INVESTMENT COMMENTARY: SMALL CAP Q2 2021

June| 2021

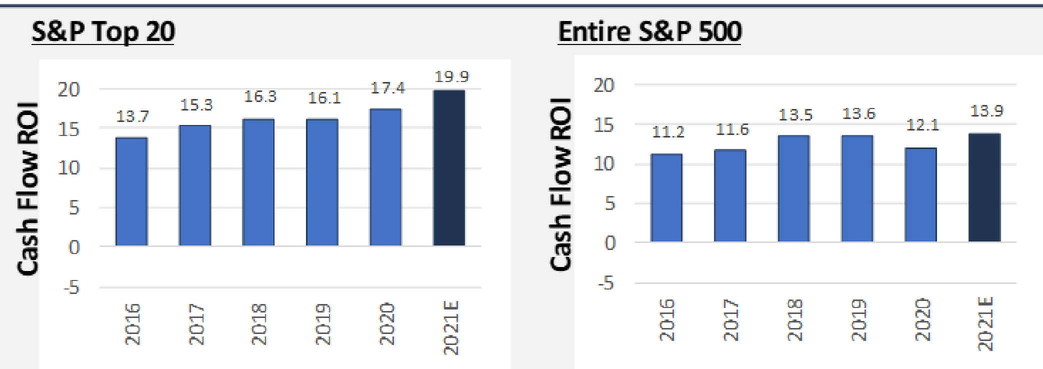
TALE OF TWO TAPES

Everyone has heard the "Main Street vs Wall Street" debate. But within the stock market itself, there is a dichotomy evolving that gets less attention. This is the theme we want to focus on in this quarter's commentary.

1. Large cap market: Quality leads the way. At any price!
2. Small cap market: Junk leads the way. Max speculation!

Large Caps

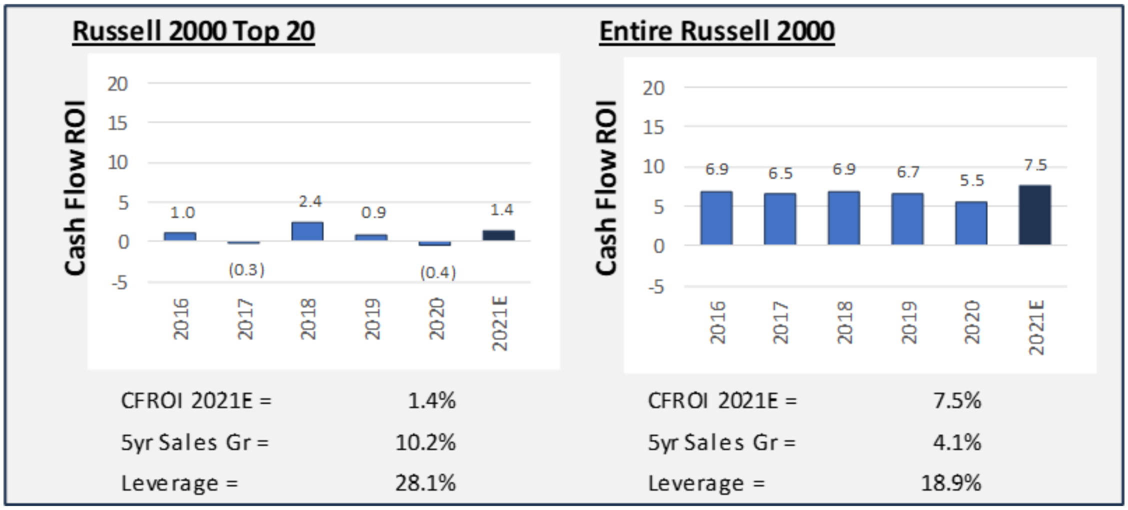
The large cap index has been dominated by the mega cap tech stocks, which are among the highest quality stocks in the entire market. These names have much **higher** Cash Flow ROIs and growth rates than the overall S&P 500. The median S&P 500 company has a projected 2021 CFROI of 13.9%, a 5-year sales growth rate of 4.1% and a debt ratio of 20.7%. In contrast, the top 20 S&P stocks have a projected CFROI of 19.9%, a 5-year growth rate of 9.2%, and a debt ratio of only 6.7%. In summary, the top 20 names in the S&P, which have the largest impact on index performance, are **much higher quality** than the rest of the index.



