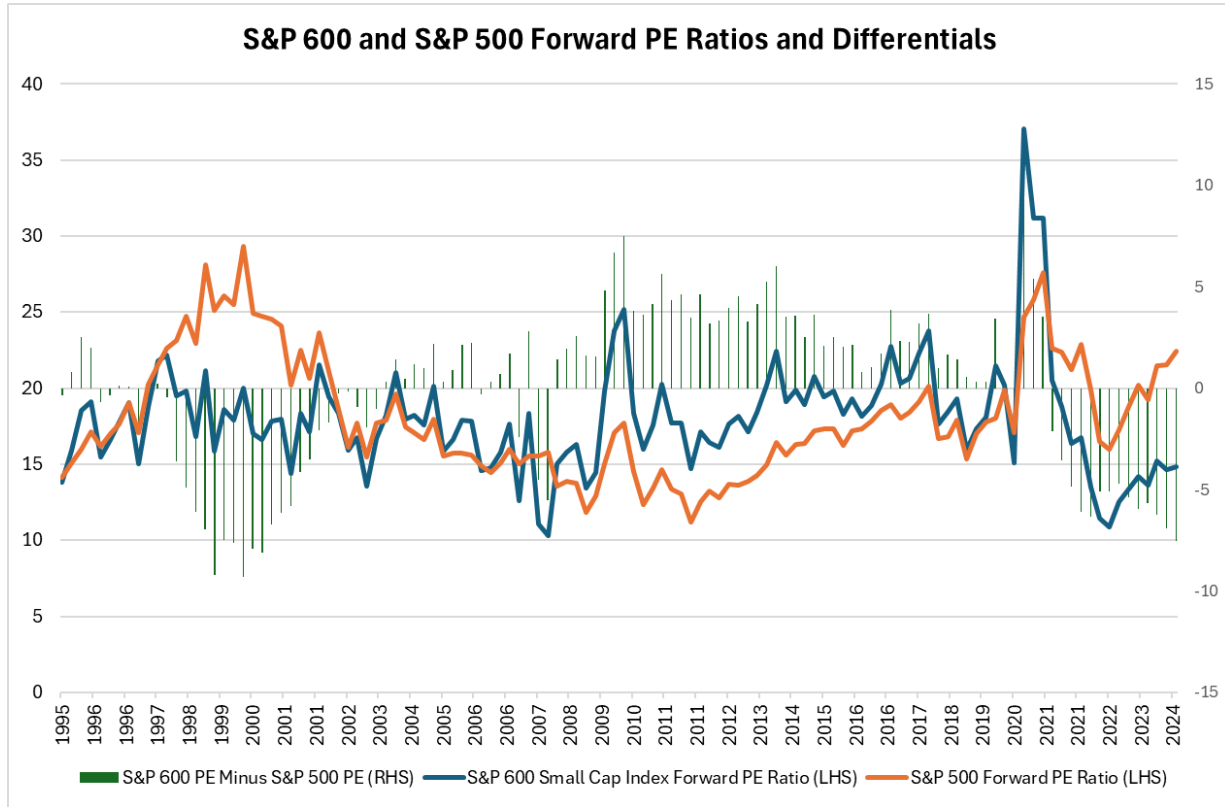
Goldman Sachs Russell 2000 more exposed to changes in rates
30% of outstanding Russell 2000 debt is floating rate vs. 6% for S&P 500 firms



