INVESTMENT COMMENTARY: SMALL CAP Q4 2021

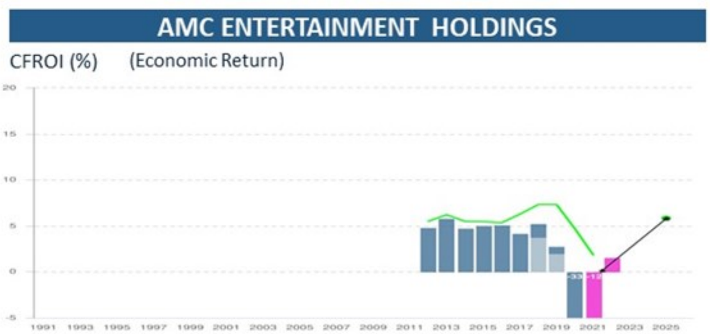
DECEMBER| 2021

2022: THE YEAR QUALITY MATTERED AGAIN?

As of this writing, two of the largest and most popular small cap names of 2021 (AMC and Gamestop) are -31% and -27% year to date (2022). That's after 2021 performance of 1,300% and 780%, respectively. Gamestop did so well in the first half of 2021 that it actually joined the Russell 1000, meaning it's -50% performance since then hasn't even hurt the Russell 2000 index.

Let's look a little deeper. AMC has a Cash Flow ROI of -12% and a default probability of 27%. Gamestop has a -1% Cash Flow ROI and an 8% default probability. This is how crazy the small cap world has become. It's not a question of Wall Street versus Main Street. This is Las Vegas Boulevard!

Here are the Cash Flow ROIs for each of these two Russell behemoths:



Source: Credit Suisse HOLT (TM)

OUR TOP TWO NAMES

For comparison, here are our top two holdings. Both have Cash Flow ROIs twice their cost of capital, both have beaten earnings estimates every quarter for two years, and both have 0% default risk. This is not a cherry-picking exercise. We own 30 names that look like this. Strong ROIs, above average sales growth, low debt, and zero default risk.

Source: Credit Suisse HOLT (TM)

Q4 REVIEW

Small caps had a positive fourth quarter in 2021 (the Russell 2000 was +2.1%) but got creamed by large caps (+9.8% for the Russell 1000 and +10.9% for the S&P 500). After a slow start to 2021, our strategy out-performed handily in Q3 & Q4 as inflation fears rose and the quality shift began to emerge. For the full year, we turned in a +16.0% return, versus +14.8% for the Russell 2000. The Russell Growth index delivered an anemic +2.8% return. We have been "accused" of being a growth strategy in the past, but we think you'll agree that the proof is in the pudding. We consider ourselves a high quality, "core" strategy. Yes, the sales growth rates of our stocks are above average, but our valuation multiples are in-line with the index (particularly on a PEG basis). And we do not speculate, which seems to be a key feature of growth strategies these days.

PERFORMANCE

Our portfolio turned in a +6.2% gain (net) for Q4, compared to +2.1% for the Russell 2000. We believe the quality of our portfolio drove this out-performance. Individual highlights are as follows. Once again, we saw broad representation amongst the top winners and losers this quarter. We trimmed our top performer (ROG) but otherwise took no significant actions, as we believe our portfolio is generally undervalued and due for a catch-up.

TOP 5 PERFORMERS

		Return	Description	Actions/Notes
ROG	Rogers	**44.8%**	Engineered materials	*Trimmed in Q4*
LITE	Lumentum	**26.6%**	Optical components	
AZEK	AZEK Company	**26.5%**	Recycled building materials	*Added in Q3*
QLYS	Qualys	**23.3%**	Cyber security	
AWR	American States Water	**21.4%**	Water utility	