CFROI 2021E =	19.9%	CFROI 2021E =	13.9%
5yr Sales Gr =	9.2%	5yr Sales Gr =	4.1%
Leverage =	6.7%	Leverage =	20.7%

Small Caps

At the same time, with the exception of Restoration Hardware & Deckers (two very high-quality small caps), the Russell 2000 has been dominated by meme stocks, biotechs, and alternative energy companies, which have very **low ROIs** and **high debt ratios**. As a baseline, the median Russell 2000 company has a projected 2021 CFROI of 7.5%, a 5-year sales growth rate of 4.1% and a debt ratio of 18.9%. But the top 20 Russell stocks (the best performers) have a projected CFROI of only 1.4%, a 5-year growth rate of 10.2%, and a debt ratio of 28.1%. In fact, only 5 of the top 20 Russell names had positive earnings in 2020 (still only 7 after the sharp rebound in Q1 2021). In summary, the top 20 names in the Russell have higher potential growth but are **much lower quality** than the rest of the index. Some say the Fed has created an environment to gamble with their small cap allocations. We say you need to know what you own.

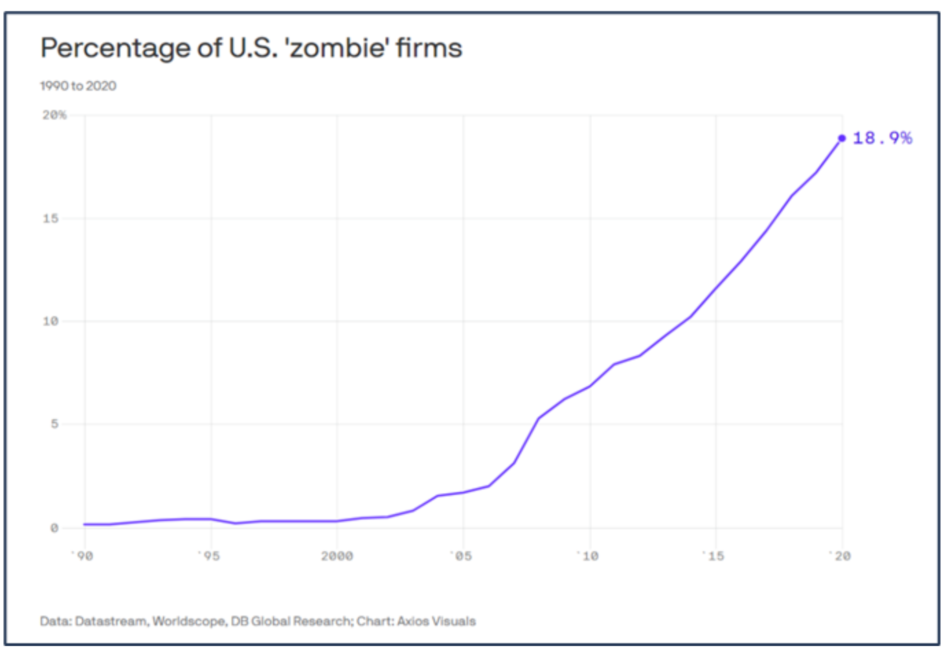


Unintended Consequences

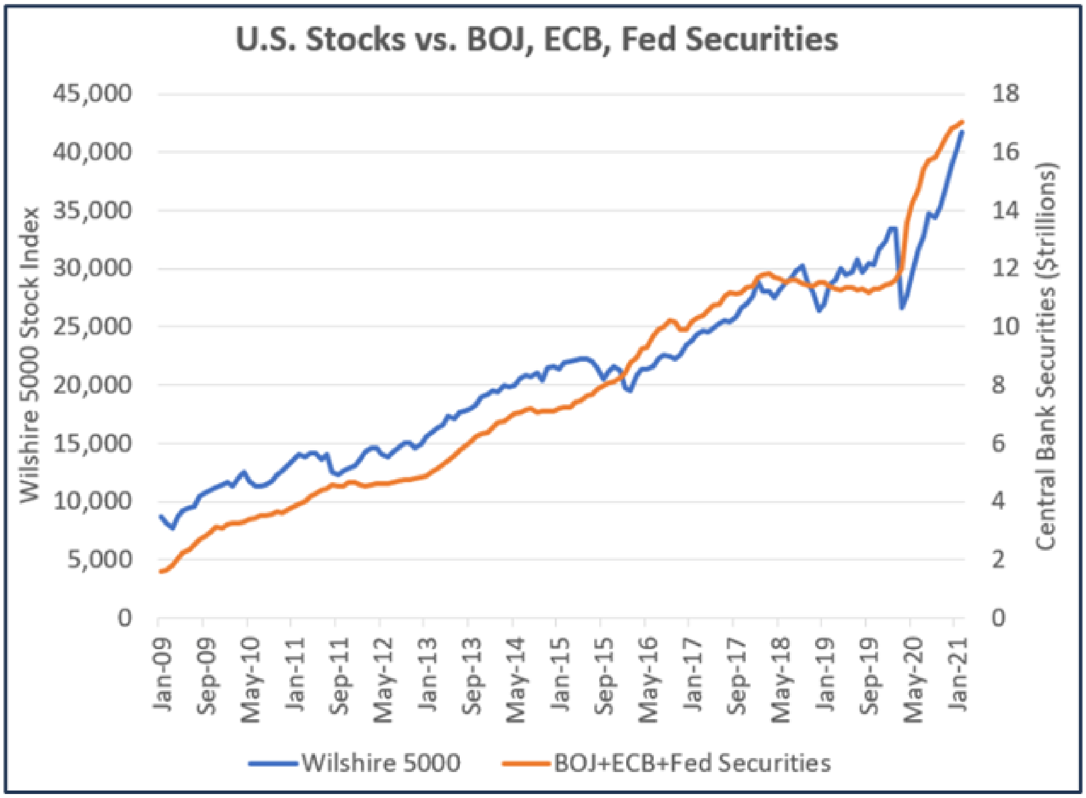
Why the disparity? For starters, the Fed has had accommodative policies in place for over 12 years now. These policies (lower rates, asset purchases) have made it easier to pay higher multiples for higher growth. And the Big Tech names are the best companies to own, as long as you can afford them. At the same time, these loose policies have allowed lower quality, debt laden companies to not only survive but to thrive. Investors have placed their bets accordingly. Quality growth in large cap land. And speculative growth in small cap land. The problem is some of these small caps are not tomorrow's emerging winners. They are "zombies."

The emergence of the "zombie company" has been one of the predominant themes of the last 10 years. Zombie companies are indebted businesses that, after covering operating costs such as wages and rent, only have enough funds to service the interest on their loans, but not the debt itself. These companies are generally dependent on refinancing their maturing debt and may face solvency risks should interest rates rise or investors withdraw from further financing.

As you can see from the chart below, the percentage of zombie companies in the US has skyrocketed from below 5% in the mid-2010s to 18.9% today. This is not healthy. And the vast majority of zombie companies are small (think Russell 2000, not S&P 500). In fact, 40% of the companies in the Russell 2000 are unprofitable. The percentage of unprofitable Russell 2000 companies is higher today than both the dot-come bubble and the pre-GFC levels of 2007.



