CHARTWELL INVESTMENT PARTNERS

Berwyn Strategies Current Outlook and Investment Strategy

"Man is the only kind of varmint that sets his own trap, baits it, then steps in it"
-John Steinbeck

Summary

■ Amidst fears that corporate earnings had peaked, stock prices fell across a wide front in 2018's fourth quarter. Stock prices may have bottomed in December as panic led to indiscriminate selling. Further downward pressure was added by tax related transactions.

■ High P/E stocks outperformed low P/E stocks, continuing a trend that has been in place for over two years. The Chartwell Growth and Balanced Strategies underperformed as the bifurcation between growth and value stocks may have reached an extreme condition.

■ Former market leaders, as represented by the FAANG** stocks, were not spared the carnage, suggesting a possible change in market leadership.

■ January brought a welcomed rally led by small-cap value stocks. The broad rally staved off fears of an impending recession. Our all equity performance increased approximately 11.8 percent.

Background

In the fourth quarter of last year, equity investors experienced the worst period since the Great Recession, ten years ago. In the quarter, the Dow Jones Industrial Average (DJIA), Standard & Poor's 500 Index (S&P 500) and NASDAQ fell 11.31 percent, 13.52 percent and 17.28 percent, respectively. Smaller capitalization stocks, as measured by the Russell 2000 retreated 20.21 percent. Volatility throughout the three-month period remained high, and as bad as the quarterly numbers cited above were, the trading ranges (peak to trough during the fourth quarter) were significantly worse. Specifically, the DJIA, S&P 500, NASDAQ and Russell 2000 indices had trading ranges of 17.67 percent, 20.21 percent, 23.70 percent and 25.64 percent, respectively.

Against the backdrop of a strong economy, stock prices dropped dramatically in October, consolidated in November and then broke down through prior support levels in December. There was a multiplicity of reasons offered for the broad and sharp decline, including the modest inversion in the U.S. Treasury yield curve, a lack of clarity as to the Federal Reserve Board's intentions for 2019, frustrating trade negotiations with China, a slowing global economy, and the increasing dysfunction in our Nation's capital. In retrospect, the most plausible explanation is that investors were concerned that corporate earnings for this economic cycle are peaking and the outlook for 2019 is becoming cloudy. Fear and confusion held sway as investors dumped equities as if a major financial reversal was imminent.

Over the past ten years, as this country emerged from the Great Recession, economic growth has been disappointingly slow. This phenomenon, particularly uncharacteristic in the early stages of an expansion, has more recently manifested itself in a bifurcated stock market where investors have placed a premium upon companies capable of growing revenues, even if this growth came in the absence of profits. In past reports we have used Tesla (TSLA) and General Motors (GM) to represent this distortion in the marketplace. TSLA and GM are both valued in the marketplace at approximately the same amount, $50 billion. TSLA's sales have been growing, but they have been unable to demonstrate sustained profitability, and their balance sheet is levered. GM is very profitable, has a 3.96 percent dividend yield and an investment grade balance sheet, yet sells at only six times earnings. Now, with this dichotomy reaching an extreme in recent months and with stock prices in both categories dropping precipitously, it will be crucial to evaluate how investors behave in the immediate future. Will the "TSLA type" companies continue to lead the market, or will investors choose to invest in companies typified by GM.

Historically, long-term investors who invest in solid companies with lower valuations have outperformed those who invest in more glamorous companies with above average price-to-earnings ratios (P/E's).* As implied in the prior discussion, this has not been true for the past two years, a condition that always leads value investors to reassess and question the premise of an investment style that is almost unassailable. The discussion below is intended to provide understanding as to why we believe it is critical to remain committed to our value approach even though it has not prevailed in the recent past.

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*P/E is the Price to Earnings Ratio and is used to determine the relative value of a company's shares. To calculate, it is the price the stock is selling at divided by the annual earnings.

