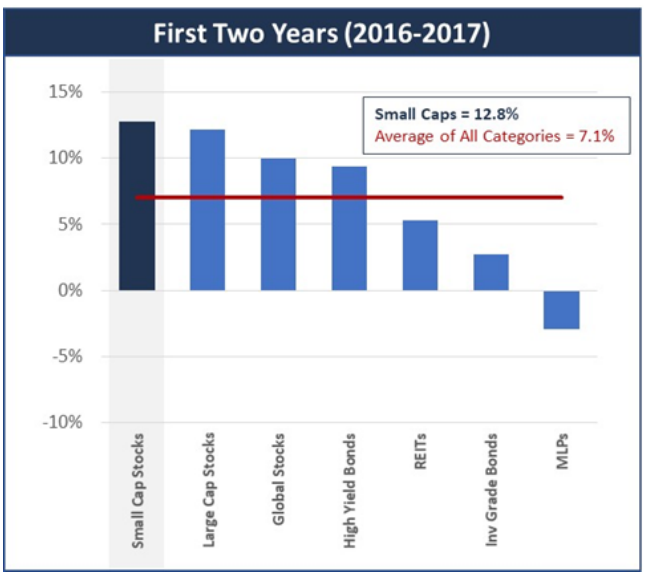
INVESTMENT COMMENTARY: SMALL CAP Q3 2019

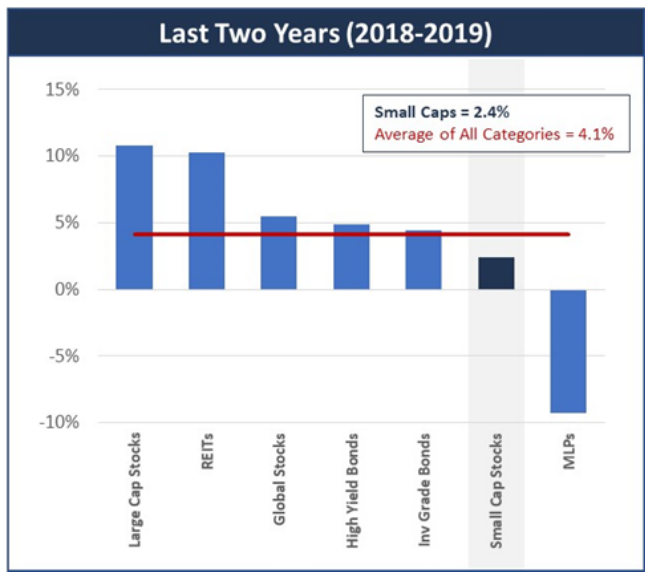
October | 2019

Shifting Winds

Small caps continue to struggle relative to large caps. In fact, over the past two years they have under-performed every major asset class except for MLPs. After watching the category lag large caps by another 4.1% this quarter (the 5th quarter small caps have lagged in the past 6 quarters), it is difficult to see the catalyst for a turnaround in the very near-term. Small caps are often a leading indicator of things to come, after all (more on that later). To be clear, we still believe small caps are the best asset class for long-term performance. And we believe long-term investors should stay the course. But we also believe investors should temper their expectations a bit in the near term.

As we approach the 4yr anniversary of our strategy, we decided to take a deep dive into the broad asset class categories and break the past 4 years into two distinct periods (the first two years and the last two years). See the asset class performance for each period below. Returns are annualized.





Source: Data since inception of Small Cap strategy (Dec 1, 2015). First Two Years = Dec 1, 2015-Sep 30, 2017; Last Two Years = Oct 1, 2017-Sep 30 2019. Small Cap Stocks represented by Russell 2000 index, Large Cap Stocks represented by S&P 500 index, Global Stocks represented by MSCI All World index, High Yield Bonds represented by IBOXX High Yield index, REITs represented by Dow Jones US REIT index, Investment Grade Bonds represented by Barclay's US Aggregate index, MLPS represented by Alerian MLP index.

Some really interesting themes emerge from this data:

- Small caps dropped from the **highest** returning asset class in our first two years (+12.8%) to the **second lowest** returning asset class (+2.4%) in the second period.
- Large caps are the **only** asset class that has returned more than 10% in both periods. This has largely been driven by Big Tech, as we will discuss in the next section.
- Clearly, **interest rates** have been a major factor in relative performance. Bonds and REITs improved the most from period 1 to period 2, as both benefited from lower rates.

- Small caps, which traditionally benefit from lower rates, have not benefitted this time around. We see this as a potential concern.

Leading Indicators?

There are many variables that economists look to as leading indicators for the economy and/or the stock market. From a fundamental standpoint, popular statistics to watch include earnings growth (which leveled off several years ago), the yield curve (which has flirted with inversion for the past year or so), unemployment (which has been a very positive driver for years but may be bottoming), as well as factors such as home sales and durable goods orders (which are now slowing). The Conference Board publishes a Leading Economics Index (LEI), which was unchanged in August after two negative moths (May & June) and one positive (July). Of course, the Conference Board is more geared towards predicting recessions than market pullbacks. And as we all know, by the time a recession hits the market has already corrected.

No matter what indicators one looks to, all the data tends to work its way into stock charts. We sometimes look at three specific stock indexes as leading indicators of things to come. Small caps are one of the three. The others are transports and banks. Banks have never really recovered from the financial crises, but we can still learn something from the general direction of this index. Small caps and transports (along with Big Tech) helped drive the market higher over the past 10 years. But the winds seem to have finally changed here as well. As you can see from the charts below, these three "leading indicators" have declined (by 10%, on average) over the past year, while large caps have continued to rise (+4.7% since September 2018). This dislocation is concerning as well. The last time we saw a similar dislocation was in 2015 -16, and it sparked a lot of concern. But ultimately corporate tax cuts and cheap money bailed us out. It's not clear what the catalyst might be this time.