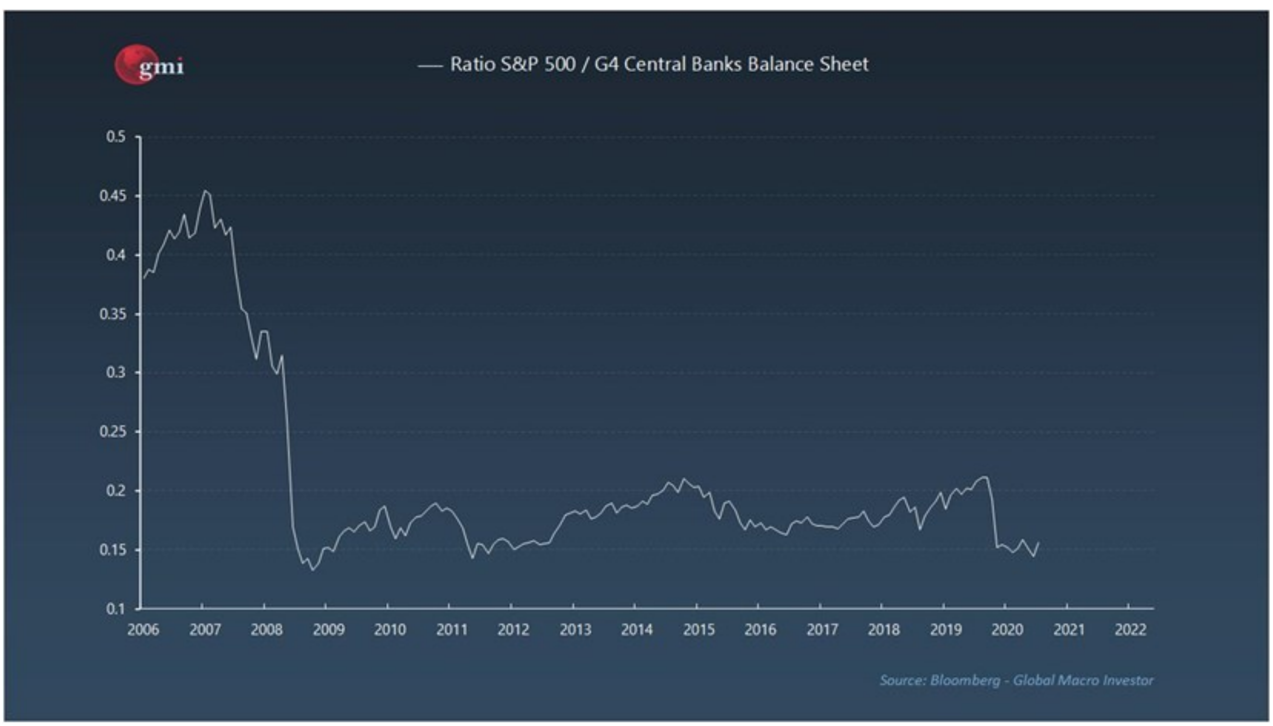
The Real "Lost Decade"



Source: www.nationalreview.com

Pundits used to refer to 2000-2020 as the lost decade, as it began with the dot-com bust and ended with the great financial crisis. Stocks basically went nowhere during this period. And the Fed has done everything in its power to show positive growth ever since. But the sad truth is the growth we have achieved has come largely through the Fed's balance sheet expansion, not through actual economic expansion. Financial assets soared, but they have just barely kept pace with the central bank's soaring balance sheet. The chart below shows this correlation.

It's even more alarming when you begin the charts before the great financial crisis. Since its 2007 peak, the S&P has actually lost a huge amount of ground versus "fiat" currencies. It's not necessarily a US dollar issue. It's a global fiat currency issue. Debt has financed most of the growth of the last decade. If you've been invested in assets, you've been fine. But it you've held cash (or worse, didn't have any cash), you've been left behind.



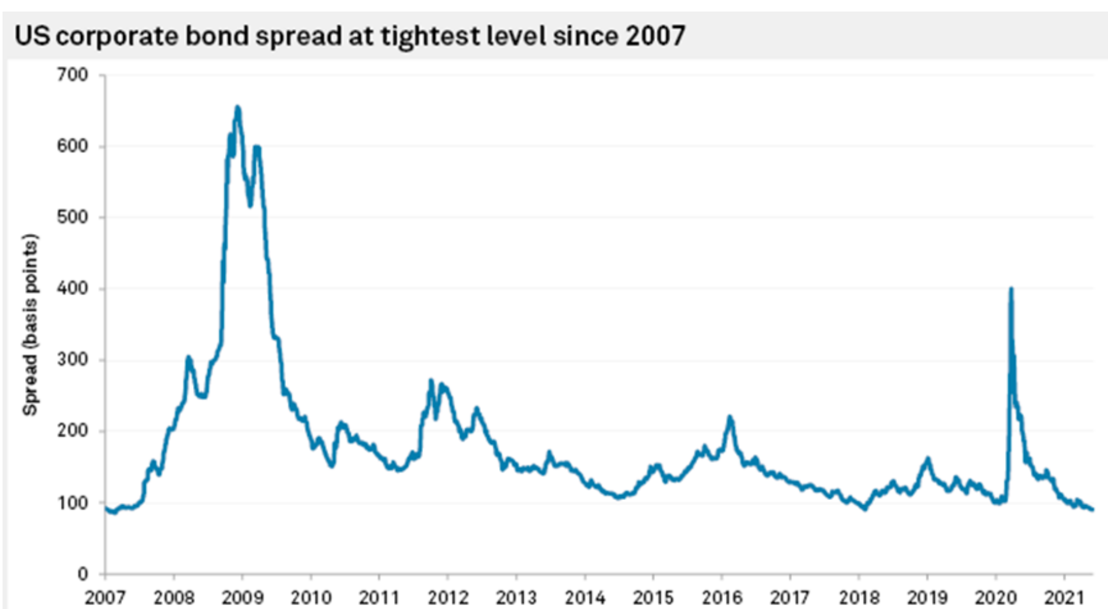
Bring on the Junk!

