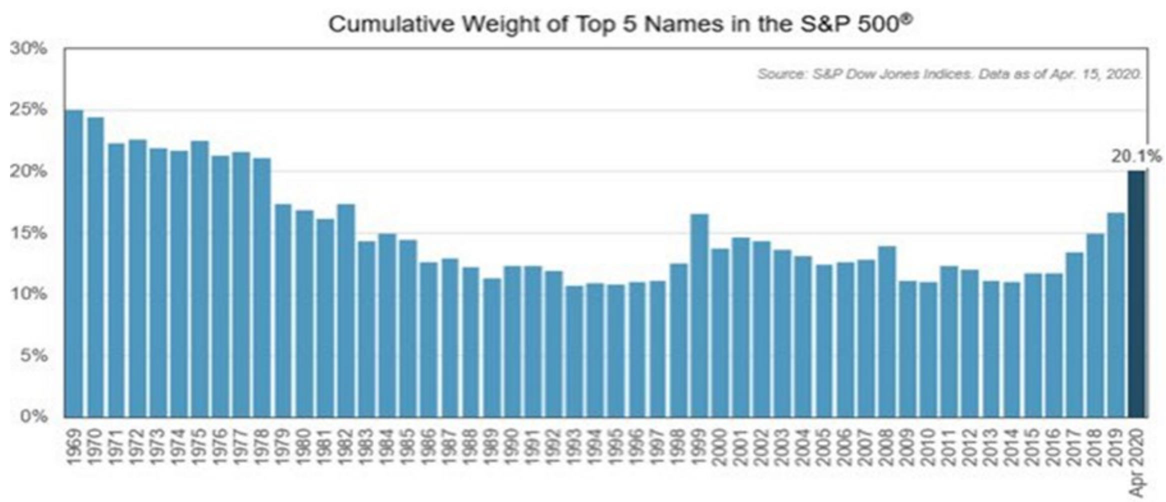
INVESTMENT COMMENTARY: SMALL CAP Q2 2020

June| 2020

So What If We All Own The Same 5 Stocks?

There is lots of discussion about how today's market is so concentrated in just a handful of stocks. And rightfully so. As of this writing, the top five stocks in the world (Apple, Microsoft, Amazon, Alphabet & Facebook) have turned in a 33% return year-to-date, versus -9% for the rest of the S&P 500. The concentration of these top 5 (which currently comprise 23% of the total market cap of the S&P 500) far exceeds that of 1999 and is nearly as high as the Nifty Fifty days of the late 1960s/early 1970s.



So What?

There will always be people who say it's different this time. And there's always a chance of that. But the historical data shows that periods of market concentration are not the healthiest sign of market strength. The last two periods of concentration (the early 1970s and then 1999) preceded the two worst bear markets since the great depression (1973-74 & 2000-02). See below.

The Economist

Comparing 1999 To Today

We often hear that the difference between the tech bubble in 1999 and today's market is that there were no earnings supporting the lofty valuations of the day. And there's no doubt that a lot of tech startups had no earnings back then. We decided to do our own digging (using the Credit Suisse HOLT database) and found some interestingly data. In fact, the Cash Flow ROI figures from the top 10 biggest global companies (then and now) do **not** support the statement that companies were less profitable back then. In fact, the median Cash Flow ROI of the top 10 companies was actually **higher** in 1999 vs today (16.4% vs 15.5%).

Top 10 in 1999			
	Mkt Cap ($bn)		CFROI
Microsoft	$	583	22.5
GE	$	504	15.9
Cisco	$	353	16.8
Exxon	$	283	3.6
Walmart	$	283	15.4
Intel	$	271	19.8
NTT Data	$	262	19.6
Lucent	$	252	11.4
Nokia	$	197	28.2
BP	$	196	0.5
Median	**$**	**277**	**16.4**

Top 10 in 2020			
	Mkt Cap ($bn)		CFROI
Apple	$	1,617	19.4
Microsoft	$	1,599	19.9
Amazon	$	1,525	9.1
Alphabet	$	1,026	10.3
Facebook	$	685	15.5
Tencent	$	641	17.4
Alibaba	$	624	15.4
Berkshire Hathaway	$	445	4.3
Visa	$	422	45.3
Johnson & Johnson	$	376	14.2
Median	**$**	**663**	**15.5**

Many people measured the size of the "tech bubble" by the relative performance of the Nasdaq index (tech) over the S&P 500 (the diversified market). The two were in parity in 1998, but the ratio (NDX/SPX) reached an alarming 3.3x by the year 2000. See chart below. As you can see, last week we passed that previous 2000 peak, reaching 3.36x!