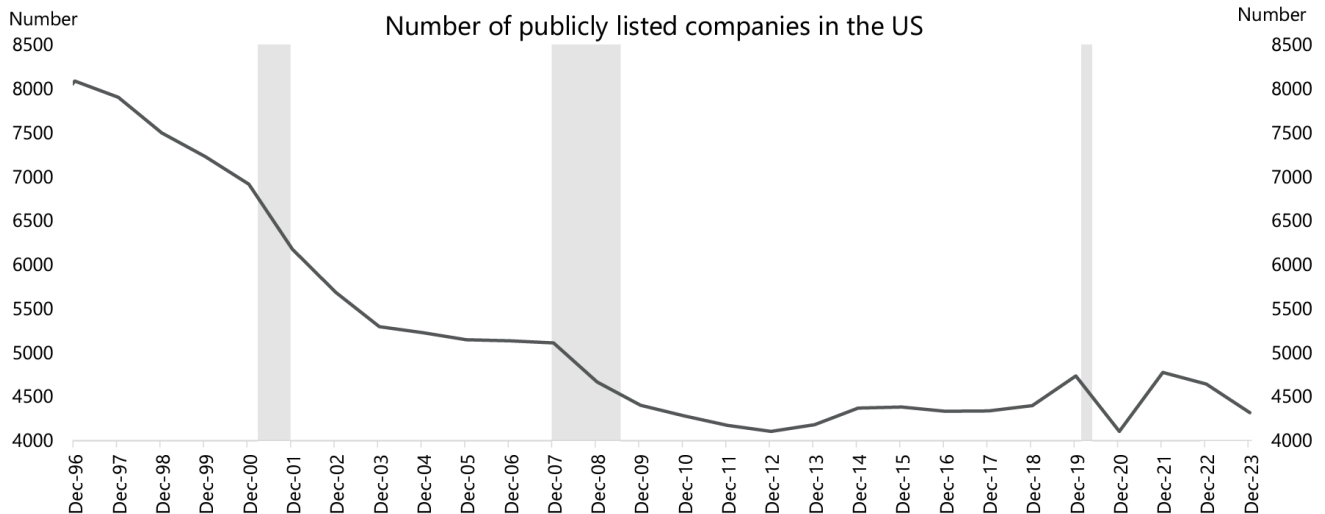
Goldman Sachs Negative net income for Russell 2000 vs. S&P 500
31% of Russell 2000 stocks have negative NTM net income vs. 0% for S&P 500



In finance, there is a concept known as the “small cap premium,” which contends that stocks with smaller market capitalizations should earn greater returns over time than stocks with higher ones. This extra return is supposed to compensate investors for assuming the additional risk often intrinsic to smaller companies. Recent data, however, is putting this theory to the test. Even if you strip out the 31% of Russell 2000 components with negative earnings, the valuation discrepancy between small-cap and large-cap stocks is notable. The S&P 600 – a small-cap index that requires index components to have positive earnings in their most recent quarter and trailing four quarters (in aggregate) – trades at 14.8x estimated 2024 earnings vs. 22.4x for the S&P 500 – the widest discrepancy since the late 1990s (see below chart). Today there is now a decidedly large-cap premium, as investors have decided they are not willing to pay up for what they consider structurally disadvantaged companies with weaker balance sheets, lower earnings and cash flow quality and higher volatility.