Perhaps the most obvious evidence of the Fed's "backstop" is in the high yield market. Back in March 2020, high yield bonds dropped a shocking 24% in less than one month. Most people thought the junk party might be over for the zombies. But the Fed moved quickly and announced that it would begin buying corporate bonds to stabilize the market. It certainly worked. The 3 year price chart of the IBOXX high yield index is below. It's been a "risk-on" market ever since, and credit spreads are back near all-time lows. And why not? No better time to go after upside than when Big Brother takes away the downside risk.

IBOXX High Yield Index *(3 years)*

Source: TD Ameritrade Thinkpipes

US Credit Spreads *(Since 2007)*



Data as of June 2, 2021.
ICE Bank of America U.S. Corporate Index Option-Adjusted Spread.
Calculated as the difference between a computed option-adjusted spread index of all bonds in a given rating category and a spot Treasury curve.
Source: Federal Reserve Bank of St. Louis

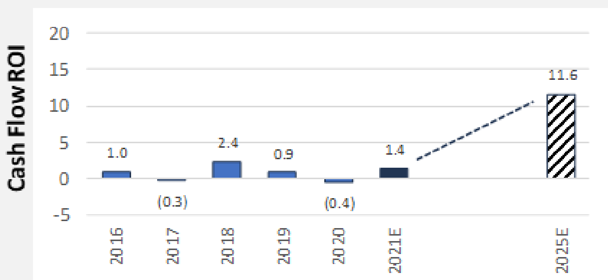
Conclusions

None of this is healthy. But some of it was unintended, the best choice among bad options. The Fed has actually done a very good job battling deflation over the past 10 years and preventing another Great Depression. But there will be no free lunch in the end. At some point, rates will have to rise. Lower quality companies will have to fail. And speculators will get hit hard.

We believe it's more important than ever to insist on quality. The Russell 2000 is the most widely used small cap benchmark, and so it is the benchmark for our core small cap strategy. But let's be clear, our strategy is the antithesis of an index fund. It is a completely different animal. We do not invest in "zombies" or "specs." We will not even invest in companies with negative earnings unless there is green on the imminent horizon. We **do** invest in strong, stable small caps with profitable businesses and competitive advantages, above-average growth rates and low financial leverage.

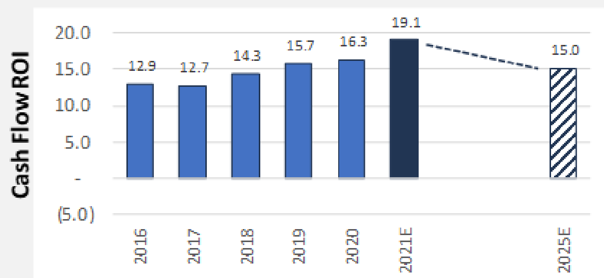
Just look at the contrasting profile of the top 20 Russell 2000 companies (left) vs our small cap portfolio (right).

Russell 2000 Top 20 Stocks



CFROI 2021E	1.4%
CFROI 2025 "priced in	11.6%
5yr Sales Gr =	10.2%
Leverage =	28.1%