Relative Performance of the Nasdaq versus the S&P 500

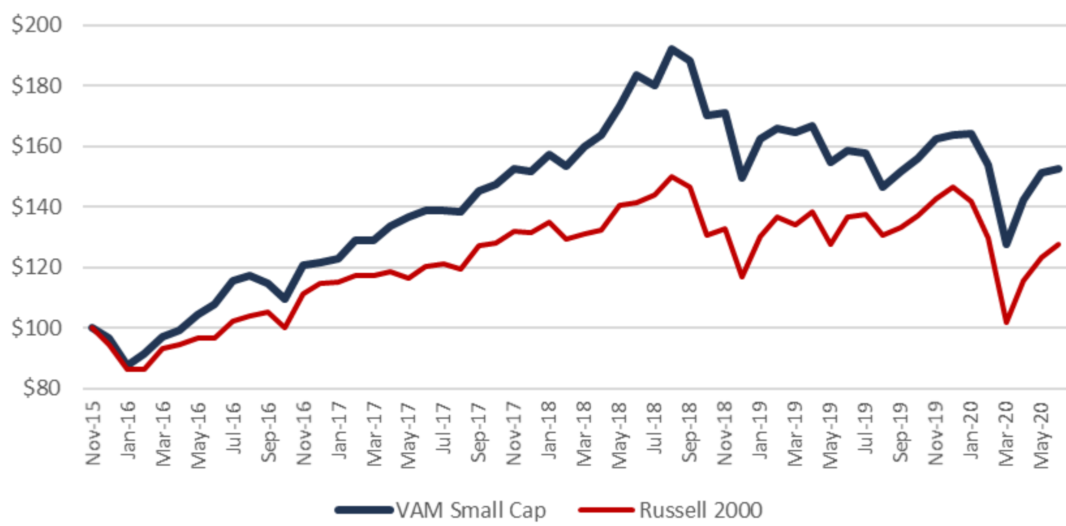
Valuation Will Someday Matter Again

We have shown this chart many times and thought it would be helpful to show an update. Buffet's favorite valuation indicator (total market cap divided by GDP) has also topped its 2000 peak. There's no way around the conclusion that the market is expensive. There are two ways this can rectify itself: (1) another market correction, or (2) a sideways stock market while the economy catches up. We are hoping for the latter.

Small Cap Review

Small caps have continued to struggle relative to large caps. The Russell 2000 was -13.0% YTD through June 30, whereas the S&P was -3.1%. Our small cap strategy continues to do well, however. We were -7.0% through June 30 (600 basis points ahead of the Russell). We are focused on quality (as always) and have taken a bit of a barbell approach, with overweights in tech and staples. We are underweight financials, as we expect rates to stay low and believe the banks will continue to struggle.

Since inception (Dec 2015), we have delivered an annualized return of 9.6% after fees, versus 5.5% for the Russell 2000, at roughly 10% lower risk (standard deviation).



	Annualized
Van Hulzen Small Cap	9.6%
Russell 2000	5.5%
Russell 2000 Growth	8.3%
Russell Microcap	4.3%

Top Holdings

Company	Business description	Weight	Size ($mm)
ePlus (PLUS)	Supply chain tech solutions	5.5%	939
BioTelemetry (BEAT)	Med tech	4.3%	1,600
Qualys (QLYS)	Cyber security	4.3%	4,116
Ciena Corp (CIEN)	Networking	4.1%	8,712
Envestnet (ENV)	Financial services	4.1%	3,962
FLIR Systems (FLIR)	Thermal imaging	4.0%	5,452
J&J Snack Foods	Snack foods	4.0%	2,366
Amer States Water (AWR)	Water utility	3.8%	2,887
AMN Healthcare (AMN)	Healthcare staffing	3.8%	2,059
Perficient (PRFT)	IT consulting	3.6%	1,173

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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