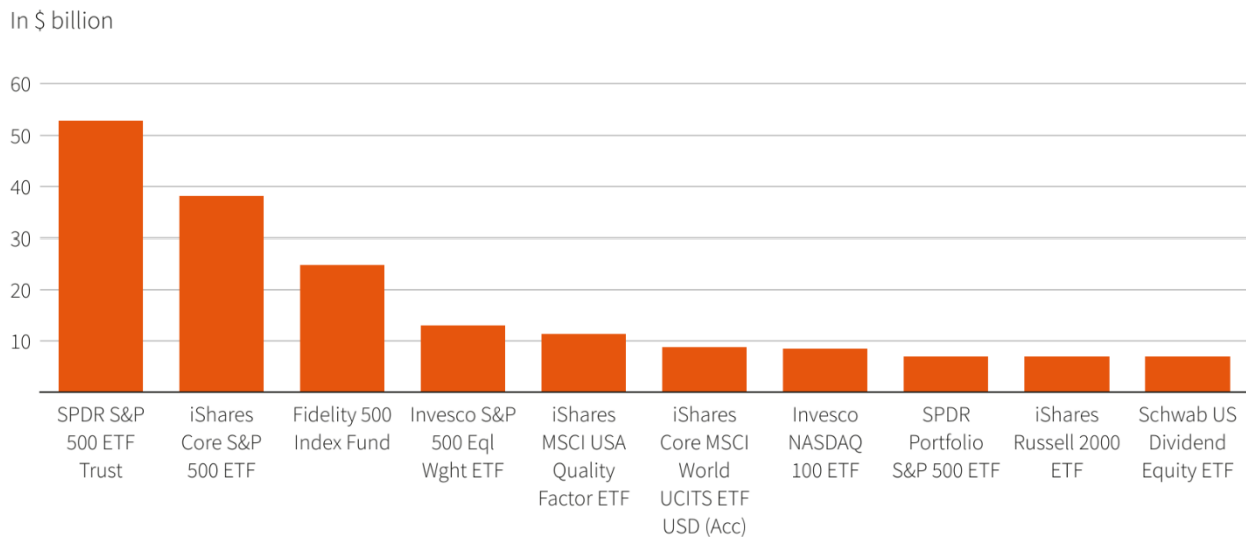


Another explanation is that fewer firms are publicly traded today as compared to thirty years ago (see below chart).⁴ This is due to increasing consolidation through mergers and acquisitions, as well as firms staying private – or private for longer before going public. The most successful firms in the Russell 2000 end up “graduating” to the larger cap Russell 1000 or S&P 500 Indices. We would liken the composition of the Russell 2000 to a form of reverse survivorship bias, in which the firms remaining in the index are on average not of the caliber of their larger cap brethren; nor are they getting replenished as frequently with new entrants, as promising firms stay private or get acquired.



Finally on the question as to whether any of this matters. We think the answer is yes. Our intuition is there is some reflexivity at work. As the returns of small-caps lag, fewer investors will allocate to them, which risks accentuating the underperformance. This, coupled with a market now more dominated by passive investing flows than active ones,⁵ threatens to leave small-cap stocks stranded. The below chart highlights the paltry inflows into U.S. small-cap stocks relative to U.S. large-caps (which include all of the below listed funds except the MSCI World ETF and Russell 2000).⁶

Biggest money inflows into global passive funds in 2023



Every large company at some point starts as a small one. If investors abandon smaller firms, such firms may decide going public is just not worth the regulatory hassle, as well as the risk of trading volatility and equity valuations untethered to business fundamentals. Investors frustrated with the lack of returns might push more firms to consider strategic alternatives – like M&A – and management teams and boards frustrated with the inability to convey their value to a receptive investing public may have heightened interest in selling. Fewer smaller firms will mean higher concentration both in public markets and in the overall economy. This isn't necessarily bad – perhaps it is even more efficient – but it does reduce the opportunities for investors to identify promising firms in their relative infancy and benefit from long-term value creation.

As always, we hope you and your families are well. Please reach out with any questions or to discuss implementing any of the ideas we covered in your portfolio.

Sincerely,

Peter Karmin
Managing Member

Stuart Loren
Director

Russell 2000 Value Screen (1/2)

