INVESTMENT COMMENTARY: SMALL CAP Q1 2022

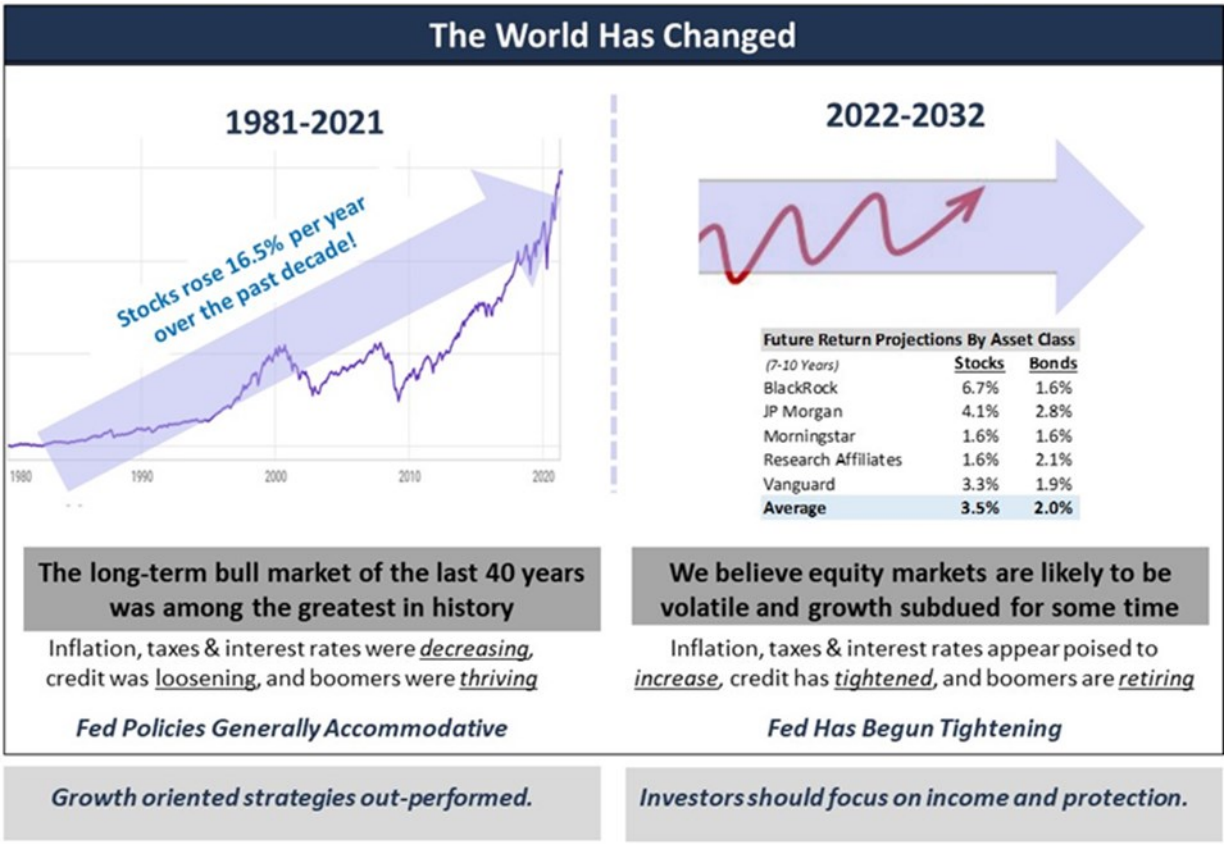
MARCH| 2022

THE WORLD HAS CHANGED

Inflation is on everyone's mind, and its effects certainly ripped through the financial markets in Q1. As of this writing, nearly every market is down. On the stock side, the S&P 500 is -8.1%, the Nasdaq is -15.1%, and the Russell 2000 small cap index is -11.5%. Bonds are actually down more than the S&P (-9.1% for the aggregate bond index), no longer the stable source of income that investors need. Have we seen the death of the 60/40 portfolio?

We believe we are at a pivotal moment in economic history, and inflation is not the only headwind we are facing. The graphic below illustrates how the strength of the markets over the last 40 years was driven by a number of factors. Throughout this time period, inflation, taxes and interest rates were all decreasing, debt exploded as credit loosened, and demographics were very favorable (as the baby boomers were in their most productive years). Fed policies were also incredibly accommodative over this time period. It's no wonder that growth stocks have vastly out-performed value stocks of late. This was particularly true over the last five years, as the Fed's accommodative policies became the single largest tailwind to the markets.

Before we dive into the ugly details, we do want to point out that there are reasons for optimism, particularly for small cap investors. The second half of the commentary speaks to this.