Van Hulzen Small Cap

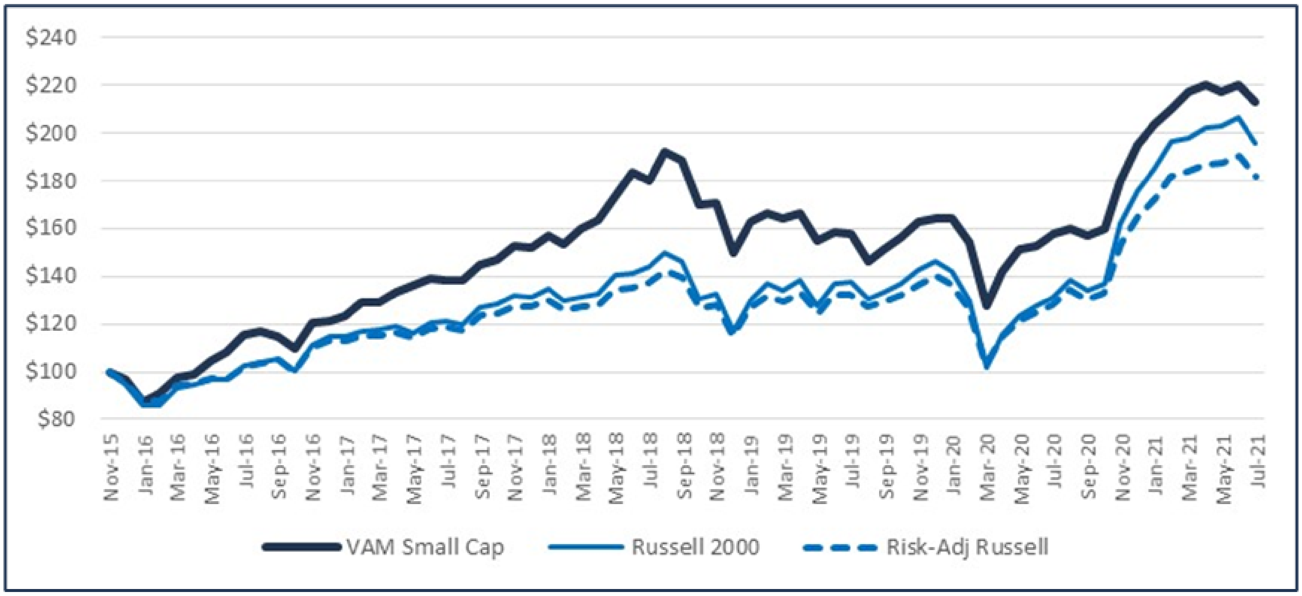


CFROI 2021E	19.1%
CFROI 2025 "priced in"	15.0%
5yr Sales Gr =	6.4%
Leverage =	8.8%

The one additional datapoint in this graphic that was not in the earlier ones is the 2025E CFROI (the striped bar). That is the "market implied" ROI, or the future ROI level that is currently "priced into" a stock based on its current valuation. As you can see, the top Russell names are "priced" to improve more than 8x from a 1.4% ROI in 2021 to an 11.6% ROI in 2025. There is no indication (or track record) that these names are capable of that level of improvement, which is why we categorize this profile as speculative. In contrast, our portfolio holdings have shown strong ROIs, well above their cost of capital, with continuous improvement over the last 5 years. But these names are currently *not* priced for that to continue. We believe they are under-valued. These names have strong competitive advantages, stable/improving margins, and are projected to grow at ~7-8% per year, on average. In our view, this disconnect between what's priced in and what's achievable (even *likely*) represents the opportunity.

Some prospects look at our growth profile and immediately label us a growth strategy. But the valuation disconnect described above lends itself to a value categorization. The reality is we are both. We call it "Growth at a Reasonable Profile," which means we want growth, but only profitable growth. For us, it's all about quality. Most institutions put this type of hybrid in the Core category.

There are of course periods where the junk will win. The Fed has made sure of that. But we believe quality will always win in the end. Our track record has built up slowly and quietly. It now sits at 5½ years. Our performance was GIPS-verified in 2018. Since our inception in 2015, we have out-performed the Russell 2000 by an average of 1.7% per year, at 13% *lower risk* (as measured by standard deviation). This translates to an **annualized alpha of 3.3%** versus the Russell.



Data range: Dec 1, 2015 – July 15, 2021

For those of you who know our history, we began managing an institutional large cap covered call strategy in the early 2000s. After building a track record with internal clients, we took that strategy to market in 2011. Ten years later, we have $650 million of covered call assets under management. That strategy has performed well and continues to grow. It is perfect for income-oriented investors who want equity exposure without all the risk.

