INVESTMENT COMMENTARY: SMALL CAP Q1 2019

April | 2019

Overview

Markets came roaring back in Q1, with the S&P 500 nearly making back it's losses from an abysmal Q4. Small caps lagged large caps, with the Russell 2000 only making back a little more than half of its losses. Clearly stocks were oversold going into the new year, but we also saw tailwinds from a dovish Fed and progress on the trade front. Our strategy delivered a gain of +9.9% for the quarter (net of fees).

Quality (Almost) Always Wins

As you know, we are laser focused on quality….not just in this strategy but across the entire Firm. We have coined our small cap process "Growth at a Reasonable Profile," after all, which highlights the fact that we do not invest in companies that are not profitable. Even our "growth" names need to prove themselves profitable before they earn their way into our portfolio. This focus has served us well over the years, as we have been fortunate to see all of our strategies out-perform their risk-adjusted benchmarks since inception.

There are, of course, short term periods where quality under-performs. Q1 was such a period. Just look at these statistics from the Russell 2000!

RUSSELL 2000	Total Shareholder Return		
	5 year	2019 YTD	
Leverage			
Bottom quintile (highest quality)	73%	13%	
Top quintile (lowest quality)	-35%	25%	!!!
Earnings			
Positive 2018 earnings	38%	17%	
Negative 2018 earnings	-28%	21%	!!!

The small cap companies that did the best in Q1 were **over-levered** firms with **negative earnings**. Yes, you read that right…the market rewarded borrowing and speculation above all else in Q1. Another indication of this is the out-performance of junk bonds over investment grade bonds. The junk bond ETF (ticker JNK) returned +8.1% in Q1, while the investment grade bonds were in the low single digits (AGG +2.9%).

Well…as you know, the companies that did the best in Q1 are not the types of companies we own in our small cap portfolio. In fact, we intentionally screen out over-levered companies in our investment process and (as mentioned above) we do not invest in a company until it is profitable. So it was a bit of a head scratching quarter for us. We did out-perform the Russell in March but under-performed slightly for the quarter.

We believe the more important data point in the above table is the long term (5 year) total shareholder return for each category. Quality **does** win in the long run. We are showing the 5 year data here, but the story is the same looking at 1, 2, 3 and 10 years as well. This (low quality rally) too shall pass.

Another headwind for us this quarter was our sector weightings. Among the sectors that performed the best were industrials and consumer discretionary (where we are slightly underweight), while the sectors that lagged behind were consumer staples and healthcare (where we are overweight).

The reason we do so much market level and sector level analysis is we think it's very important to understand the reasons for under-performance when it does happen. We do not want unintended risks showing up in our portfolio. And after reviewing the individual holdings, we can confidently say we continue to be very comfortable with our names. If anything, we are positioned somewhat conservatively (relative to the Russell) at the moment. But after the massive Q1 rally we've just seen, we feel good about that.

Upside/Downside Capture

As we pointed out last quarter, we are keenly focused on risk management. We are well diversified, we limit position size, we establish downside targets for all holdings (using fundamental as well as technical analysis), and we rank ideas based on a ratio of upside potential divided by downside risk (as opposed to upside alone).

We are proud to report that this focus on risk management continues to pay off. For the 40 months ending March 31, 2019, our cumulative Upside Capture is 118%, while our downside capture is 85%. This results in an **Upside/Downside ratio of 1.4**.

85%	*Downside capture*
118%	*Upside capture*
1.4	***Upside/Downside Ratio***

Portfolio Attribution

Given the statistics we shared above, there was naturally a good bit of dispersion between individual holdings in the first quarter. Our strongest performers were spread across the technology, consumer discretionary and financial sectors. Our biggest under-performers were in the healthcare and consumer staples sectors. We took action on six names from this "biggest movers" list in Q1.