| Ticker | Company Name | Sector | Industry | Price | Market Cap (\$ in Millions) | Net Debt to EBITDA | PE Ratio | PEG Ratio | EV to EBITDA | EV to Sales | FCF Yield (%) | Operating ROIC (%) | Dividend Yield (%) | YTD Total Return (%) |
|--------|-------------------------------|------------------------|--------------------------------|--------|-----------------------------|--------------------|----------|-----------|--------------|-------------|---------------|--------------------|--------------------|----------------------|
| PR | Permian Resources Corp | Energy | Oil, Gas & Consumable Fuels | 15.42 | 11,872.63 | 1.33 | 9.33 | 0.68 | 4.17 | 3.09 | 5.54 | 16.86 | 5.19 | 15.84 |
| WFRD | Weatherford International PLC | Energy | Energy Equipment & Services | 115.50 | 8,449.30 | 0.81 | 15.75 | 0.78 | 6.49 | 1.64 | 7.99 | 27.90 | 0.00 | 18.06 |
| NXT | NEXTracker Inc | Industrials | Electrical Equipment | 57.98 | 8,415.65 | -0.53 | 19.05 | 1.12 | 13.08 | 2.84 | 5.02 | 65.44 | 0.00 | 23.76 |
| UFPI | UFP Industries Inc | Industrials | Building Products | 115.02 | 7,102.93 | -0.84 | 14.92 | 0.93 | 8.68 | 0.95 | 11.11 | 18.48 | 1.15 | -7.86 |
| NSIT | Insight Enterprises Inc | Information Technology | Electronic Equipment, Instrume | 205.03 | 6,674.92 | 0.94 | 19.06 | 1.36 | 11.71 | 0.72 | 10.04 | 19.54 | 0.00 | 15.71 |
| CHX | ChampionX Corp | Energy | Energy Equipment & Services | 31.16 | 5,933.51 | 0.41 | 15.75 | 1.26 | 7.59 | 1.60 | 7.98 | 22.16 | 1.22 | 7.27 |
| CMC | Commercial Metals Co | Materials | Metals & Mining | 50.74 | 5,871.04 | 0.42 | 10.84 | | 5.96 | 0.83 | 11.19 | 19.01 | 1.42 | 2.03 |
| SM | SM Energy Co | Energy | Oil, Gas & Consumable Fuels | 47.52 | 5,466.52 | 0.66 | 7.27 | 0.81 | 3.54 | 2.56 | 8.01 | 18.38 | 1.52 | 23.81 |
| MGY | Magnolia Oil & Gas Corp | Energy | Oil, Gas & Consumable Fuels | 24.67 | 5,002.04 | -0.01 | 11.32 | 1.42 | 5.01 | 3.65 | 8.79 | 24.87 | 2.11 | 17.17 |
| BCC | Boise Cascade Co | Industrials | Trading Companies & Distributo | 126.29 | 4,985.84 | -0.45 | 11.84 | | 6.61 | 0.67 | 8.97 | 22.30 | 0.63 | -2.07 |
| WIRE | Encore Wire Corp | Industrials | Electrical Equipment | 289.30 | 4,570.13 | -1.49 | 15.30 | 1.27 | 9.43 | 1.48 | 5.41 | 20.69 | 0.03 | 35.46 |
| STNG | Scorpio Tankers Inc | Energy | Oil, Gas & Consumable Fuels | 80.75 | 4,288.45 | 1.12 | 6.09 | 1.00 | 5.33 | 3.76 | 18.33 | 15.98 | 1.98 | 34.29 |
| URBN | Urban Outfitters Inc | Consumer Discretionary | Specialty Retail | 45.11 | 4,213.24 | 0.60 | 12.42 | 1.09 | 6.30 | 0.82 | 7.69 | 12.84 | 0.00 | 26.39 |
| ALKS | Alkermes PLC | Health Care | Biotechnology | 24.42 | 4,132.38 | -0.76 | 9.58 | 0.44 | 8.58 | 2.50 | 9.54 | 27.90 | 0.00 | -11.97 |
| WHD | Cactus Inc | Energy | Energy Equipment & Services | 51.65 | 4,109.01 | -0.39 | 17.83 | 1.65 | 10.86 | 3.79 | 8.03 | 29.27 | 0.93 | 14.33 |