Source of return projections: Morningstar, Jan 2022

Emerging headwinds

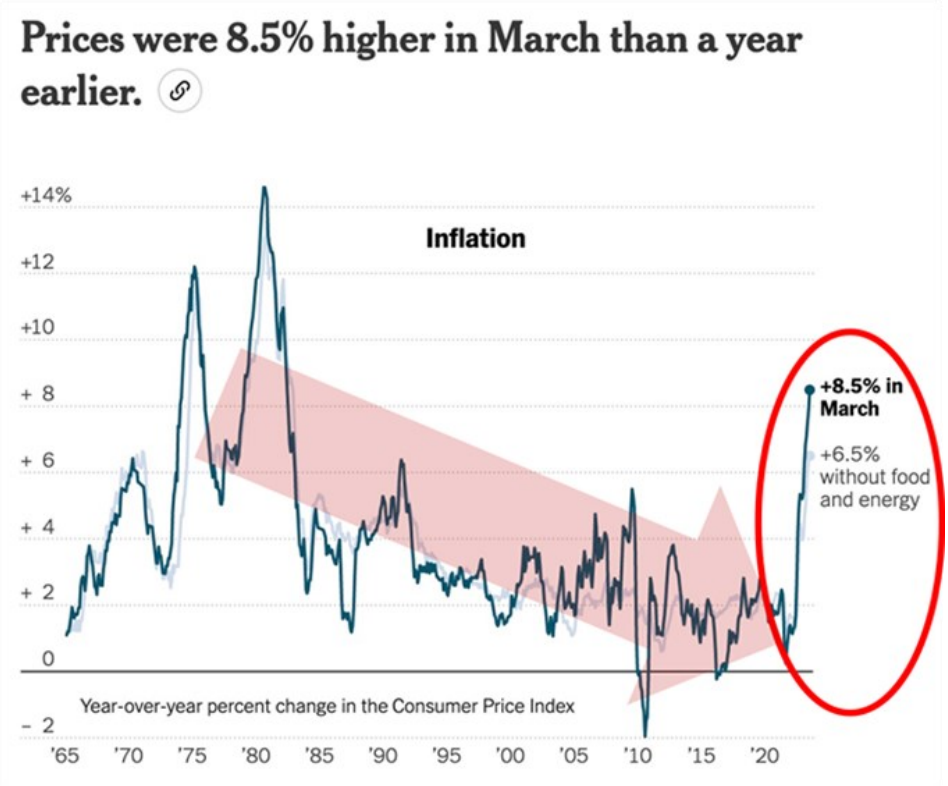
The tailwinds that drove the bull market in stocks (and bonds) over the past 40 years have gradually been shifting to headwinds. We want to explore these themes more closely, and we will address each of the categories mentioned above:

1. Inflation
2. Interest rates
3. Taxes
4. Credit (Debt)
5. Demographics
6. Fed policy

And then we will discuss **where small caps fit into all this** and how you can not only survive but thrive in the coming environment of economic headwinds.

1. Inflation

We have not seen meaningful inflation since the early 1980s. Disinflationary environments are typically seen as "risk-on" periods, as long duration assets (like high growth tech stocks) are seen as more valuable. This trend has clearly changed in 2022.