To be clear…we are not bearish. We simply want to point out some of the headwinds we are observing in the market. We are committed to long-term out-performance in the small cap category. But it is a risky category. And we think some continued patience may be required in the near term

Portfolio Positioning & Attribution

Our small cap portfolio turned in a good September (+3.4% versus 2.1% for the Russell) but under-performed by 1.9% for the full quarter. We have been gradually lowering our beta throughout the year by lightening up on financials and consumer discretionary names. We remain slightly overweight in technology, however, as well as healthcare and staples.

Speaking of shifting winds, for the first time since inception, our strongest performers this quarter were consumer stocks! UEIC (discretionary), PETS and JJSF (both consumer staples) were the top 3, followed by two industrials (ALG and SP). And four of our top 5 loser this quarter were tech companies! Talk about shifting winds! So far this year, only 2 of our top five are tech companies. One of them was acquired at a premium (CTRL), and the other we closed near its peak (IRBT), before it sold off.

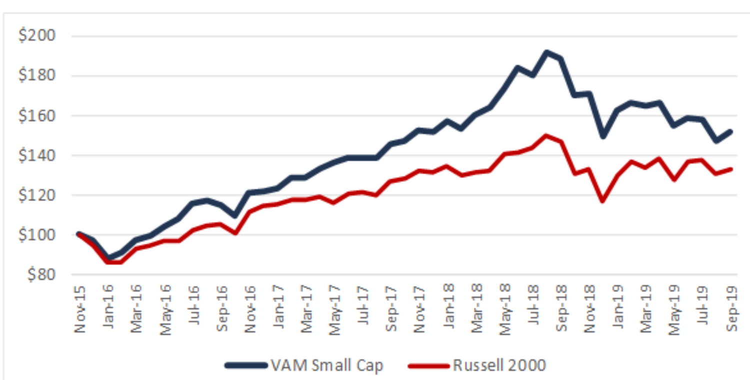
It's also worth pointing out that PETS, which has struggled of late, posted a significant beat on October 21, which appears to have finally chased some of the short sellers away. The shares are up 43% since the announcement.

Biggest Gainers YTD		Biggest Losers YTD	
TopBuild (BLD)	130.3%	Glu Mobile (GLUU)	-56.3%
iRobot (IRBT)	56.4%	BioTelemetry (BEAT)	-41.5%
Alamo (ALG)	51.7%	Carbonite (CARB)	-41.3%
Control4 Corp (CTRL)	34.7%	SailPoint Technologies (SAIL)	-34.4%
J&J Foods	34.1%	PetMed Express (PETS)	-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

Since inception, the strategy has out-performed the Russell 2000 by 3.7% annually (18.5% 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	51.8%
Russell 2000	33.2%
Russell 2000 Growth	32.4%

Returns are net of fees (11/30/15-9/30/19). 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.

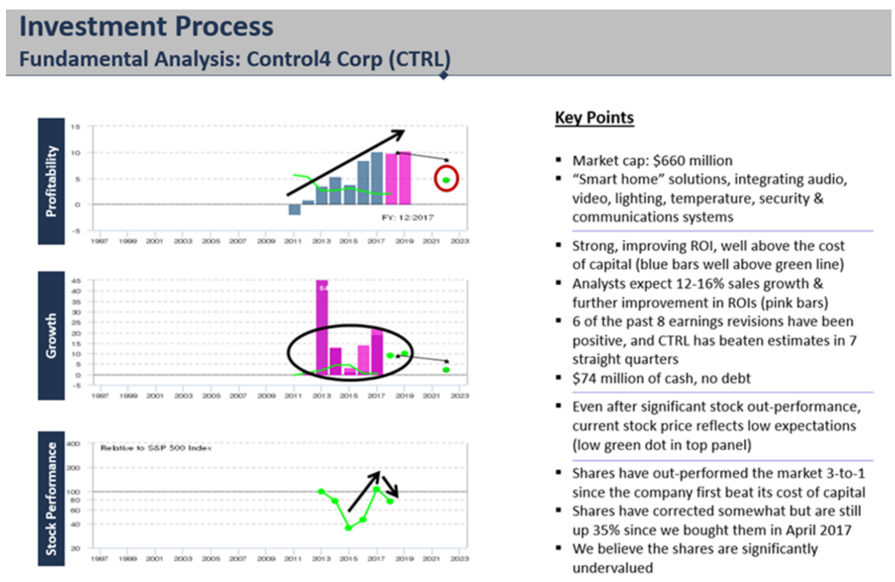
Top Ten Holdings

Our median market cap is approx. $1.4 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	6.0%	1,700
BioTelemetry (BEAT)	Remote healthcare technology	5.5%	1,400
SP Plus Corp (SP)	Parking management svcs	4.7%	880
Primo Water (PRMW)	Filtered water	4.5%	460
US Ecology (ECOL)	Environmental services	4.4%	1,400
Axos Financial (AX)	Consumer banking	3.9%	1,800
CSW Industrials (CSWI)	Building products	3.8%	1,000
Supernus Pharma (SUPN)	Specialty pharma (CNS)	3.7%	1,400
Upland Software (UPLD)	Cloud-based enterprise softwa	3.7%	980
AMN Healthcare (AMN)	Nurse staffing services	3.6%	2,700

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.

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