| AEO | American Eagle Outfitters Inc | Consumer Discretionary | Specialty Retail | 20.70 | 4,066.11 | 1.57 | 11.79 | 1.00 | 5.51 | 0.94 | 9.49 | 13.23 | 2.42 | -1.05 |
| ASO | Academy Sports & Outdoors Inc | Consumer Discretionary | Specialty Retail | 54.77 | 3,950.31 | 1.73 | 8.24 | 1.54 | 5.15 | 0.86 | 12.25 | 17.89 | 0.80 | -16.87 |
| PAGS | Pagseguro Digital Ltd | Financials | Financial Services | 11.15 | 3,675.13 | -1.05 | 8.93 | 0.55 | 2.94 | 0.68 | 24.66 | 39.54 | 0.00 | -10.59 |
| CRC | California Resources Corp | Energy | Oil, Gas & Consumable Fuels | 50.31 | 3,434.44 | 0.20 | 7.87 | 0.46 | 2.91 | 1.22 | 6.93 | 17.72 | 2.46 | -6.85 |
| LBRT | Liberty Energy Inc | Energy | Energy Equipment & Services | 20.14 | 3,356.37 | 0.37 | 8.15 | 0.58 | 3.42 | 0.81 | 10.57 | 30.09 | 1.39 | 11.73 |
| CVCO | Cavco Industries Inc | Consumer Discretionary | Household Durables | 354.82 | 2,939.04 | -1.62 | 17.70 | 0.59 | 11.99 | 1.38 | 7.05 | 17.34 | 0.00 | 2.37 |
| SLVM | Sylvamo Corp | Materials | Paper & Forest Products | 69.92 | 2,875.65 | 1.69 | 10.23 | | 5.84 | 0.98 | 9.01 | 19.51 | 2.58 | 43.96 |
| YOU | Clear Secure Inc | Information Technology | Software | 18.54 | 2,685.15 | -8.39 | 19.94 | 0.80 | 13.15 | 2.66 | 8.38 | 15.81 | 2.16 | -7.91 |
| DFH | Dream Finders Homes Inc | Consumer Discretionary | Household Durables | 26.43 | 2,477.24 | 1.81 | 8.32 | 0.56 | 6.01 | 0.82 | 6.33 | 21.38 | 0.00 | -25.61 |
| PGNY | Progyny Inc | Health Care | Health Care Providers & Servic | 25.73 | 2,450.03 | -5.17 | 17.15 | 1.05 | 9.51 | 1.69 | 7.77 | 11.75 | 0.00 | -30.80 |
| TNK | Teekay Tankers Ltd | Energy | Oil, Gas & Consumable Fuels | 66.62 | 2,282.25 | -0.54 | 4.74 | | 3.44 | 2.40 | 25.33 | 27.16 | 1.50 | 38.20 |
| ROCK | Gibraltar Industries Inc | Industrials | Building Products | 70.65 | 2,152.69 | -0.56 | 15.01 | 1.00 | 8.84 | 1.42 | 10.11 | 18.62 | 0.00 | -10.55 |
| BFH | Bread Financial Holdings Inc | Financials | Consumer Finance | 40.84 | 2,025.03 | 0.56 | 8.53 | | 7.84 | 0.78 | 97.88 | 5.45 | 2.06 | 25.37 |
| AMPH | Amphastar Pharmaceuticals Inc | Health Care | Pharmaceuticals | 40.05 | 1,958.52 | 1.22 | 10.55 | 0.78 | 7.62 | 3.05 | 8.22 | 24.10 | 0.00 | -35.25 |
| ARRY | Array Technologies Inc | Industrials | Electrical Equipment | 12.82 | 1,945.68 | 1.77 | 11.85 | 0.69 | 9.56 | 2.14 | 11.21 | 13.17 | 0.00 | -23.69 |
| RAMP | LiveRamp Holdings Inc | Information Technology | Software | 29.15 | 1,928.39 | -6.95 | 18.89 | 1.45 | 11.64 | 2.22 | 5.26 | 2.83 | 0.00 | -23.05 |
| TNC | Tennant Co | Industrials | Machinery | 97.91 | 1,861.02 | 0.77 | 14.71 | 1.84 | 9.54 | 1.57 | 7.59 | 17.41 | 1.14 | 6.18 |
| BLBD | Blue Bird Corp | Industrials | Machinery | 57.32 | 1,851.38 | 0.04 | 21.04 | 0.43 | 11.74 | 1.41 | 6.46 | 73.46 | 0.00 | 112.61 |
| PAX | Patria Investments Ltd | Financials | Capital Markets | 12.12 | 1,792.25 | -1.52 | 9.71 | 0.86 | 7.37 | 4.26 | 8.41 | 22.47 | 5.78 | -18.74 |

