INVESTMENT COMMENTARY: SMALL CAP Q1 2020

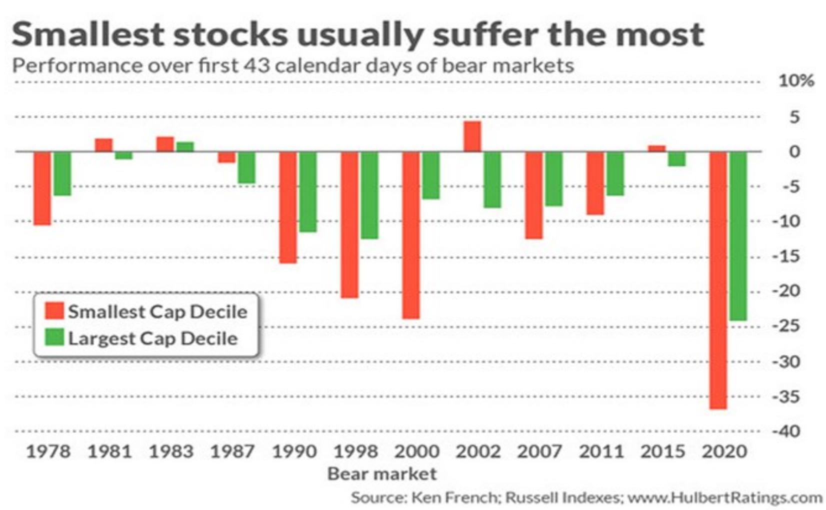
April | 2020

Q1 2020: Small Cap Commentary

Best Week Ever for Small Caps!

Last week was the best week **ever** for the Russell 2000, with small caps rising approximately 18%! With this kind of headline, someone waking up from a coma might be expected to think to themselves “wow, things must really be going well!” Of course, we all know better. The economy is at a complete standstill. Many businesses have zero revenues for the past few weeks. And as such, we believe it’s impossible to know where the market is going in the short term. But we do know the following:

- The previous “best week over” for the Russell was in the fall of 2008, in the midst of (but not at the conclusion of) a major market crash
- This was the fastest decline into bear market territory ever recorded, including the 1929 crash
- Small caps will typically lead on the downside (see chart below) **as well as** the upside
- Things are not expected to go back to “normal” for a very long time
- **However**, and this is a big one, the Federal Reserve has provided an unprecedented amount of monetary stimulus (we’re talking leaps and bounds above its response to the 2008-09 crisis) and has made it clear that it does not want businesses to fail
- This recent rally is largely a function of the actions taken by the Fed over the past several weeks
- We are in the midst of a shifting landscape, and many questions remain



Opportunity of a Lifetime*

Many market pundits have been saying the current selloff represents an opportunity of a lifetime. And we actually agree, with one **major caveat**, which is why we’ve added an asterisk (*) to the phrase. It has never been more important to insist on **quality**. If you are a regular reader of our commentaries, then you know that we have been cautioning investors about quality dislocations in the market ever since volatility returned in 2018 after a long hiatus.

Our Q1 2019 commentary highlighted how the weakest companies (over-levered companies, many with negative earnings) saw the greatest stock performance in that particular quarter. This trend actually continued throughout most of 2019. Last quarter, we reviewed market performance over the entire past decade, noting that while there will always be exceptions over short periods of time, **quality always wins** in the end.

“Quality” vs “Defensive”

Although the terms are sometimes used interchangeably, it’s important to point out that quality stocks are not necessarily defensive stocks. Some quality stocks are defensive, while some are more growth-oriented. As you’ll see from the portfolio statistics below, our portfolio has very high cash flow ROIs (a defensive trait) but also has significantly higher sales growth and is not focused on dividends (not defensive traits). After providing nice downside protection in Q1 (see next paragraph), our strategy has actually snapped back just as fast as the Russell over the past two weeks. This may be surprising to many, as sharp market rallies often favor the lowest quality stocks. And this was true in some cases, but we also believe we are seeing a sustainable shift in the market’s appetite…away from speculation and towards quality growth. There will be clear winners and losers this year, and we will continue to place our bets on the highest quality names.