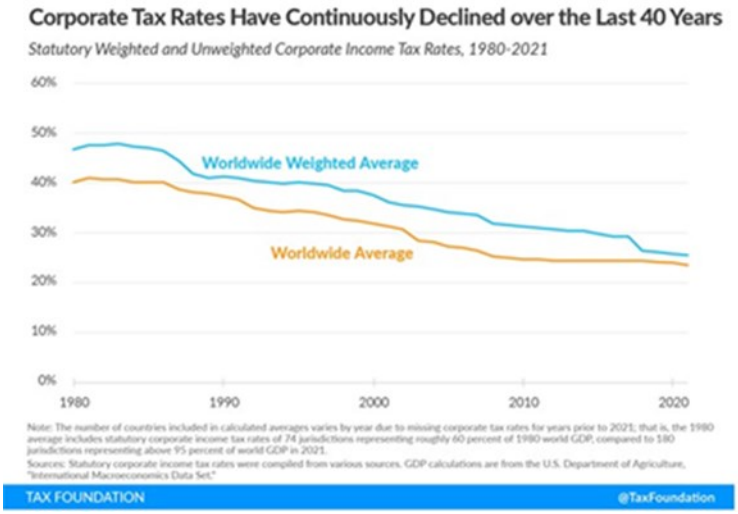


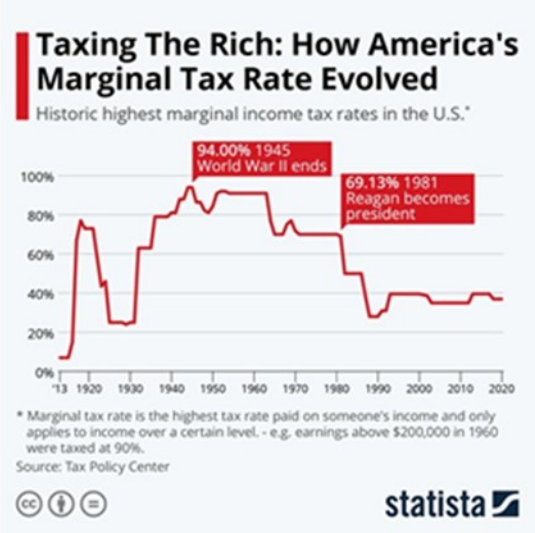
2. Interest rates

Rates typically trend with inflation, as rate hikes are one of the primary tools used to fight inflation. Rates have been at historic lows for much of the past 10 years, as the Fed was too busy fighting deflation to worry about inflation. But the 10year Treasury has doubled in the past 6 months, and the Fed seems committed to hiking rates into the foreseeable future. This will be challenging for stocks and terrible for bonds.

3. Taxes

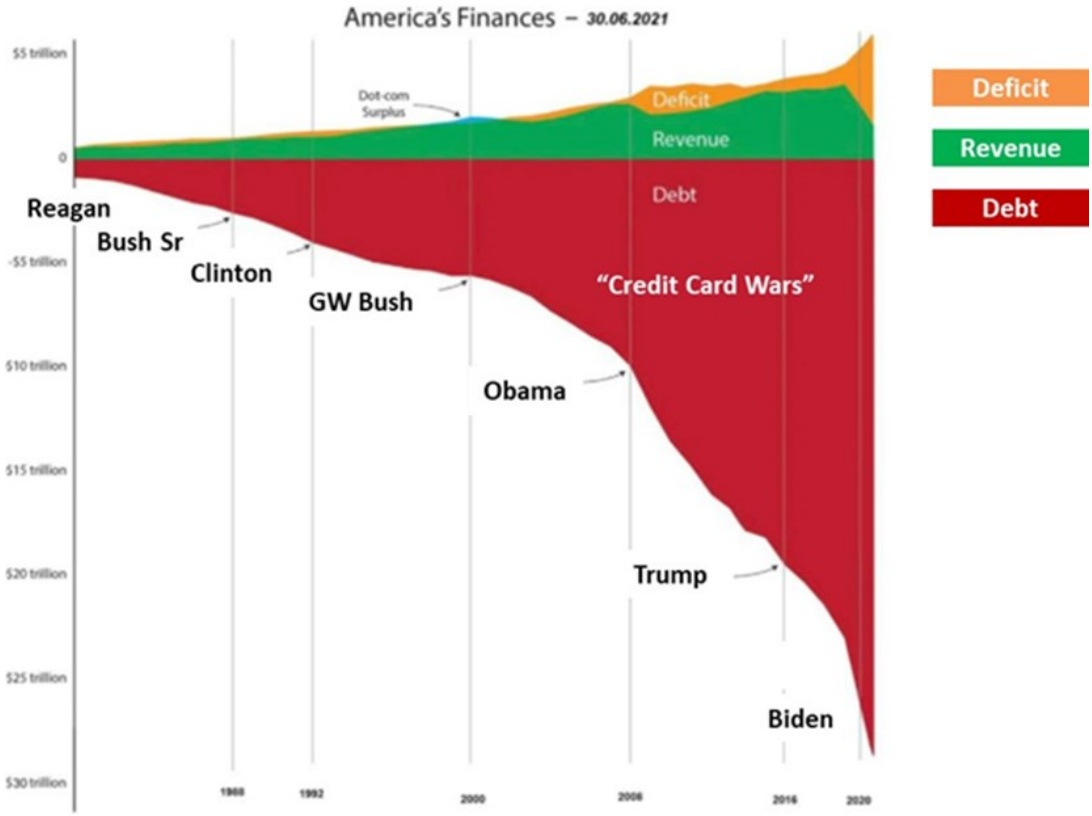
Taxes are a contentious political topic. But the reality is tax rates have declined steadily over the past 40 years. The US corporate tax rate has declined by about 40% since 1980. It's hard to imagine this will remain the case as federal deficits soar and Congress looks for a way out.