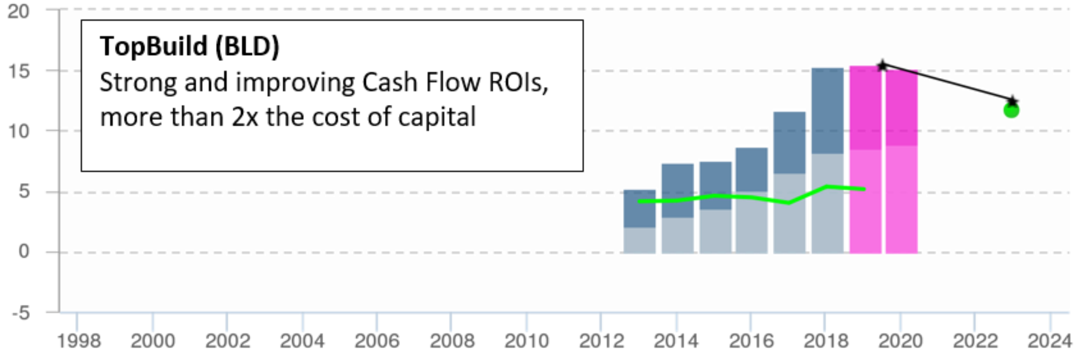
On the winner side, we sold IRBT after an 88% gain as it popped well above its long-term trading channel and the downside risk began to outweigh further upside potential. We also trimmed BLD and CRCM after nice gains. On the loser side, we trimmed LGND at $221 for a nice gain and then sold our remaining shares as the company's fundamentals began to weaken. As always, we have scrutinized all of our holdings and would like to highlight one from each category.

Biggest Gainers YTD		**Biggest Losers YTD**	
iRobot (IRBT)	56.4%	Ligand Pharmaceuticals (LGND)	-26.2%
TopBuild (BLD)	45.4%	AMN Healthcare (AMN)	-16.9%
Five Below (FIVE)	40.5%	US Ecology (ECOL)	-13.1%
Care.com (CRCM)	39.4%	Sprouts Farmers Market (SFM)	-9.8%
Envestnet (ENV)	33.0%	Control4 (CTRL)	-7.6%

Past performance is no guarantee of future results. Indexes are not available for direct investment. Please see disclosures at the end of this presentation for more information.

Q1 Example Winners:

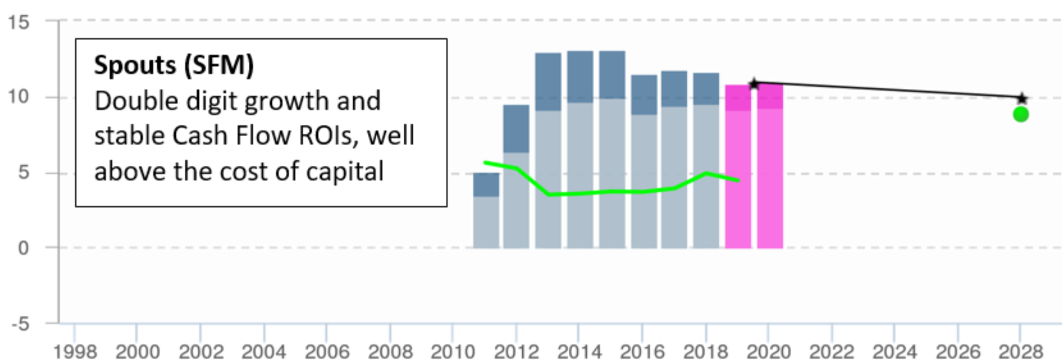
TopBuild (BLD) delivered a +45% return in Q1. BLD provides insulation and other building products to the construction industry. It had sold off aggressively in the second half of 2018 as rates began rising and real estate began slowing. We picked it up at $45 in late October and recently trimmed our position at $65 (keeping a 2% position). The stock is currently trading at just over $70. Although this company is clearly subject to cyclicality as well as interest rate risk, it has a strong management team and is among the leaders in its peer group in Cash Flow ROIs and shareholder returns. BLD's consensus top line growth estimate is ~9% for 2019.