BOTTOM 5 PERFORMERS

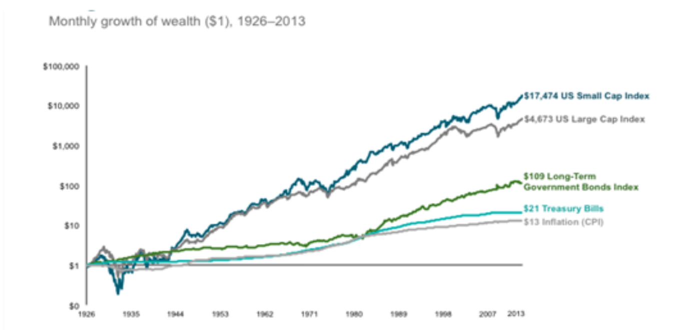
		Return	Description	Actions
TLRY	Tilray	-37.7%	Cannabis	*Predecessor company was best performer for full year 2021*
FCFS	First Cash	-14.1%	Pawn shops	
LHCG	LHC Group	-12.5%	Home health care	
FIZZ	National Beverage	-8.0%	Soft drinks	
CSWI	CSW Industrials	-5.3%	Fire & smoke detection	

Past performance may not be indicative of future results. Please see the end of this article for additional information.

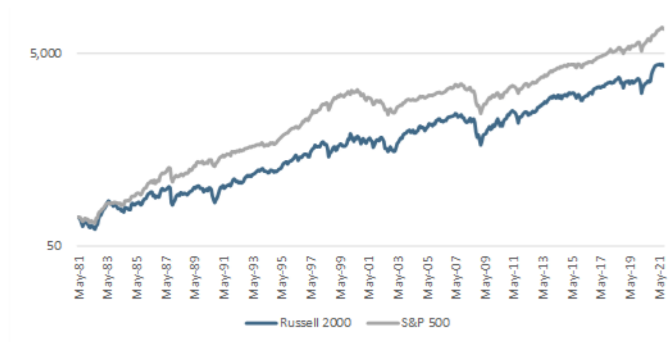
2022 OUTLOOK

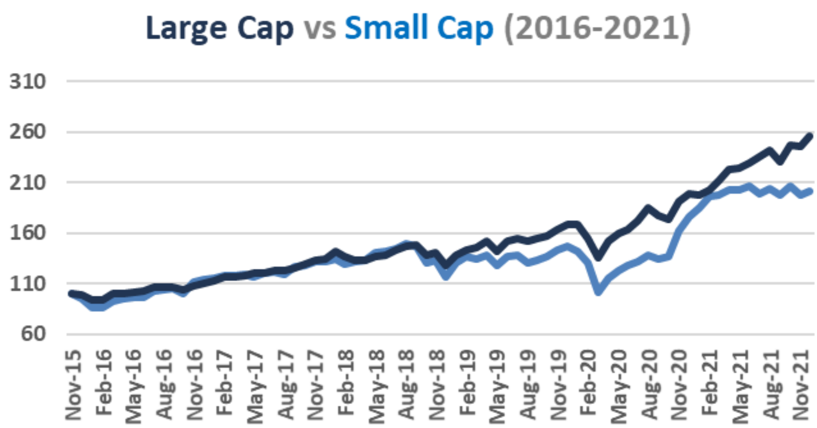
The one true certainty is that nobody knows what we're in store for in the upcoming year. Anyone pretending they do should be ignored. Coming into 2022, we were sitting at record high market valuations, but Fed policy has been instrumental in driving that and continues to be a wild card. Small caps have out-performed large caps over the very long term, but large caps have out-performed roughly 2-to-1 for the last 40 years and absolutely crushed small caps over the past 6 months. Our approach is to position ourselves to have the best possible outcome in any market environment.