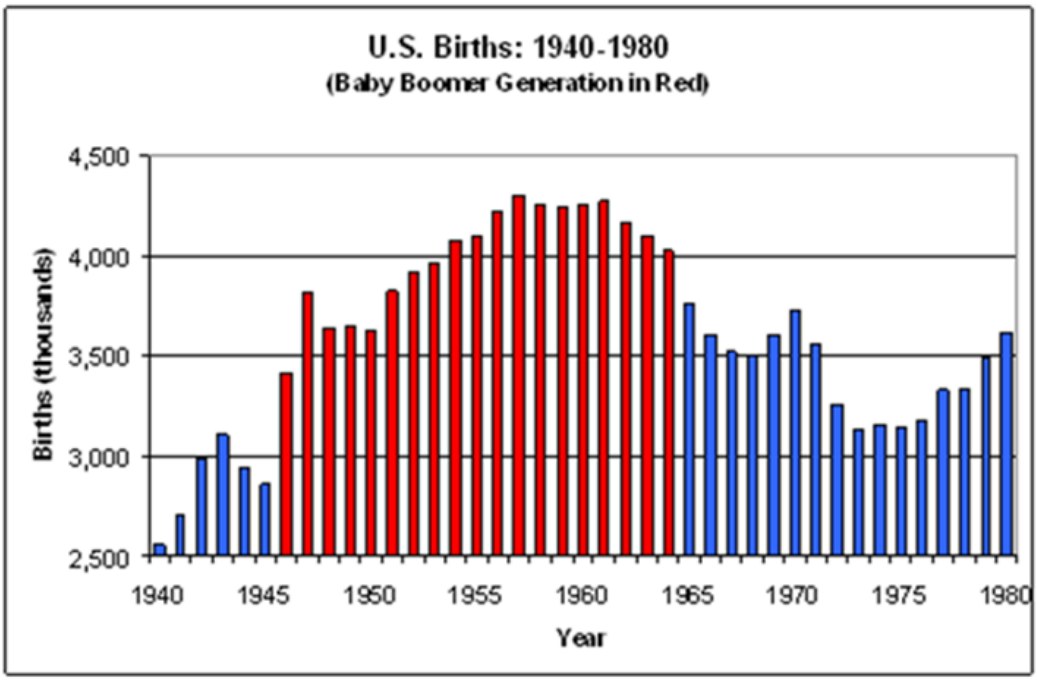
4. Credit (Debt)

This one will surprise nobody. The federal debt as a % of GDP is projected to rise next year to the largest amount ever recorded, including the WWII period. What does surprise some is that this is a bipartisan issue. The only time in the past 40 years we had a (tiny and brief) surplus was 23 years ago, at the peak of the tech bubble. All of the wars since Vietnam have effectively been "credit card wars. Quantitative tightening and inflation are two of the only ways to chisel away at this debt load, and both are bad for economic growth.