**FAANG- Facebook, Apple, Amazon, Netflix, Google.

Berwyn Strategies Current Outlook and Investment Strategy

A company's P/E is the most common parameter used by investors to determine the initial attractiveness of a potential investment. Historically, most stocks have sold at P/Es in the 14 to 18 range, depending upon the level of interest rates, a company's growth prospects and other factors. The recent behavior of investors, as described above, has broadened this range and today there are many more companies selling at single-digit P/Es since the period of high interest rates in the late 1970s and early 1980s. In our last Quarterly Strategy Letter (QSL) we listed seven companies in our IMA portfolios whose P/Es were less than ten. After the December collapse as shown in Table 1, there are now twice that number, fourteen, with P/Es in the 4.5 to 9.9 range. Given the level of today's interest rates, it seems as if there are three outcomes possible. One possibility is that the valuation is correct because earnings are about to drop and the low P/E has been discounting that eventuality. In this case one would not expect much change in the price of the stock. A second possibility is that because of their low valuation, they become the target of a takeover attempt; this would be a positive outcome. In fact, one of our holdings, First Data Corp. rose sharply in January based on a buyout offer from Fiserv. Another possibility, which is already happening on a broad scale, is that the company, seeing the value in their own stock price, buys shares back; this tactic generally results in higher earnings per share and reduces the overall dividend payment made by the company due to the reduced share count. So, in the absence of a recession, or other event negative to earnings stability, it seems reasonable to expect stocks with single digit P/Es to rise in price – particularly in an environment where the ten-year Treasury bond yields less than 3 percent.

STOCK	P/E	STOCK	P/E
ACCO	6.6	METHODE TECHNOLOGY	8.2
CLEVELAND CLIFFS	5.7	MICRON TECHNOLOGY	4.5
FERRO	8.7	PULTE GROUP	7.5
FLAGSTAR BANCORP	8.6	SCAN SOURCE	9.9
GENERAL MOTORS	6.1	UNUM	6.2
HOOKER FURNITURE	9.4	WINNEBAGO	8.0
KNOLL FURNITURE	9.2	WESTERN DIGITAL	5.3

Table 1: STOCKS WITH SINGLE DIGIT P/E's HELD IN IMA's AS OF 01/18/2019
Source: Chartwell Investment Partners

At the other end of the broadened valuation range are the FAANG stocks. These high flyers of the past two years are familiar names: Facebook (FB), Amazon (AMZN), Apple (AAPL), Netflix (NFLX) and Google (GOOG). The P/E's of two of the five FAANG stocks fall in the same category of popular stocks as does TSLA. In fact, this group is partly responsible for the distortion between the performance of the S&P 500 and the broad market. To some degree, the FAANG stocks have been discredited because of their poor performance in this past autumn's decline. From their all-time highs, made earlier in 2018, to their December lows, they fell as much as 43.73 percent (FB), 38.29 percent (AMZN), 39.00 percent (AAPL), 47.73 percent (NFLX) and 23.85 percent (GOOG). For the three-month period, ending in December, as a group they fell 23.4 percent in price. This is a larger decline than experienced by any of the major indices and more than most high P/E stocks. Could the FAANG stocks be losing favor with investors?

The answer to this question is important. If the FAANG stocks and other stocks selling at higher P/Es are going to be displaced as market leaders, it suggests that the current period of consolidation will be extended while the dynamic of the marketplace determines the next market leaders. In any event, the next several months will be an important period of analysis and assessment.

CHARTWELL INVESTMENT PARTNERS

Berwyn Strategies Current Outlook and Investment Strategy

Current Strategy

The sharp downturn experienced in the fourth quarter makes it difficult to feel bullish on the stock market, however, it is important for long-term value investors to recognize that many companies are now on the bargain counter and opportunities abound. Keep in mind that the stocks in our portfolios were selling at attractive prices prior to the fourth quarter pullback and now present unusually compelling long-term investments. This is not a time for retreat, but for seizing the moment, in our opinion. Since year-end, a broad-based rally has been in progress. This is not an unusual occurrence after a fourth quarter decline, particularly amongst small-cap stocks, as tax-loss selling abates when the new year begins. This rally has persisted throughout the month of January and continues to be led by small-cap value stocks as discussed below.

Despite the January rally, it is unlikely that the major indices will be hitting new highs in the immediate future. From a "technical" standpoint, considerable damage has been done that only time can repair. In addition, it is most probable that the market will need to find new leadership as the economic fundamentals and political climate unfolds. Nevertheless, we are very encouraged by the stock market's behavior in January and will be taking a constructive approach to rebuilding our clients' assets in the months ahead.