Source: Credit Suisse HOLT

Q1 Example Losers:

Sprouts (SFM) is an organic grocer that went public into significant industry headwinds in 2013. The stock has under-performed the market despite delivering some very impressive profits and growth. Sprouts is the closest competitor to Whole Foods but has always had stronger operating margins as well as asset utilization. And in fact, Sprouts has been the subject of acquisition rumors ever since Amazon bought Whole Foods. The business model is unique in that it has always been centered around fruits and vegetables (the highest margin foods), but unlike most grocers Sprouts is less concerned about appearances (abundant displays of produce) and more focused on minimizing waste. This, combined with its industry leading margins, make for an impressive Cash Flow ROI. The stock is volatile but has been making higher highs and higher lows for the past two years. We are long term believers in this company, which has a consensus sales growth rate in the range of 10-11% for the next two years.



Source: Credit Suisse HOLT

Top Ten Holdings

Our top 10 holdings currently include two tech names, three healthcare, two consumer discretionary, one financial, one consumer staple and one industrial name. The median market cap is approx. $1.6 billion.

Company	Business description	Weight	Size ($mm)
Pet Med Express (PETS)	Pet meds & supplies	6.0%	480
Primo Water (PRMW)	Filtered water	5.4%	580
Carbonite (CARB)	Backup/disaster recovery	5.3%	870
Supernus Pharma (SUPN)	Specialty pharma (CNS)	5.1%	2,000
Prestige Consumer Health (PBH)	OTC healthcare products	5.1%	1,500
Sprouts Farmers Market (SFM)	Organic groceries	4.5%	2,700
BioTelemetry (BEAT)	Remote cardiac monitoring	3.9%	2,000
Five Below (FIVE)	Specialty value retailer	3.9%	7,000
Texas Roadhouse (TXRH)	Restaurants	3.8%	4,500
Axos Financial (AX)	Consumer banking	3.7%	1,900

Conclusion

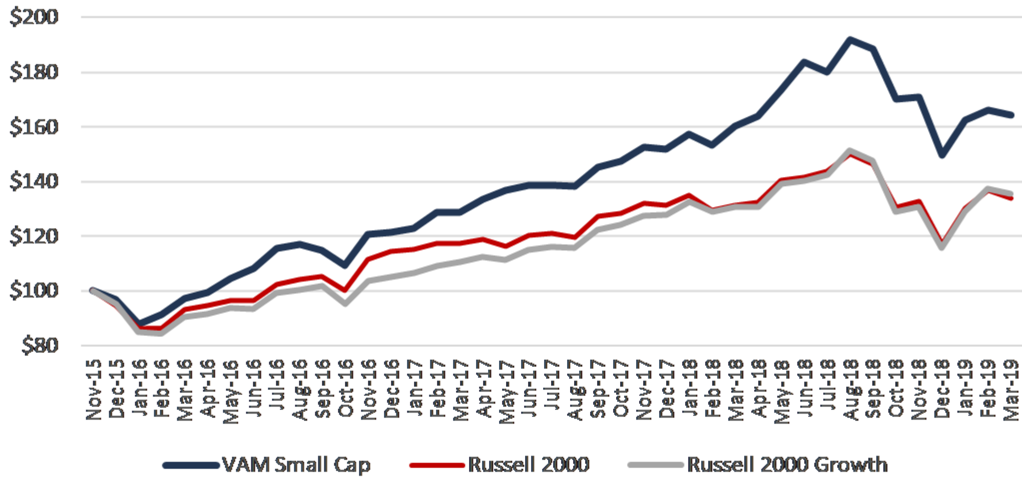
We believe there continues to be a big opportunity in the small cap space and expect this category to outperform large caps and global stocks over the long run. However, despite the market's disregard for quality in Q1, we believe this will be a critical theme going forward and the most successful managers will be those who are able to navigate the risks of the category, particularly leverage risk. This type of risk management is central to our process.