Russell 2000 Value Screen (2/2)*

| Ticker | Company Name | Sector | Industry | Price | Market Cap (\$ in Millions) | Net Debt to EBITDA | PE Ratio | PEG Ratio | EV to EBITDA | EV to Sales | FCF Yield (%) | Operating ROIC (%) | Dividend Yield (%) | YTD Total Return (%) |
|--------|----------------------------------|------------------------|--------------------------------|--------|--------------------------------|-----------------------|--------------|--------------|-----------------|-------------|------------------|-----------------------|-----------------------|-------------------------|
| CPRX | Catalyst Pharmaceuticals Inc | Health Care | Biotechnology | 14.97 | 1,768.18 | -2.68 | 9.72 | | 8.28 | 3.17 | 9.22 | 17.40 | 0.00 | -10.95 |
| LZB | La-Z-Boy Inc | Consumer Discretionary | Household Durables | 40.70 | 1,707.35 | 0.58 | 13.14 | 1.19 | 6.49 | 0.89 | 6.13 | 11.07 | 1.97 | 11.44 |
| COCO | Vita Coco Co Inc/The | Consumer Staples | Beverages | 29.03 | 1,645.54 | -2.20 | 30.08 | 1.97 | 19.22 | 2.99 | 6.48 | 32.64 | 0.00 | 13.18 |
| HRMY | Harmony Biosciences Holdings Inc | Health Care | Pharmaceuticals | 28.89 | 1,640.72 | -0.75 | 11.83 | 0.52 | 6.96 | 2.05 | 12.66 | 31.78 | 0.00 | -10.56 |
| CTS | CTS Corp | Information Technology | Electronic Equipment, Instrume | 50.96 | 1,557.83 | -0.58 | 23.87 | 1.49 | 12.40 | 2.71 | 5.24 | 13.03 | 0.31 | 16.61 |
| LZ | Legalzoom.com Inc | Industrials | Professional Services | 8.11 | 1,526.27 | -3.66 | 15.90 | 1.36 | 9.38 | 1.84 | 6.27 | 19.01 | 0.00 | -28.23 |
| IAS | Integral Ad Science Holding Corp | Communication Services | Media | 9.48 | 1,521.95 | 0.94 | 30.98 | 1.19 | 8.83 | 2.96 | 6.95 | 1.23 | 0.00 | -34.12 |
| WKC | World Kinect Corp | Energy | Oil, Gas & Consumable Fuels | 25.32 | 1,517.64 | 1.66 | 10.00 | 0.74 | 5.42 | 0.04 | 10.02 | 8.39 | 2.69 | 12.62 |
| BHE | Benchmark Electronics Inc | Information Technology | Electronic Equipment, Instrume | 39.94 | 1,439.67 | 0.84 | 19.20 | 0.87 | 9.26 | 0.61 | 14.23 | 8.05 | 1.65 | 45.29 |
| SCS | Steelcase Inc | Industrials | Commercial Services & Supplies | 12.59 | 1,436.66 | 1.13 | 13.84 | 1.38 | 6.56 | 0.54 | 18.21 | 10.50 | 3.18 | -5.45 |
| APOG | Apogee Enterprises Inc | Industrials | Building Products | 61.82 | 1,367.97 | 0.37 | 13.74 | 1.37 | 7.63 | 1.08 | 11.77 | 23.86 | 1.62 | 16.72 |
| CDRE | Cadre Holdings Inc | Industrials | Aerospace & Defense | 32.36 | 1,314.02 | 0.72 | 30.36 | 1.88 | 13.55 | 2.54 | 5.06 | 18.27 | 1.08 | -1.11 |
| GIC | Global Industrial Co | Industrials | Trading Companies & Distributo | 32.06 | 1,224.08 | 0.51 | 16.61 | 1.04 | 11.16 | 0.94 | 6.99 | 28.79 | 3.12 | -16.40 |
| CRAI | CRA International Inc | Industrials | Professional Services | 171.83 | 1,188.31 | 1.85 | 27.58 | 1.72 | 16.05 | 1.99 | 5.43 | 16.08 | 0.98 | 74.78 |
| SCSC | ScanSource Inc | Information Technology | Electronic Equipment, Instrume | 44.07 | 1,088.93 | -0.01 | 13.53 | 1.35 | 7.39 | 0.33 | 26.72 | 8.94 | 0.00 | 11.26 |
| HIBB | Hibbett Inc | Consumer Discretionary | Specialty Retail | 87.16 | 1,041.39 | 1.10 | 10.70 | 1.53 | 5.59 | 0.77 | 14.79 | 16.92 | 1.15 | 21.43 |
| AGX | Argan Inc | Industrials | Construction & Engineering | 77.60 | 1,036.30 | -9.39 | 18.22 | 1.82 | 8.60 | 0.80 | 12.87 | 13.59 | 1.55 | 67.76 |
| ATEN | A10 Networks Inc | Information Technology | Software | 13.39 | 996.96 | -3.12 | 17.10 | 0.81 | 11.06 | 3.15 | 6.69 | 18.14 | 1.79 | 2.52 |
| NX | Quanex Building Products Corp | Industrials | Building Products | 29.43 | 974.50 | 0.41 | 12.51 | 0.89 | 6.81 | 0.97 | 10.88 | 16.51 | 1.09 | -3.24 |
