INVESTMENT COMMENTARY: SMALL CAP Q4 2019

December | 2019

2010-19: Reflecting on the "Teen Years"

In our covered call commentary, we focused on the record run of the S&P 500 over the last decade. The longest bull market on record persisted (and continues to persist) despite an aging population and a significantly lower GDP growth rate (1.8% for the decade compared to a 3.4% average for the previous 50 years). And stock prices have continued the advance despite stagnant earnings growth over the past 3 years. We identified what we believe are the two primary reasons for this resilient market:

The Federal Reserve: Rates dropped from 4.7% to 2.1% over the past 10 years, with the Fed balance sheet expanding throughout the decade. The Fed's stance has encouraged borrowing and risk taking.

Corporate Cash Flows: Free cash flows exploded during the decade ending December 2019, from 4.7% of sales to 9.9%. There are several drivers here. First, interest as a percent of sales declined from an average of 4.4% to 2.1%. This drop is due to the lower interest rate decisions by the Fed and increases corporate profits. Second, corporate tax rates dropped from 31.7% in 2011 to 19.9% in 2019. Despite making more money in 2019, corporations are expected to pay roughly $120 billion ***less*** in taxes than they paid in 2008.

This All May Be True, But Isn't The P/E Still Reasonable?

Despite a P/E ratio that is only somewhat overvalued by historic measures, it is important to remember that much of the margin expansion has come from low interest rates and low tax rates and an abundance of easy money.

Other measures are not so benign. One of the broadest measures of market extremes is to compare the size of the US total stock market to the size of the US economy (GDP).

Historically, the stock market has been slightly smaller than the total economy. In the chart to the right, the 2000 "dot-com" bubble reached a level where stocks were 48% larger than GDP. At the end of 2019, stocks reached an all-time-extreme level of 153% of the size of the GDP.

And let's not forget how we got here. The last 4-5 years have been all about Big Tech. The top five tech stocks (Apple, Microsoft, Alphabet, Amazon & Facebook) make up 18% of the total market cap of the S&P 500. These stocks have fueled a record dispersion between growth and value stocks, a phenomenon we've highlighted many times. Not only do these types of dispersions typically normalize, but this kind of concentration in a small number of stocks is not healthy for the overall market. In the past, it has led to under-performance.

What About Small Caps?

Well, there's the long term and there's the short term. Despite having out-performed large caps over the very long term (since 1926, top chart below), **small caps lagged large caps by an average of 1.7% per year during the last 10 years** (11.8% versus 13.5%). And in fact, there has been a "Big Cap" bias for over 30 years! The second chart below shows that the S&P 500 has out-performed the Russell 2000 since the mid-1980s. This divergence was especially obscene in the late years of the 1990s tech bubble and is equally obscene today. Note: When looking at these comparisons, it's important to make sure you look at *total returns*, including dividends. It's easy to find charts online that show small caps out-performing during this same 30 year time-frame, but those charts show "price only," which is only part of the story (large caps have a much higher dividend yield than small caps).

Source: Morningstar (top) and Bloomberg (bottom)

Looking Forward

Investors are eager to capitalize on this divergence between small and large cap stocks. A quick Google search on the category yields articles predicting small caps will be "back in vogue" in 2020. We believe this size divergence will correct itself, too, but we feel this will happen over the long term, not in a year or two. We believe the current market environment is rife with risks. Not only are we making new highs every day in the late stages of a record bull market, but Big Tech is bound to falter at some point, and this change in leadership will lead to uncertainty. There is no shortage of other risk factors, too…including ballooning deficits, a trade war & election uncertainty. When we do see elevated volatility, we expect to see small caps under-perform large caps as they typically do in down markets. After all, 35% of small caps are unprofitable (compared to just 5% of S&P 500 stocks). Many of these small companies are over-levered, as well, as they have once again been extended extremely lenient credit terms. These names will be the first to get hit in a downturn.

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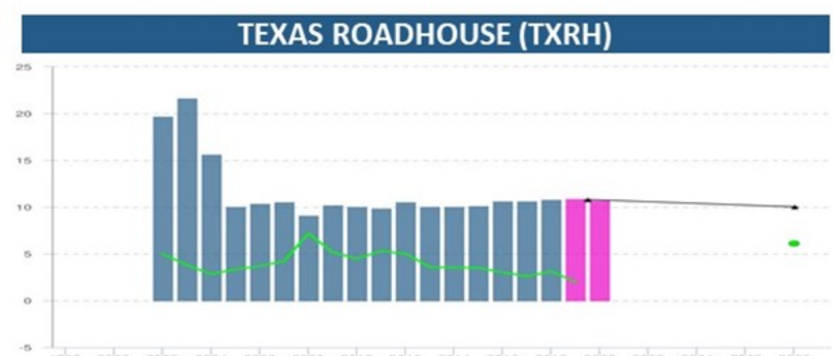
Quality First: We Will Not Waver

We believe our investment process lends itself to the above-mentioned environment. **We are 100% focused on quality.** The median company in our portfolio has leverage of approx. 13% versus 28% for the small cap index. Our portfolio also boasts a 14.5% Cash Flow ROI and a 9% five-year sales growth rate (compared to 8% and 6% for the index, respectively).