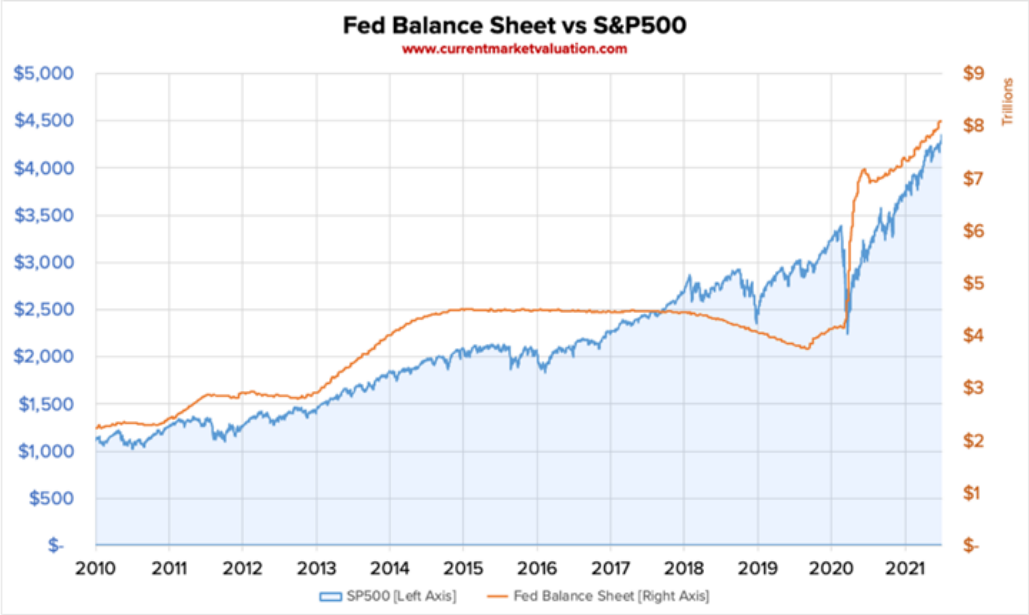
5. Demographics

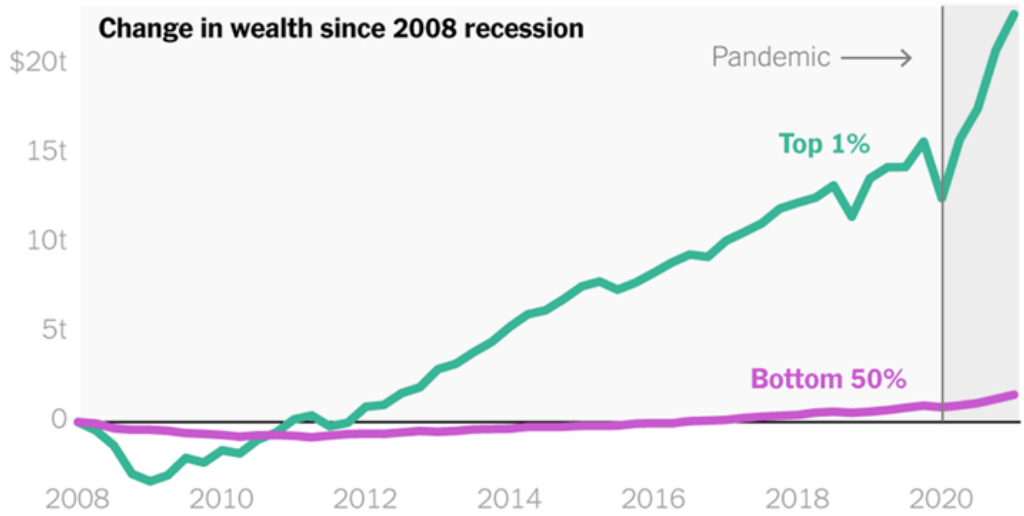
The largest wave of births in US history occurred between 1946-1964, during the post-World War II "baby boom." These people were at their most productive over the past 30-40 years but began retiring about 10 years ago, so you might say we're about halfway through this trend. But the mass retirement of the boomer generation accelerated even faster over the past two years because of Covid. The net effect of this will be a slowdown in growth, as this generation spends less money on houses, cars and vacations and more on prescription meds, shifting from net contributors to social security & Medicare to net users of those services.



6. Fed Policy

If you're wondering if the Fed's policies have really propped up the markets, have a look at the correlation between the Fed's balance sheet and the stock market. Much of the money printed over the past decade has gone directly into the markets. This has fueled the widening divide between the top 1% of Americans and the bottom 50%.



