INVESTMENT COMMENTARY: SMALL CAP Q2 2019

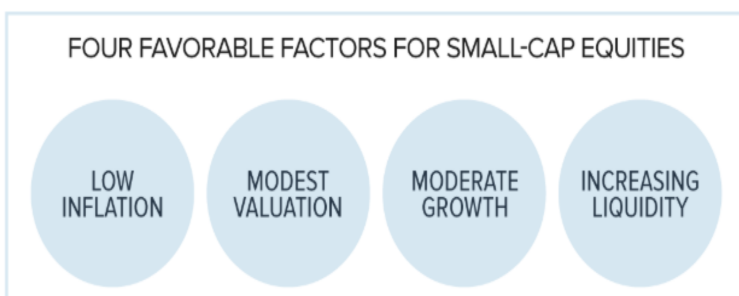
July | 2019

What's wrong with small caps?

The three leading US stock market averages (the S&P, the Dow & the Nasdaq) have had a monster first half and are now above their October 2018 peak levels. Small cap stocks, however, have not kept pace. The Russell 2000 is still 11% off its 2018 peak, which occurred more than a month earlier than the other indices (in late August). For the 12 months ended June 30, small caps were down (Russell 2000 was -3.3%) while large caps were significantly up (+9.7% for the S&P 500). Many economists see this as a warning sign, as small caps are often a leading indicator of things to come.

However, we came across some other analysis that gives us a little more hope. According to the analysts at Royce Funds, this level of divergence between small cap and large cap has occurred in only 16 out of 229 monthly rolling 12 -month periods over the past 20 years (that's only 7% of the time!). And in the 12-month periods that followed these divergences, small-caps outperformed large-caps more than 92% of the time. We often talk about mean reversion at Van Hulzen, and we believe this could be yet another example.

Royce also sees more reason for future optimism than most economists. Specifically, they believe low inflation, Fed accommodation and attractive small cap valuations could be just the combination the markets need to jump start the small cap category.



Low Inflation: Environments with low inflation have historically been very positive for all financial assets—and particularly positive for stocks.

Modest Valuation: In contrast with large-caps, and based on a variety of measures, small-cap valuations are close to their historical average. Even better, small-caps are cheap compared with their historical spreads to bond yields.

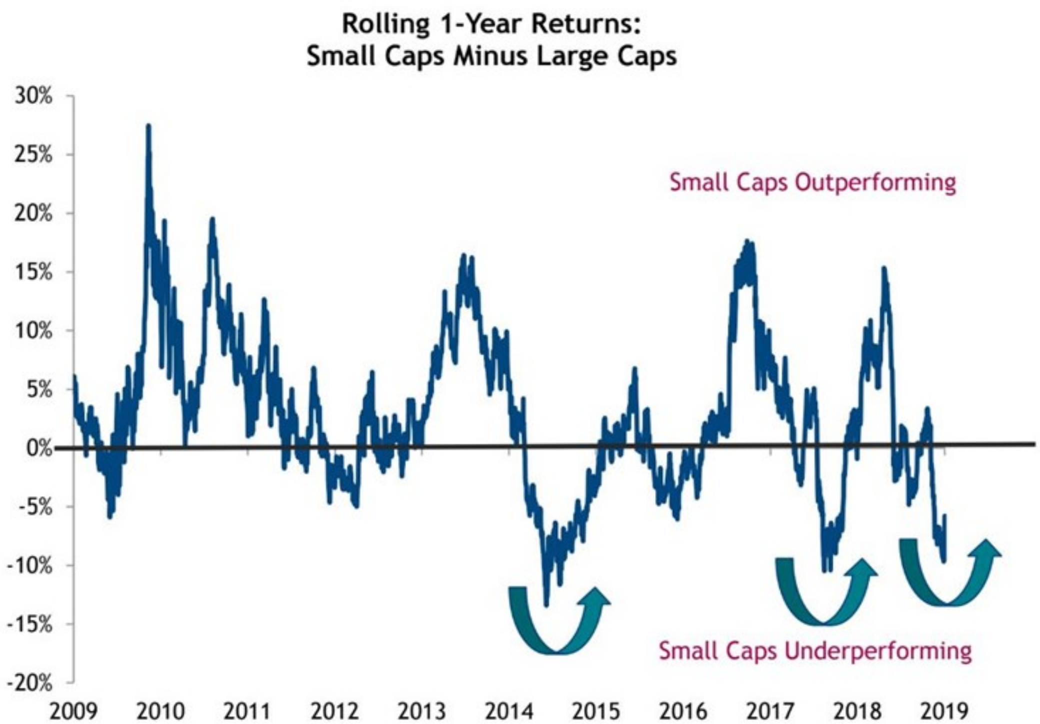
Moderate Growth: We see an important distinction between a slowing, but still growing, economy and one that's contracting. Based on our company research, we see the U.S. squarely in the first of these two conditions. We also think that the most recent quarter might be the bottom in year-over-year earnings growth. Second-half earnings prospects for many of our holdings seem promising given the relatively weaker third and fourth quarters of 2018 to which they'll be compared.

