

INVESTMENT COMMENTARY: SMALL CAP Q2 2022

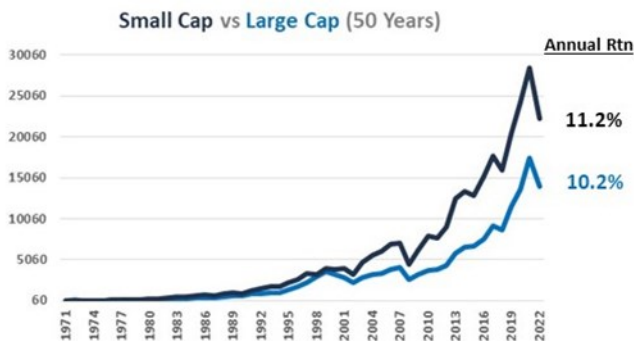
Time for Quality Small Caps to Shine!

Pessimism has flooded the streets. We don't even need to list all the market stats for Q2. We all know it was bad. Instead, we would like to paint a positive picture of the future, and it begins with small caps. By future we mean the intermediate term. Nobody can predict the next lock down or war, after all. And by small caps, we mean **high quality small caps**, the companies that are in tip-top shape and are poised to be tomorrow's leaders.

Good news #1: We continue to out-perform the beleaguered Russell 2000. In Q2, we outperformed by 100 basis points. Year to date, we are 410 basis points ahead, demonstrating how well quality can protect on the downside. And since inception (6½ years now), we have delivered an 11.0% return (that's outperformance of 2.8% per year), at 13% less risk. This combination has resulted in annualized Alpha of 4.0%.

Good news #2: Small caps, as a category, continue to underperform large caps. The Russell is -23.4% YTD versus -20.6% for the S&P 500. Why is this good news? Because small caps have a long history of out-performing large caps, and each quarter they fall further, they get cheaper and cheaper relative to their bigger siblings. Just look at the two charts below. Over the past 50 years, small caps have outperformed large caps by 100 basis points per year. However, over the more recent past large caps have crushed the category by a whopping 610 basis points per year! We believe this temporary differential is likely to unwind over the coming years.

Small Caps Have Out-Performed Over 50 Years



But Large Caps Have Dominated In The Recent Past



Data source for charts: Recent (S&P 500 vs Russell 2000). 50 Year Data: Portfoliovisualizer.com (Large cap: S&P 500 since 1977, Professor Kenneth French research data from 1972-1977; Small Cap: Russell 2000 since 1990, Professor French data from 1972-1990)

Indexing Is Dead: It's A Stock Pickers Market

We are stock pickers. We own 30-35 stocks and rank them based on upside potential divided by downside risk. It's no secret that the past decade saw the rise of the index fund. Many investors rode the markets up as the biggest players got bigger and bigger. This was true of the Russell as well, although less pronounced than the S&P 500.

We have managed to outperform the Russell during this indexing explosion, through good old fashioned stock picking. And while we didn't outperform every year (some years saw the lowest quality names explode to the upside!), our long-term performance shows the fruits of our labor.

We believe this separation between high quality and low quality will continue in the coming years. And we are very well positioned. Let's have a quick look at the overall profile of our portfolio versus both the Russell 2000 and the S&P 500.

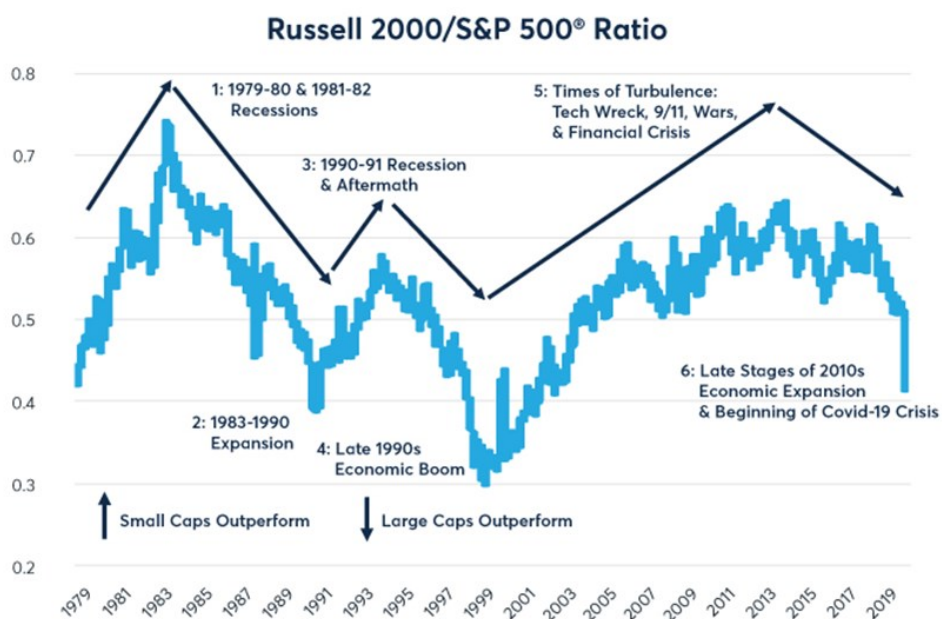
	ROI 2023E	Sales Gr 5yr	Leverage	Default Prob
VAM Small Cap	14.5%	12.9%	13.3%	0.4%
Russell 2000	7.2%	6.4%	21.2%	3.9%
S&P 500	13.7%	7.1%	17.6%	0.2%

Our portfolio actually beats the S&P 500 as far as the highest quality factors: Cash Flow ROI, Sales Growth & Leverage. And although the small cap index is famous now for its “zombie” status (19% of US companies can barely make their interest payments, and the vast majority of those companies are small caps), we are a different breed. We have much lower leverage than the index, and we do not tolerate default risk.