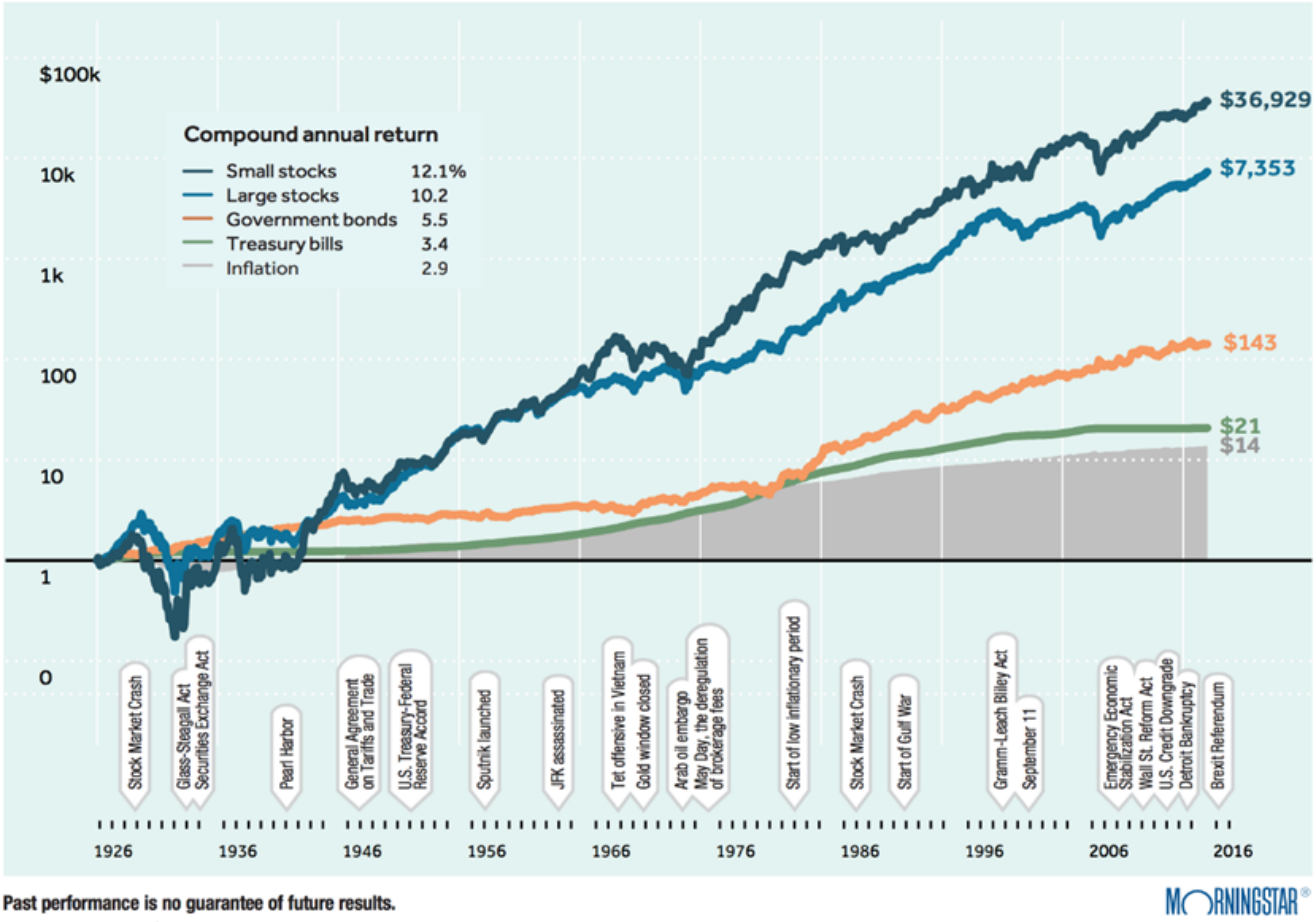


Bringing it all together

All of the powerful forces we have outlined are turning into headwinds. Inflation has burst onto the scene over the past year. Interest rates are rising. Tax rates may be safe if the Republicans take control of Congress (as expected), but for how long? Boomers are retiring and becoming a net negative for economic growth. The debt is completely out of control, and the Fed appears to be tightening into an economic slowdown. As Crash Davis famously said to his coach mid-game during a team meeting on the mound, "We're dealing with a lot of sh*t."

Where do small caps fit in?

As appealing as it may be to just go to cash, you have to stay invested if you want to keep up with inflation. Stocks are the highest returning asset class and should not be abandoned. And small caps have historically out-performed large caps over the long term, by approximately 2% per year (see below).



Past performance is no guarantee of future results.

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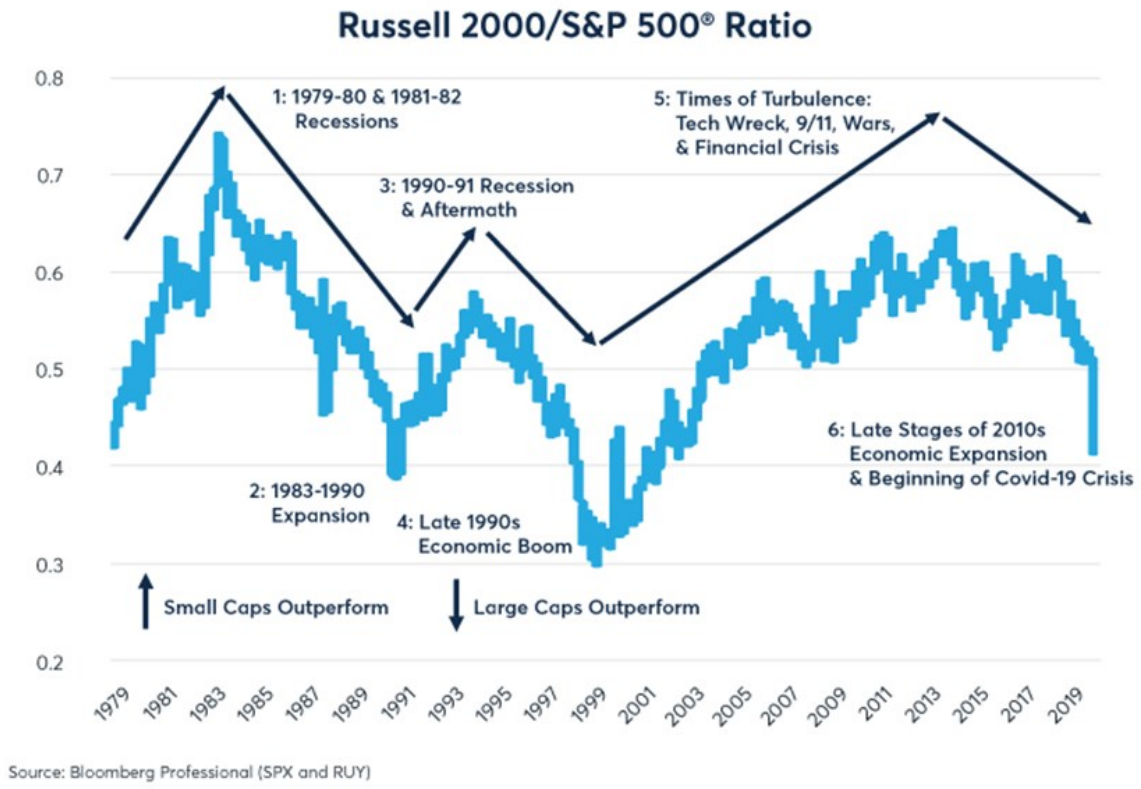
But the fact is, small caps have lagged large caps by an average of 3.3% per year over the past decade. The S&P has delivered an incredible 16.5% over the past 10 years (!!), compared to 13.2% for the Russell 2000. There were of course reasons for this. We saw peak globalization during the last decade, which benefits large international companies more than smaller domestic ones, and over the past 5 years we've seen a flight to Big Tech. The combined Tech/Comm Services sectors represent just 17.4% of the Russell 2000, versus 33.4% for the S&P 500. If 2022's technology weakness continues, small caps stand to fare well in comparison.