Small Caps Have Out-Performed Since 1926



Large Caps Have Out-performed Since 1982

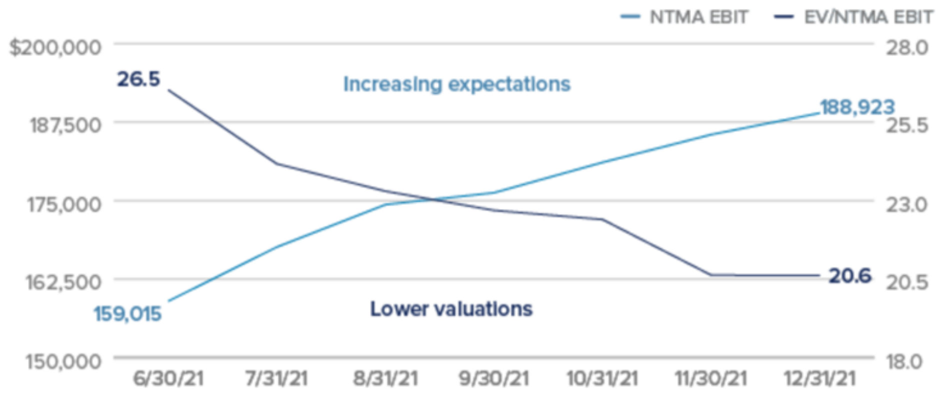




One theme we do feel strongly about is **quality**. We believe speculative stocks have had their run and are particularly vulnerable, as they were after the blow off top of 1999-2000. This could affect the small cap index in particular because leverage is widespread and the Fed has not let the zombie (most vulnerable) companies fail. But if rates continue to rise, the most levered companies may indeed begin to fail. We should be able to side-step this completely, as we have much lower leverage than the overall index and have a keen focus on minimizing default probabilities.

Aside from the leverage issue, the overall breadth of the market is improving. The equal weighted indices (both small cap and large cap) are beginning to out-perform the cap weighted indices, which have long been driven by Big Tech (in large cap land) and the AMCs and GMEs of the world (in small cap land). This is a positive thing. And small cap fundamentals are generally improving, despite the under-performance of the category (see below).

Improving Small-Cap Fundamentals, Declining Valuations
NTMA EBIT versus EV/NTMA EBIT for the Russell 2000 from 6/30/21-12/31/21



NTMA EBIT: Next 12-Month Analyst Forecasted Earnings Before Interest and Taxes
EV/NTMA EBIT: Enterprise Value Over Next 12 Months Analyst Forecasted Earnings Before Interest and Taxes.
Source: FactSet

INLFATION

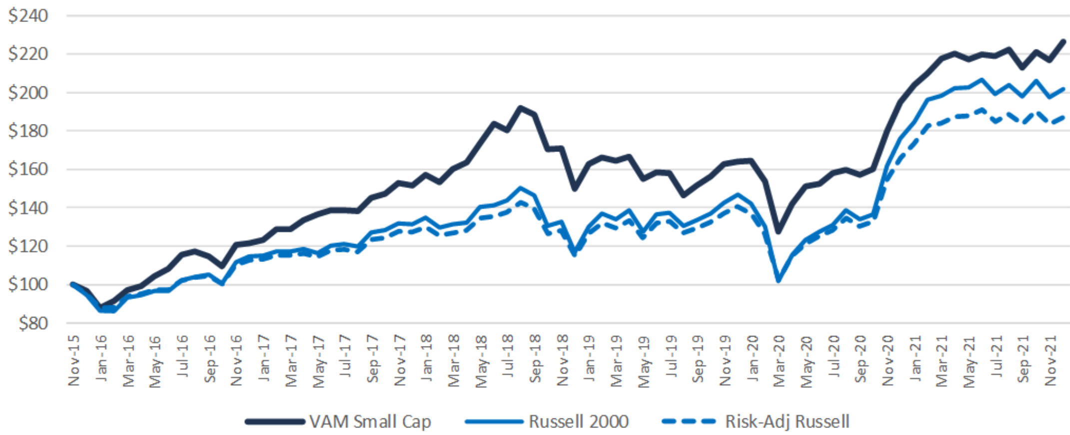
And then there is inflation. According to research from Royce & Associates, small caps are the only major asset class that's beaten inflation in every decade since the 1930s. Large-cap stocks, bonds, and cash all have had less success than small-caps during inflationary periods. Royce believes this is largely due to their size, as smaller companies can adapt more quickly than large companies. We believe this is especially true with high-quality small caps, such as the names we own.