Increasing Liquidity: Much of the discussion about the recent dovish pivot for the U.S. Federal Reserve, as well as the ECB, has been centered on expectations for lower rates. We think that central banks will likely also increase financial market liquidity. The relevance of this for small-cap investors is that periods of low economic growth accompanied by increased liquidity have historically led to financials assets being bid up.

Source: Royce Funds

Turnaround on the horizon?

Keith Lerner, chief market strategist at SunTrust Private Wealth, agrees that there is a big opportunity for small caps. “With U.S. large-caps breaking out to a record high, small-caps provide investors a potential opportunity for an asset class that has not fully recovered.” The chart below shows that these periods of under-performance are typically short lived and result in sharp recoveries.



What worked in the first half

In our Q1 commentary, titled “Quality (Almost) Always Wins,” we highlighted some alarming statistics that suggested that the top small cap performers had in fact been among the lowest quality stocks (as defined by high leverage and negative earnings). This quarter we decided to take a closer look at some of the top performers YTD and found some interesting statistics.

Among the top 20 small cap performers in the first half:

- 10 of the top 20 were Biotech companies
- Only 9 had positive EBITDA and only 4 had positive earnings
- The average Cash Flow ROI (a key measure of ours) was -12.6%
- The average 2018 sales growth rate was a paltry 0.9%
- 4 were significantly over-levered (52% on average, vs 25% for the Russell)

Based on these statistics, it seems to us that investors who are sticking with the small cap category have gravitated towards the most speculative stocks in the space. As you know, we couldn’t be more different. Our investment process focuses on quality above all else, as we look for companies with strong Cash Flow ROIs, low debt and above average growth rates.

In the following two charts, we compare one of the market's top small cap performers (ArQule Inc, ticker ARQL, up 270% ytd) to our worst performing holding (Biotelemetry, ticker BEAT), which was down 35% in the first half after more than doubling in 2018. Both stocks are in the Healthcare sector. As you can see, these are radically different profiles: ARQL is still losing money but is priced to beat its cost of capital handily within the next 5 years, whereas BEAT is already (very) profitable and growing the top line at 12% per year. And future expectations (what's "priced in" today) are quite reasonable.

Source: Credit Suisse HOLT

Our process is all about quality. We call it "Growth at A Reasonable Profile" (a slightly different version of GARP) because we invest in companies that are already profitable and are expanding their businesses rapidly. This process has worked well for us over the long term. We will stick to our knitting no matter how much others choose to speculate.

Portfolio Attribution

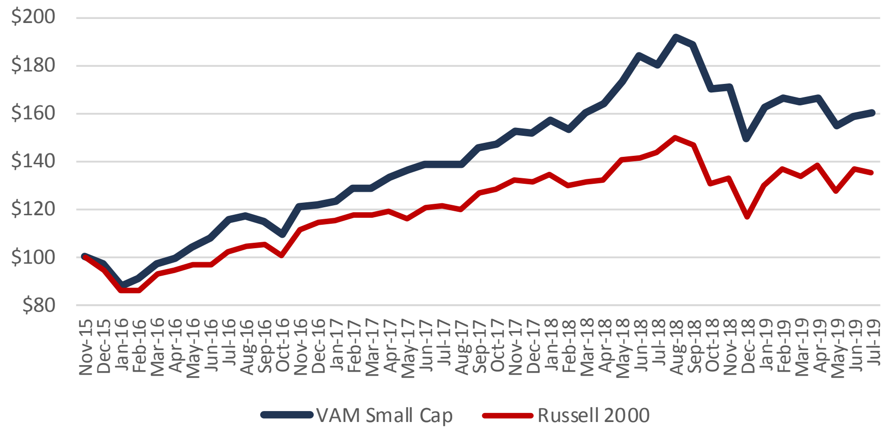
Once again we saw a good bit of dispersion between individual holdings in the first quarter. Our strongest performers were mostly in the technology sector, plus we saw one of our case-study names (Control4 Corp) get acquired in Q2. Our biggest under-performers were mostly in the healthcare sector, which continues to be weak. We sold out of Ligand (LGND) in Q1 as management revised down significantly.