And we do have some relevant reference points from the past. During the blow-off top of the late 1990s tech bubble (1996-1999), large caps out-performed small caps by a whopping 14.5% per year (S&P 27.6% vs RUT 13.1%). But over the next 4 years (1999-2003), small caps outperformed by an average of 9.2% per year (RUT +3.9% vs S&P -5.3%).

And while large caps have typically done better than small caps during periods of economic expansion, small caps have done better during periods of economic distress. See below.



And of course, there's our favorite point….

Not all small caps are the same! Much of the Russell 2000 is overleveraged and unprofitable, not exactly well positioned for an economic downturn. Our approach puts quality first, focusing on high and sustainable ROIs, above average sales growth, low debt and little/no credit risk. We believe in profitable growth, not growth at any cost. And our approach has paid off. Since the inception of this strategy in December 2015, we have outperformed the Russell 2000 by 2.7% per year, at 13% less risk. This has resulted in an annualized Alpha of 4.7%.

Alpha	
a = Rp – [Rf + (Rm – Rf) ß]	
Rp = Realized return of portfolio	12.9%
Rm = Market return	10.2%
Rf = risk-free rate	0.1%
ß = Beta	0.80
Alpha (relative to RUT)	**4.7%**

Q1 REVIEW

Small caps, like all equity markets, had a terrible start to the year in Q1, and the losses have continued into Q2. For the first three months, the Russell 2000 was -7.5% and the Russell 2000 Growth index was -12.6%. **Our strategy compared very favorably at -3.6%.** Our focus on quality growth and low relative beta has continued to pay off, as it has for the full 6yr track record.

As we mentioned in the Q4 commentary, 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.

TOP 5 PERFORMERS

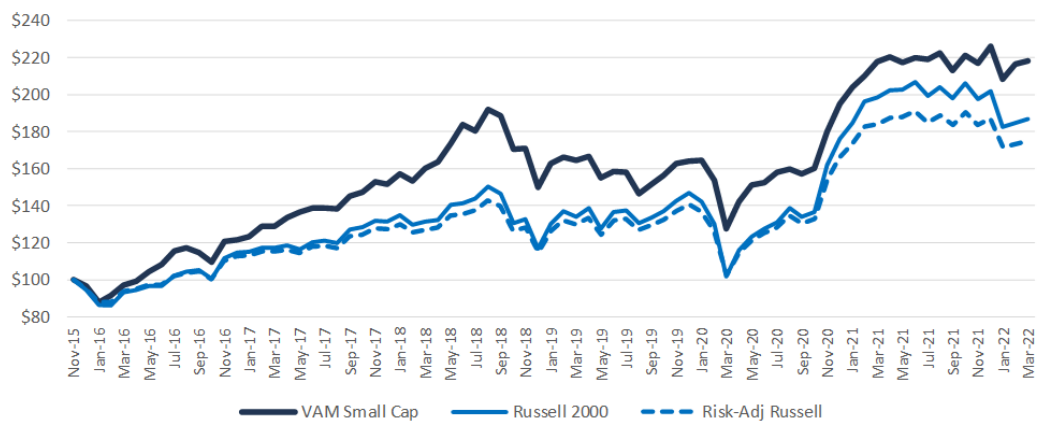
		Return	Description	Actions/Notes
LHCG	LHC Group	36.3%	Home health care	
ENPH	Enphase Energy	33.6%	Solar technology	*New position in Q1*
STLD	Steel Dynamics	31.7%	Steel producer	
PCRX	Pacira Pharma	25.1%	Non-opiod pain medications	
MANT	Mantech	19.7%	Tech solutions for US DoD	