Delivering On Expectations

Did quality work in Q1? Yes it did. Our strategy out-performed the Russell 2000 by 4.5% in March (the worst month of the quarter) and 8.4% for the quarter. We did this by insisting on the highest quality parameters in our stock selection process. We call our process “Growth At A Reasonable Profile” because we invest in companies with competitive advantages and above average growth profiles, but to pass our criteria the growth has to be **profitable** growth. We look at operating margins, asset utilization and cash flow ROIs as our primary guidelines, while also tracking earnings revisions and momentum as well as Transaction ROIs, a company’s track record for creating value through acquisitions.

Consider some of our portfolio statistics, relative to the Russell:

- **Cash Flow ROI (5yr avg):** **13.5% (vs 6.5% for the Russell)**
- **Sales growth (5yr avg):** **9.0% (vs 6.0%)**
- **Leverage (debt/total cap):** **12.3% (vs 26.3%)**
- **Default probability:** **2.1% (vs 11.2%)**

We would argue the last two statistics may be the most important in the type of environment we are currently facing. With the top line completely uncertain for most small businesses, cash is going to be king for quite some time. Companies that have over-extended themselves with respect to leverage are going to struggle. Our metric for default probability comes from the Merton Model, developed by Robert Merton in 1974 to calculate how capable a company is at meeting financial obligations. As you can see, our portfolio carries significantly less debt than the Russell and has a much lower probability of default.

More Insights from the Quarter

We cut and analyzed the Q1 performance of the Russell 2000 constituents, as we always do, and found some interesting conclusions:

- **Leverage**: The quintile with the most leverage (and highest default probability) had the best total shareholder return over the past week. However, this quintile had the worst performance in Q1 and the worst performance over the past 5 & 10 year periods
- **Cash Flow ROI**: The top CFROI quintile had the second-best stock performance for the quarter but was the top quintile **by far** for the 5 & 10 year periods
- **Total Shareholder Return**: When sorted by stock performance, the quintiles stack up exactly as you might expect, with the top performers having the lowest leverage and credit risk.

Q1 TSR	Leverage %	Default Prob %
Qutintile 1	14.2	1.3
Qutintile 2	14.4	2.5
Qutintile 3	16.5	7.0
Qutintile 4	35.8	16.4
Qutintile 5	68.3	34.1