Biggest Gainers YTD		Biggest Losers YTD	
TopBuild (BLD)	97.5%	BioTelemetry (BEAT)	-34.9%
iRobot (IRBT)	56.4%	PetMed Express (PETS)	-33.6%
Envestnet (ENV)	38.5%	SailPoint Technologies (SAIL)	-29.6%
Upland Software (UPLD)	35.6%	Glu Mobile (GLUU)	-29.2%
Control4 Corp (CTRL)	34.7%	Ligand Pharma (LGND)	-26.2%

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.

Performance

The strategy gained 2.4% in June and is up 7.0% so far this year. Over the full track record, we have out-performed the Russell 2000 by 5.0% annually (24.5% cumulative outperformance). We have not taken excessive risk in order to achieve these results (standard deviation is slightly lower than the benchmark). Please see our strategy fact sheet for complete performance information and risk statistics.



	Return
Van Hulzen Small Cap	60.1%
Russell 2000	35.6%
Russell 2000 Growth	38.2%

Returns are net of fees (11/30/15-7/15/19). 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.

Top Ten Holdings

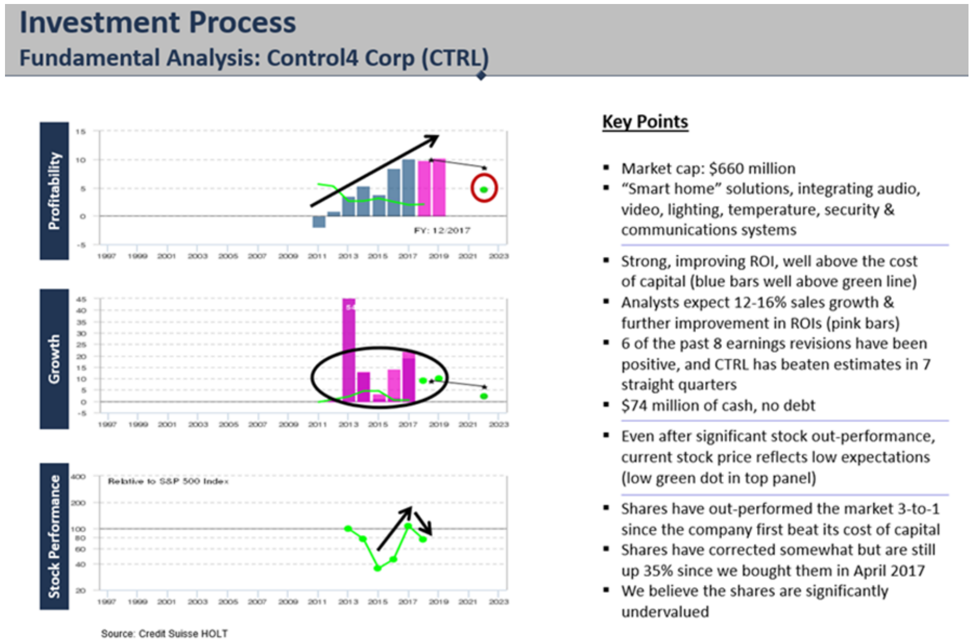
Our median market cap is approx. $1.6 billion. As of July 15, the top 10 holdings are as follows:

Company	Business description	Weight	Size ($mm)
Prestige Cons Health (PBH)	OTC healthcare products	6.1%	1,600
Carbonite (CARB)	Backup/disaster recovery	5.3%	840
Primo Water (PRMW)	Filtered water	5.0%	530
Supernus Pharma (SUPN)	Specialty pharma (CNS)	4.5%	1,700
US Ecology (ECOL)	Environmental services	4.1%	1,400
Five Below (FIVE)	Specialty value retailer	4.1%	6,900
Envestnet (ENV)	Wealth management systems	4.0%	3,500
Sprouts (SFM)	Organic groceries	4.0%	2,300
SP Plus Corp (SP)	Parking management svcs	3.9%	740
Texas Roadhouse (TXRH)	Restaurants	3.5%	3,900

Supernus Pharmaceuticals
US ecology
Carbonite BACKUP. SIMPLE.
taste perfection PRIMO
Prestige Consumer HEALTHCARE

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



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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

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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

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