To demonstrate our point, we want to make a quick comparison. A number of small cap bulls have highlighted CHUY as a top pick for 2020. Chuy's is a Tex-Mex restaurant chain that offers a good product but is a cost of capital business that carries approx. 42% leverage (if you capitalize all their lease obligations) and has returned just 40 cents on the dollar relative to the market since its IPO in 2012. Some analysts are impressed with their 6-7% projected sales growth.



Source: Credit Suisse HOLT™

Portfolio Performance & Positioning

2019 was a solid year but challenging with respect to relative performance. Let's face it… when you're keenly focused on quality, you won't always keep up when markets bounce back from a steep sell-off. As stated in our Q1 commentary, quality (almost) always wins. As you may recall, we turned in a very impressive relative return of +9.6% in 2018 (-1.4% versus -11.0% for the Russell 2000). But the stocks that bounced back the strongest after that sell-off were the ones with negative earnings and the most leverage (see our Q1 commentary for more on that). That's not us. For the full year, our portfolio returned +9.5%.

We just passed the four-year mark on our track record. Since inception, we are still significantly ahead of all our benchmarks, even after 2019. We have delivered an annualized return of 12.9% versus 9.8% for the Russell 2000. It's been a "bigger is better" market since we launched in 2015, with the S&P out-performing everything, then mid-caps, then the Russell 2000 and (finally) the Russell Microcap index. Our strategy holds a handful of microcaps and has a median market cap of approx. $1.2 billion (on the small end of the small cap category). As another reference point, the annualized return of the Russell Microcap index is 8.1% since our inception.

There is some good news to report on a number of our largest holdings. Short sellers appear to have backed away from a few of our names. PETS, which had been beaten down particularly hard, had a nice quarter at +32%. And LOGM, the parent company of GoToMeeting, was acquired this quarter and returned approx. 24%. The biggest laggards included two healthcare stocks, two consumer stocks and an industrial.

Biggest Gainers YTD		Biggest Losers YTD	
Carbonite (CARB)	47.8%	iRobot (IRBT)	-17.9%
SP Plus (SP)	40.0%	Supernus Pharma (SUPN)	-13.7%
PetMed Express (PETS)	32.3%	US Ecology (ECOL)	-9.2%
Prestige Consumer (PBH)	23.6%	Primo Water (PRMW)	-8.6%
LogMeIn (LOGM)	23.6%	HMS Holdings (HMSY)	-8.4%

Track Record

Since inception, the strategy has out-performed the Russell 2000 by 3.1% annually (17.2% cumulative outperformance). We have not taken excessive risk in order to achieve these results (standard deviation is 16.2% versus 16.6% for the Russell 2000 and 17.5% for the Russell Microcap. Please see our strategy fact sheet for complete performance information and risk statistics.

Returns are net of fees (11/30/15-12/31/19). 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. $1.2 billion. As of December 2019, the top 10 holdings are as follows:

Company	Business description	Weight	Size ($mm)
ZIX Corp (ZIXI)	Email encryption services	6.0%	400
BioTelemetry (BEAT)	Remote healthcare technology	5.9%	1,600
Upland Software (UPLD)	Cloud-based enterprise softwa	5.6%	900
Independent Bank (IBCP)	Consumer banking	4.8%	500
Alamo Group (ALG)	Tractors & mowers	4.2%	1,400
CSW Industrials (CSWI)	Building products	4.1%	1,200
Primo Water (PRMW)	Filtered water	4.0%	500
Envestnet (ENV)	Financial tech solutions	3.8%	3,700
ePlus (PLUS)	Supply chain tech solutions	3.8%	1,200
Axos Financial (AX)	Consumer banking	3.7%	1,900

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 previous portfolio holdings (CTRL) to demonstrate our investment approach. Control4 (CTRL) is a "smart home" solution provider that was recently acquired. 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 when we found it, we believed it was an ideal takeover candidate.

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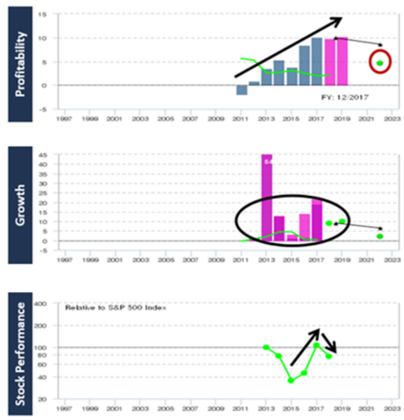
Investment Process

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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