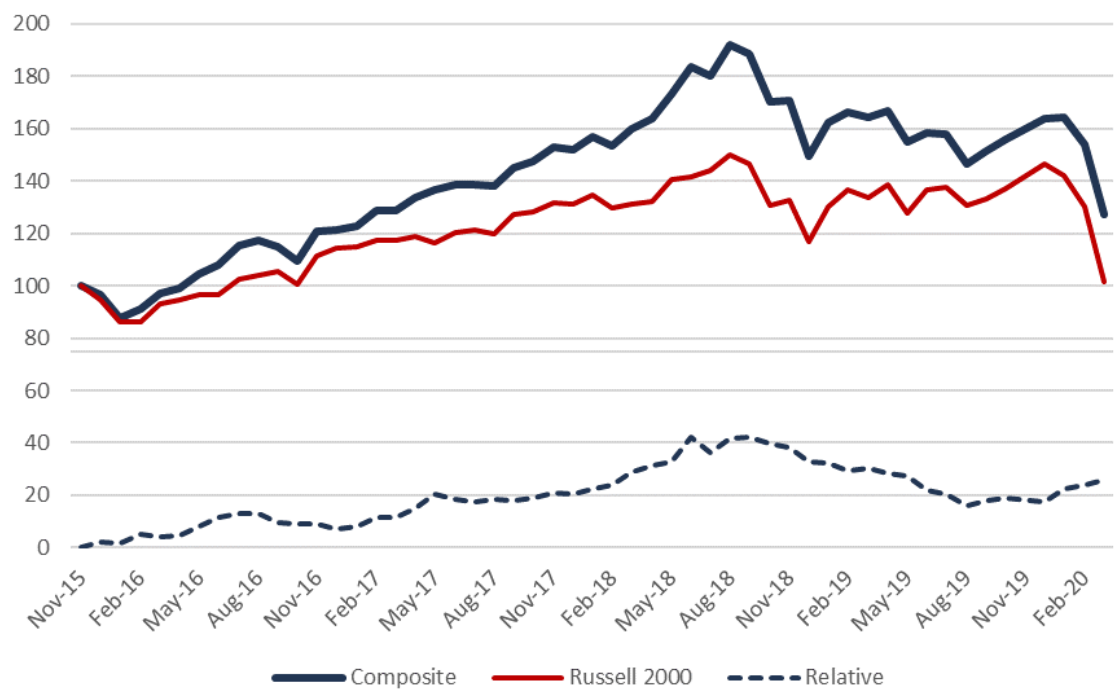
Upside/Downside Ratio

We have out-performed the Russell 2000 by an average of **5.4% per year** since we launched the strategy 4½ years ago. This has been a challenging time to manage money, as we experienced record market complacency in 2017 and 2019 and extreme volatility in both 2018 and 2020. There is perhaps not a better time to consider risk management in your manger selection process. And that analysis should of course include upside and downside capture.

Our out-performance has been a combined effort, with slightly higher upside capture and significantly better downside capture. Our upside/downside ratio is a strong 1.2x. Please see the Performance and Risk Statistics table below for more information and a comparison of our strategy's performance to the Russell 2000, Russell Growth & Russell Microcap.

Long Term Track Record

Since inception, the strategy has out-performed the Russell 2000 by 5.4% annually (25.7% cumulative outperformance). We have not taken excessive risk in order to achieve these results (standard deviation is 18.3% versus 19.9% for the Russell 2000 and 21.1% 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 – 3/31/20). 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 & RISK STATISTICS *(net of fees)*

Performance (net)	Van Hulzen	Russell 2000	Russell Growth	Russell Micro
Month	-17.2%	-21.7%	-19.1%	-23.8%
3 Months	-22.2%	-30.6%	-25.8%	-32.3%
Year To Date	-22.2%	-30.6%	-25.8%	-32.3%
2 Years	-20.4%	-22.5%	-15.7%	-28.5%
3 Years	-1.0%	-13.3%	-0.2%	-18.8%
Inception	27.5%	1.8%	10.2%	-7.0%
Annualized	**5.8%**	**0.4%**	**2.3%**	**-1.7%**

Risk Statistics *(since inception)*				
Standard Deviation	18.3%	19.9%	19.6%	21.1%
Alpha (relative to Russell 2000)	5.2%			
Beta	0.9			
Sharpe Ratio	0.2			
Information Ratio	0.7			
Tracking Error	7.7%			

Upside/Downside Capture	
Up capture	102%
Down capture	85%
Ratio	**1.2**

Top Ten Holdings

Our median market cap is approx. $1.7 billion. As of March 2020, the top 10 holdings are as follows:

Company	Business description	Weight	Size ($mm)
Qualys (QLYS)	Cyber security	6.0%	3,700
Five Below (FIVE)	Discount retail	5.9%	4,300
ePlus (PLUS)	Supply chain tech solutions	5.7%	830
PetMed Express (PETS)	Online pet pharmacy	5.2%	590
Amer States Water (AWR)	Water utility	4.8%	3,100
J&J Snack Foods	Snack foods	4.5%	2,300
Lumentum (LITE)	Optical comms equipment	4.4%	6,000
Alamo Group (ALG)	Tractors & mowers	4.3%	1,100
SP Plus (SP)	Parking management	4.0%	470
Independent Bank (IBCP)	Consumer banking	4.8%	320

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.

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