We also believe our rigorous approach to stock selection and strong track record of alpha generation make us an attractive choice for clients. It's not hard to find small cap managers who are willing to speculate, but we believe quality always wins in the end.

We are pleased to have passed the critical 3-year mark and are proud of our performance thus far. Please feel free to reach out to us with any questions or to schedule a call.

Full Track Record

We have achieved excellent results thus far, out-performing the Russell 2000 by more than 6% annually over our first 40 months (30% cumulative outperformance). We have not taken excessive risk in order to achieve these results (standard deviation is in line with the benchmark). Please see our strategy fact sheet for complete performance information and risk statistics.



	Return
Van Hulzen Small Cap	64.5%
Russell 2000	33.9%
Russell 2000 Growth	35.4%

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Approach

The strategy uses a "Growth At A Reasonable Profile" approach, which basically means we are not speculative. Just like you've come to expect from us in the large cap space, our focus is on quality first. But in the small cap space, we are just as open to growth and momentum stocks as we are value stocks. A "reasonable profile" means the business must be established and already profitable, earning returns above its cost of capital. Beyond these simple parameters, we look for companies that are leaders in their industries, expanding rapidly (2-3x the market), and consistently beating expectations for growth.

Portfolio Construction

Our strategy is well diversified, with a max position size of 6% and broad representation across sectors. We believe in long term value creation based on a disciplined capital allocation process. A handful of lucky concentrated bets is not the path to achieving long-term goals. We target companies with market caps between $500 million and $3 billion and have a below average portfolio turnover profile.

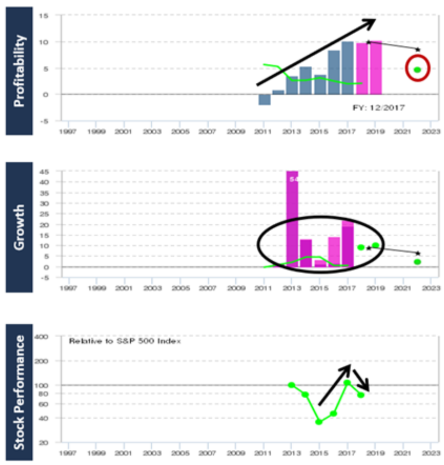
Fundamental Analysis

Fundamentals come first. Always. But we also incorporate technical analysis into our investment process, to provide key downside/support levels and also to provide confirmation of buy/sell signals. Small-cap stocks can be volatile and technical analysis provides information into position sizing, entry and exit decisions and can trigger due diligence reviews.

We’d like to highlight one of our portfolio holdings (CTRL) to demonstrate our investment approach. Control4 (CTRL) is a “smart home” solution provider that has provided us with a 60% return since inception but that we believe is still significantly undervalued. It is a market leader and a very profitable business that is growing 12-16% per year. With a market cap of just $660 million, we believe it is an ideal takeover candidate.

Investment Process

Fundamental Analysis: Control4 Corp (CTRL)



Source: Credit Suisse HOLT

Key Points

- Market cap: $660 million
- “Smart home” solutions, integrating audio, video, lighting, temperature, security & communications systems

- Strong, improving ROI, well above the cost of capital (blue bars well above green line)
- Analysts expect 12-16% sales growth & further improvement in ROIs (pink bars)
- 6 of the past 8 earnings revisions have been positive, and CTRL has beaten estimates in 7 straight quarters
- $74 million of cash, no debt

- Even after significant stock out-performance, current stock price reflects low expectations (low green dot in top panel)

- Shares have out-performed the market 3-to-1 since the company first beat its cost of capital
- Shares have corrected somewhat but are still up 35% since we bought them in April 2017
- We believe the shares are significantly undervalued

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