But we also believe there is a large market for high quality small caps that will continue standing (and growing) well after the Fed's support goes away. We have approximately $50 million invested in this strategy today. And we believe now is the time to take this strategy to market. You are invited to join us.

Top Ten Holdings

Our median market cap is approx. $3.1 billion. As of June 2021, the top 10 holdings are as follows:

Company	Business description	Weight	Size ($mm)
Axos Financial (AX)	Internet banking	4.9%	2,700
First Cash (FCFS)	Pawn shops	4.8%	3,100
Lumentum (LITE)	Optical equipment	4.4%	6,300
CSW Industrials (CSWI)	Building products	4.1%	1,900
LHC Group (LHCG)	Home health services	4.1%	6,500
Mercury Systems (MRCY)	Aerospace technology	3.9%	3,600
JAZZ Pharma (JAZZ)	Pharmaceuticals	3.8%	10,400
AZEK Company (AZEK)	Recycled building materials	3.8%	6,100
Gibraltar Industries (ROCK)	Solar racking	3.8%	2,500
Qualys (QLYS)	Cyber Security	3.7%	4,200

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.

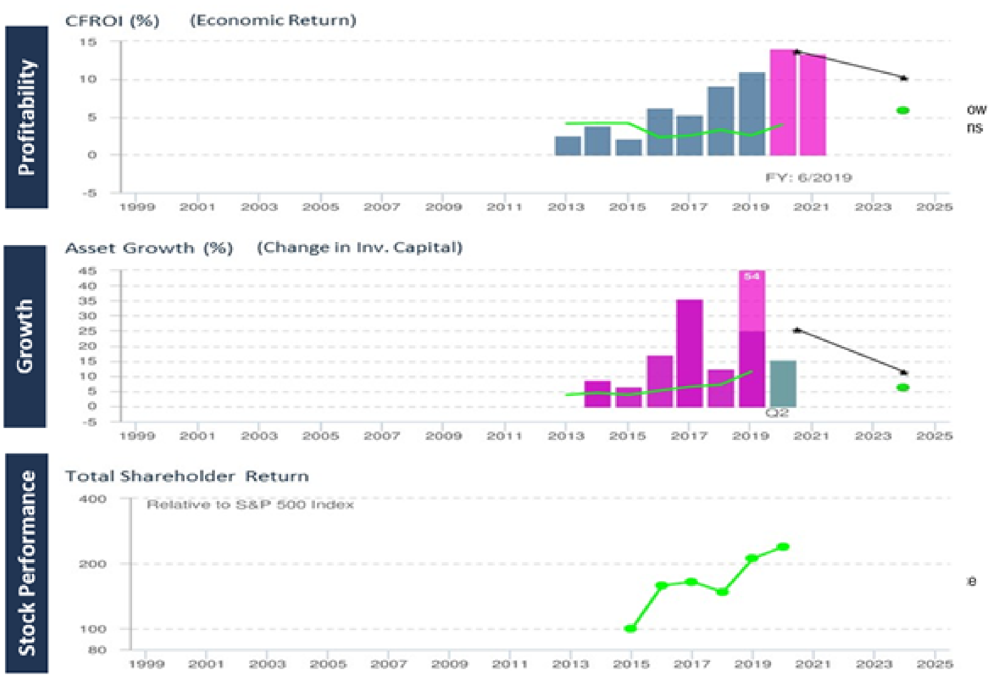
Portfolio Construction

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 $5 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 core portfolio holdings (LITE) to demonstrate our investment approach. Lumentum (LITE) manufactures optical and photonic products for the communications sector, enabling the transmission of video, audio & text data over high capacity fiber optic cable. It is a market leader and a very profitable business that has historically grown the top line 10-12% per year, while also expanding its margins. The company has impressive momentum in its Cash Flow ROIs and a great track record of positive earnings revisions.



Source: Credit Suisse HOLT

Key Points

- Market cap: $5.9 billion
- ROI improved from less than 2% to 14% over past 5yrs
- ROIs above the cost of capital
- Analysts expect 10-12% sales growth & improving ROIs
- Has beaten estimates 5 of the last 6 quarters (by an average of 12%)
- Rated BUY by 9 analysts

- Current stock price reflects low expectations (low green dot in top panel)

- Shares have out-performed nearly 3-to-1 over 5 years
- We believe the shares are still undervalued

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