While there are certainly short term obstacles, we believe long term prospects look strong. Over the long term, we expect small-caps to reassert leadership over large-caps, based on their record of out-performance during periods of above-average economic growth, their lower relative valuation, and their broader market participation.

However, since its inception in 1979, the Russell 2000 has never had four consecutive years of positive double-digit returns. Will it be able to break the trend? We believe the chances are better for small caps than large caps this year, but only time will tell.

FULL TRACK RECORD

Our strategy crossed the 6 year mark last month, and it's been a good six years. We outperformed the Russell 2000 in 4 of those 6 years, and on a cumulative basis we are well ahead of our benchmarks, at lower risk. Our annualized return since inception is **14.4%**, versus 12.2% for the Russell 2000. The risk-adjusted Russell 2000 (which assumes the Russell has the same standard deviation as our strategy) has an annualized return of just 10.8% over this period.



	Annualized	Std Dev
Van Hulzen Small Cap	14.4%	17.6%
Russell 2000	12.2%	20.2%
Russell 2000 Growth	12.6%	20.3%

Note: Performance is net of fees. Inception date: November 30, 2015.

ALPHA

Perhaps the best measure of a strategy's performance is it's alpha, as this metric incorporates not only the nominal return but also the risk profile. For our full track record, we have delivered an annualized alpha of **+4.5%**.

Alpha

$a = Rp - [Rf + (Rm - Rf)\, ß]$

Rp = Realized return of portfolio	14.4%
Rm = Market return	12.2%
Rf = risk-free rate	0.1%
ß = Beta	0.80
Alpha (relative to BXM)	**4.5%**

TOP TEN HOLDINGS

Our median market cap is approx. $3.5 billion. As of December 31, 2021, the top 10 holdings are as follows:

Company	Business description	Weight	Size ($mm)
Axos Financial (AX)	Internet banking	6.0%	3,400
Lumentum (LITE)	Optical equipment	5.7%	7,600
Qualys (QLYS)	Cyber Security	4.9%	5,300
The AZEK Company (AZEK)	Recycled building materials	4.6%	7,000
Pacira Pharma (PCRX)	Non-opiod pain meds	4.5%	2,700
CSW Industrials (CSWI)	Building products	4.2%	1,900
Addus Homecare (ADUS)	Hospice & personal home care	4.0%	1,500
Marten Transport (MRTN)	Temperature controlled trucking	3.9%	1,400
Focus Financial (FOCS)	Investment management	3.6%	3,900
American Water (AWR)	Water utility	3.6%	3,700

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.

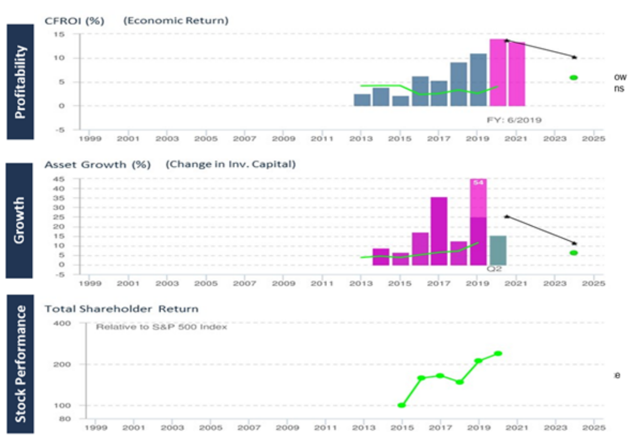
Portfolio Construction

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 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 is growing 10-12% per year. 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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