Performance

The Chartwell Berwyn Growth (CBGS) and Balanced (CBBS) Strategies performed poorly in the fourth quarter, falling 24.10 percent and 15.74 percent, respectively. This is not the news that an adviser finds easy to deliver, however, it represents the widespread sale of stocks by investors eager to take profits from a long-term bull market, lack of confidence in the economy (although there are no evident signs of weakness) and absolute fear and confusion, as political events added to the chaos in the month of December. In our opinion, selling pressure in the final two weeks of 2018 could be described as "indiscriminate." With only one exception, none of our portfolio companies reported any serious fundamental weakness in their business operations during the fourth quarter.

Figure 1 illustrates the performance of CBGS and CBBS individually managed accounts (IMAs) over the 2000 to 2018 period, as compared to the growth in the S&P 500, the Russell 2000 (benchmark for the CBGS) and the benchmark for the CBBS. Despite this year's disappointing performance, $10,000 invested in the CBGS and CBBS has grown to $44,975 and $42,679, respectively. Starting from the same level, $10,000, the benchmarks for the CBGS and CBBS, plus the S&P 500, grew to $34,412, $33,394 and $24,651, respectively.

Comparison of the Change in Value of $10,000 Invested in Chartwell Berwyn Growth and Balanced Strategy Account Composites
12/31/99-12/31/18

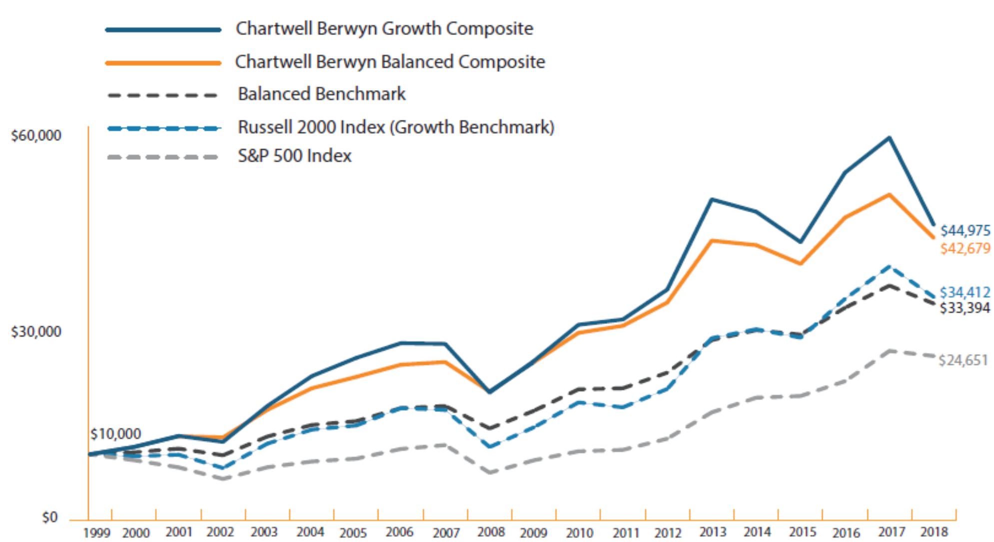

Figure 1
Source: Chartwell Investment Partners

CHARTWELL INVESTMENT PARTNERS

Berwyn Strategies Current Outlook and Investment Strategy

Top 3 Contributors
As of 12.31.2018

Holding	Change
Pulte Group	up 5.38%
Navigant Consulting	up 4.50%
Excelon	up 4.09%

Source: Chartwell Investment Partners

Top 3 Detractors
As of 12.31.2018

Holding	Change
McDermott International	down 64.5%
Spartan Motors	down 50.7%
Devon Energy	down 43.4%

Source: Chartwell Investment Partners

**The numbers in parentheses following each company mentioned reflect the percentage of the portfolio's net assets comprised of such securities as of 12/31/18. Holdings are subject to change. A full listing of portfolio holdings is available upon request.

There is good news. January has brought a significant and broad market rally. In particular, our value stocks, that had been so harshly treated in the prior quarter, have led the advance. Our all-equity accounts are up approximately 11.8 percent*** as compared to gains of 7.3 percent, 8.0 percent and 9.8 percent for the DJIA, S&P 500 and NASDAQ, respectively. So, whereas low P/E stocks fell more than most higher P/E stocks in the fourth quarter, they are rallying more as investors demonstrate a return to more rational behavior.