BOTTOM 5 PERFORMERS

		Return	Description	Actions/Notes
AZEK	AZEK Company	-41.6%	Recycled building materials	*Best performer for Q4*
ROCK	Gibraltar Industries	-32.3%	Building products for solar	
ETSY	Etsy	-27.7%	Internet retail	*Added to position*
AX	Axos Financial	-22.9%	Internet banking	
PNR	Pentair	-21.4%	Flow technologies	

PERFORMANCE

Once again, we saw broad representation amongst the top winners and losers this quarter. We added ENPH to the portfolio after its large sell-off and also added to our existing ETSY position (also after the sell-off). We did not sell out of any of our holdings during Q1, as we believe our portfolio is generally undervalued and well positioned.



	Annualized	Std Dev
Van Hulzen Small Cap	12.9%	17.5%
Russell 2000	10.2%	20.1%
Russell 2000 Growth	9.5%	20.7%

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

FULL TRACK RECORD

Our strategy crossed the 6yr mark last quarter, 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 **12.9%**, versus 10.2% for the Russell 2000. The Russell growth index has delivered a 9.5% return with a much higher standard deviation. And the risk-adjusted Russell 2000 (which assumes the Russell 2000 has the same standard deviation as our strategy) has an annualized return of just 9.1% over this period.

TOP TEN HOLDINGS

Our median market cap is approx. $4.5 billion. As of March 31, 2022, the top 10 holdings are as follows:

Company	Business description	Weight	Size ($mm)
Pacira Pharma (PCRX)	Non-opiod pain meds	6.0%	3,500
Lumentum (LITE)	Optical equipment	5.6%	6,900
Qualys (QLYS)	Cyber Security	5.6%	5,500
Axos Financial (AX)	Internet banking	5.3%	2,700
CSW Industrials (CSWI)	Building products	4.4%	1,800
Enphase (ENPH)	Solar semiconductors	4.3%	27,600
Marten Transport (MRTN)	Temperature controlled trucking	4.3%	1,400
Addus Homecare (ADUS)	Hospice & personal home care	4.1%	1,400
Etsy (ETSY)	Internet retail	3.8%	16,100
Jazz Pharma (JAZZ)	Pharmaceuticals	3.8%	9,800

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.

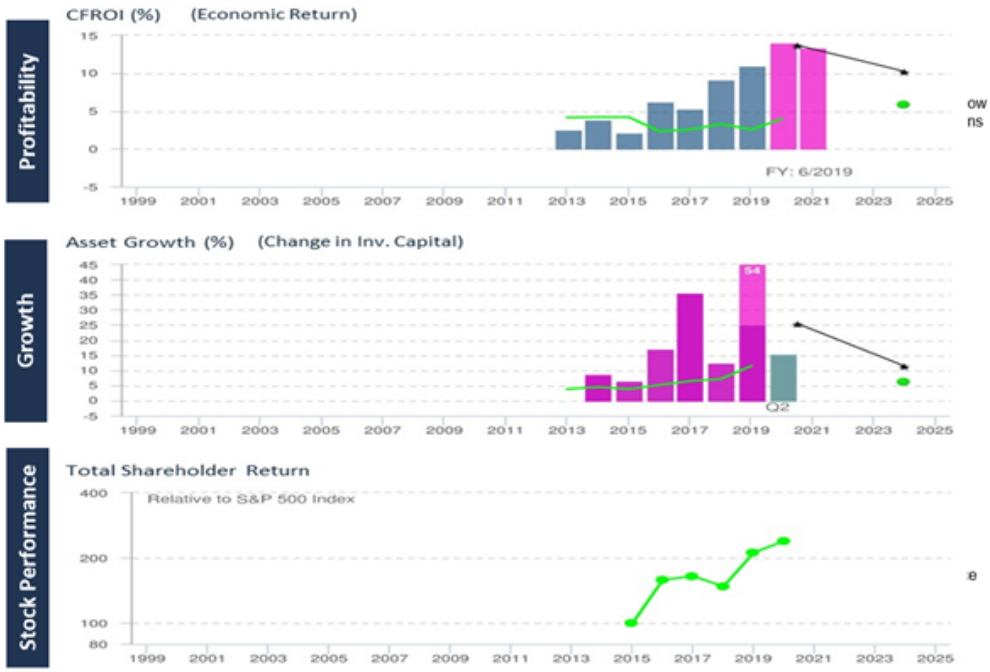
Portfolio Construction

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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