History Is On Our Side

Last quarter we pointed out some relevant reference points from the past, and we will reiterate them here. 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%). That is an incredible spread!

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.



Source: Bloomberg Professional (SPX and RUY)

Q2 REVIEW

Q2 was even worse than Q1 for markets, including small caps. For Q2, the Russell 2000 was -17.2% and the Russell 2000 Growth index was -19.3%. **Our strategy compared favorably at -16.3%**. Our focus on quality growth and low relative beta has continued to pay off, as it has for the full 6½ year track record.

Once again, we saw broad representation amongst the top winners and losers this quarter. Unlike the large caps, our tech names were generally not our biggest losers. We feel very strongly about our high-quality tech portfolio. We did not sell out of any of our holdings during Q2, but two were acquired (LHCG and MANT). We used the proceeds to add to two of our worst performing (but great fundamental) holdings, ETSY and UPST, plus we started a position in PDC Energy, to balance out our renewable energy holdings. We believe our portfolio is generally undervalued and well positioned.

TOP 5 PERFORMERS

		Return	Description	Actions/Notes
FIZZ	National Beverage	12.5%	Beverages	
MANT	Mantech	10.7%	Tech solutions for US DoD	<i>Acquired in Q2</i>
FCFS	First Cash	2.3%	Pawn shops	
SP	SP Plus	0.8%	Parking & travel services	
JAZZ	Jazz Pharma	-0.2%	Pharmaceuticals	

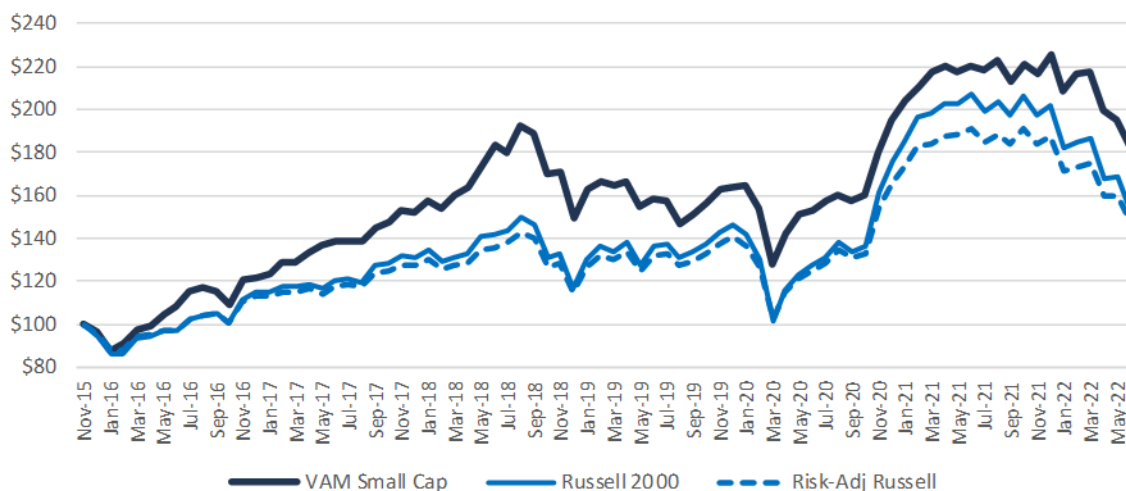
BOTTOM 5 PERFORMERS

		Return	Description	Actions/Notes
UPST	Upstart Holdings	-71.8%	AI-based loan svcs	<i>Added after selloff</i>
TLRY	Tilray	-59.9%	Cannabis	
ETSY	Etsy	-42.2%	Internet retail	<i>Added after selloff</i>
AZEK	AZEK Company	-32.6%	Recycled building materials	
HAIN	Hain Celestial	-31.0%	Health foods	

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 late last year, 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 **11.0%**, versus 8.2% for the Russell 2000. The Russell growth index has delivered a 7.1% 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 8.9% over this period.



	Annualized	Std Dev
Van Hulzen Small Cap	11.0%	17.9%
Russell 2000	8.2%	20.5%
Russell 2000 Growth	7.1%	21.1%

Top Ten Holdings

Our median market cap is approx. \$3.1 billion. As of June 30, 2022, the top 10 holdings are as follows:

Company	Business description	Weight	Size (\$mm)
Pacira Pharma (PCRX)	Non-opioid pain meds	5.3%	2,600
Lumentum (LITE)	Optical equipment	5.2%	5,600
Five Below (FIVE)	Discount retail	5.1%	6,700
CSW Industrials (CSWI)	Building products	5.0%	1,600
Jazz Pharma (JAZZ)	Pharmaceuticals	4.9%	9,700
Marten Transport (MRTN)	Temp controlled trucking	4.4%	1,400
Addus Homecare (ADUS)	Hospice/personal home care	4.1%	1,400
Texas Roadhouse (TXRH)	Restaurants	4.1%	5,100
Etsy (ETSY)	Internet retail	4.0%	9,400
FirstCash Holdings (FCFS)	Pawn shops	3.9%	3,300

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.



Key Points

- Market cap: \$5.6 billion
 - ROI improved from less than 2% to 14% over past 5yrs
 - ROIs above the cost of capital
 - Analysts expect 14% sales growth & improving ROIs
 - Has beaten estimates in 6 consecutive quarters (by an average of 10%)
 - Rated BUY by 9 analysts
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- Current stock price reflects low expectations (low green dot in top panel)
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- Shares have out-performed nearly 2-to-1 since it went public 6 years ago
 - We believe the shares are still undervalued

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