Top 3 Contributors: The best performing stock in our IMA portfolios during the fourth quarter was PulteGroup (PHM)(1.9%)**, a builder of residential homes and adult communities. PHM rose 5.38 percent on a total return basis and in January, reported improved earnings for the 2018 year-end quarter. The second-best performer was Navigant Consulting (NCI)(1.8%), which gained 4.50 percent. NCI, has been in the portfolio for several years and has now become fully priced in our opinion. In recent days, we have sold NCI at a generous profit. Excelon (EXC)(2.0%), a provider of electrical power, was the third best performing stock for the quarter, gaining 4.09 percent.

Top 3 Detractors: McDermott International (MDR)(0%), a global provider of energy services, was the worst performing stock in the quarter, falling 64.5 percent. MDR reported a loss for the third quarter and was sold for tax related reasons, since we did not foresee a near-term resolution to the problems stated in their earnings release. Spartan Motors (SPAR)(0%) fell 50.7 percent in the quarter after reporting weak third quarter earnings. Due to our low-cost basis, SPAR was sold at a profit, prior to year-end. Lastly, our third worst stock performer was Devon Energy (DVN)(1.2%) a domestic oil and gas exploration company, whose shares dropped 43.40 percent in price. DVN has been restructuring its operations by selling off its pipelines and other non-core assets, and focusing on its oil and gas production properties in Texas, Oklahoma, the Rocky Mountains and Canada. DVN is also using cash from its asset sales to repurchase shares.

If you have any questions about your investment account, please don't hesitate to call Mike Magee (484.324.6835), Bob Killen (610.407.4851), or Pete Schofield (610.407.4858).

*** January performance is sourced from Fact Set.

Past performance is no guarantee of future performance. Investment involves a risk of loss.

This commentary is for informational purposes only. It is not an offer to buy or sell any security and should not be construed as investment advice. The views in this report were those of the Adviser at the time of writing this report and may not reflect our views on the date this report is first published or anytime thereafter.

*The Chartwell Berwyn Growth Strategy Composite includes all fully discretionary, fee-paying equity accounts with a growth objective whose asset size is $300,000 or greater at the beginning of the measurement period. The fee for certain retail and high net worth clients with individually managed accounts is generally 1% of the value of the assets under management. For individual bond holdings the fee is 5/8 of 1% and for bond mutual funds, including exchange traded funds, the fee is 3/8 of 1%. The fee for these accounts is negotiable.

*The Chartwell Berwyn Balanced Strategy Composite includes all fully discretionary, fee-paying accounts with a balance between growth and income as a principal objective whose asset size is $300,000 or greater at the beginning of the measurement period.The fee for certain retail and high net worth clients with individually managed accounts is generally 1% of the value of the assets under management. For individual bond holdings the fee is 5/8 of 1% and for bond mutual funds, including exchange traded funds, the fee is 3/8 of 1%. The fee for these accounts is negotiable.

The composites do not include accounts where total cash flows exceed 10% of the account's value during any quarterly period or accounts holding securities purchased by anyone other than the Advisor. No accounts using leverage or short positions are included in the composites. An individual client's account may have performed better or worse than the composites' returns presented above. The composites contain taxable and non-taxable accounts. The returns are before taxes and net of all advisory fees and commission charges. The net performance results for each composite are presented after deducting the actual fee charged to each account in the composite based on the management fee schedule in the Firm's Brochure or the fee negotiated between the account holder and Chartwell. Returns include the reinvestment of dividends and interest (total return). Returns for other Chartwell composites are available upon request.

As of 12/31/2018, Chartwell managed $9.2 billion in assets, $7.1 billion as advisor and $2.1 billion as sub-advisor. During the most recent quarter, the Chartwell Berwyn Growth Strategy Composite consisted of 16 accounts which represented 10.9% of total Berwyn Strategy Individually Managed Accounts and 0.1% of total Chartwell assets. During the most recent quarter, the Chartwell Berwyn Balanced Strategy Composite consisted of 30 accounts which represented 40.5% of total Berwyn Strategy Individually Managed Accounts and 0.5% of total Chartwell assets.

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