| THR | Thermon Group Holdings Inc | Industrials | Electrical Equipment | 28.85 | 974.18 | 1.43 | 14.59 | 1.46 | 9.57 | 2.06 | 5.64 | 12.62 | 0.00 | -11.42 |
| MTUS | Metallus Inc | Materials | Metals & Mining | 20.59 | 903.12 | -1.44 | 12.11 | 0.81 | 4.33 | 0.50 | 10.02 | 16.26 | 0.00 | -12.20 |
| BBSI | Barrett Business Services Inc | Industrials | Professional Services | 134.69 | 881.11 | -0.04 | 17.40 | 1.30 | 11.67 | 0.78 | 10.34 | 22.59 | 0.89 | 16.89 |
| USNA | USANA Health Sciences Inc | Consumer Staples | Personal Care Products | 45.44 | 865.66 | -3.16 | 16.37 | 1.36 | 4.68 | 0.61 | 6.92 | 19.17 | 0.00 | -15.22 |
| PRLB | Proto Labs Inc | Industrials | Machinery | 30.07 | 761.25 | -1.49 | 19.58 | 0.78 | 8.15 | 1.27 | 5.88 | 5.03 | 0.00 | -22.82 |
| KELYA | Kelly Services Inc | Industrials | Professional Services | 21.21 | 753.71 | -1.63 | 10.85 | 0.83 | 4.48 | 0.15 | 6.65 | 4.29 | 1.41 | -1.26 |
| IIIN | Insteel Industries Inc | Industrials | Building Products | 31.88 | 620.86 | -2.26 | 20.37 | 1.70 | 10.45 | 0.95 | 9.02 | 6.43 | 0.38 | -16.59 |
| HCKT | Hackett Group Inc/The | Information Technology | IT Services | 21.73 | 600.05 | 0.35 | 13.88 | 0.79 | 9.68 | 2.03 | 6.54 | 39.27 | 2.02 | -4.14 |
| CCRN | Cross Country Healthcare Inc | Health Care | Health Care Providers & Servic | 14.16 | 492.40 | -0.01 | 20.20 | | 8.21 | 0.35 | 39.63 | 15.41 | 0.00 | -37.46 |
| HVT | Haverty Furniture Cos Inc | Consumer Discretionary | Specialty Retail | 27.57 | 447.42 | 0.81 | 20.23 | 1.69 | 7.25 | 0.70 | 8.14 | 10.50 | 4.64 | -20.73 |
| VPG | Vishay Precision Group Inc | Information Technology | Electronic Equipment, Instrume | 31.29 | 417.84 | -0.40 | 22.35 | 1.12 | 8.67 | 1.23 | 7.09 | 10.84 | 0.00 | -8.16 |
| HDSN | Hudson Technologies Inc | Industrials | Trading Companies & Distributo | 8.94 | 406.87 | -0.05 | 15.47 | 0.62 | 7.36 | 1.54 | 10.52 | 27.14 | 0.00 | -33.73 |
| LOVE | Lovesac Co/The | Consumer Discretionary | Household Durables | 23.27 | 361.86 | 1.54 | 19.00 | 0.63 | 5.95 | 0.66 | 8.64 | 9.51 | 0.00 | -8.92 |
| RGP | Resources Connection Inc | Industrials | Professional Services | 10.59 | 358.02 | -1.60 | 15.97 | 1.06 | 6.26 | 0.41 | 8.92 | 11.09 | 5.29 | -23.55 |
| IMMR | Immersion Corp | Information Technology | Technology Hardware, Storage & | 10.67 | 339.89 | -5.51 | 9.44 | 0.47 | - | 2.33 | 13.82 | 17.13 | 1.69 | 53.08 |
| RLGT | Radiant Logistics Inc | Industrials | Air Freight & Logistics | 5.29 | 248.64 | 0.71 | 17.46 | | 7.62 | 0.35 | 12.12 | 4.50 | 0.00 | -20.33 |
| | | | | | | | 14.98 | 1.08 | 8.12 | 1.57 | 11.35 | 19.08 | 1.12 | 3.75 |

Data Source: Bloomberg (06/18/24)

Averages

*Screened for firms in the Russell 2000 Index with (1) positive trailing 12-month earnings, (2) net debt to EBITDA under 2x, (3) free cash flow yields over 5% and PE to earnings growth (or PEG) ratios below 2.

Citations and Disclosures

¹ Disney World, available at: <https://disneyworld.disney.go.com/attractions/magic-kingdom/its-a-small-world/>.

² Bloomberg (June 17, 2024). Unless otherwise cited, all financial data herein is from Bloomberg.

³ Goldman Sachs (June 17, 2024).

⁴ Apollo (March 4, 2024).

⁵ Morningstar, *It's Official: Passive Funds Overtake Active Funds* (Jan. 17, 2024), available at:

<https://www.morningstar.com/funds/recovery-us-fund-flows-was-weak-2023>.

⁶ LSEG Lipper, Reuters (Feb. 1, 2024), available at: <https://www.reuters.com/markets/us/global-markets-funds-passive-2024-02-01/>.

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