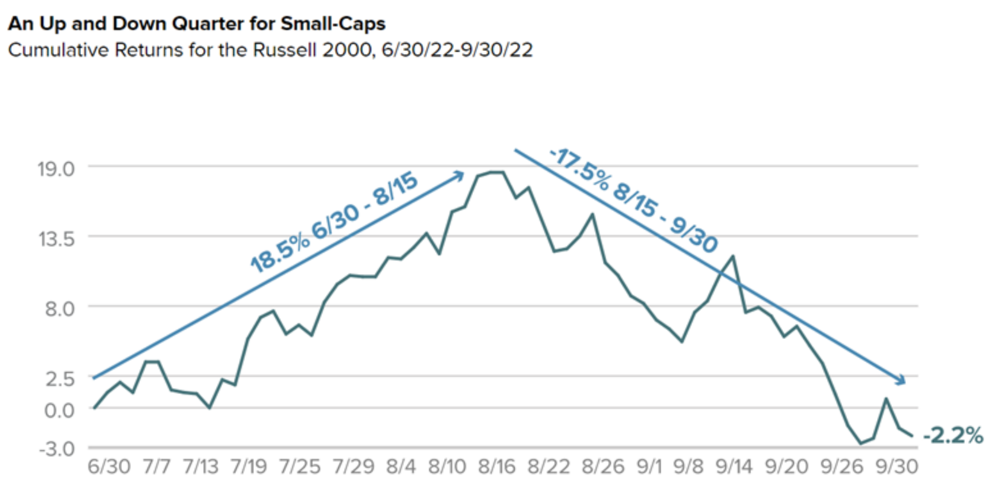
INVESTMENT COMMENTARY: SMALL CAP Q3 2022

Deglobalization Could Mean Small Cap Opportunities!

Roller Coaster Quarter

Stocks got the full roller coaster experience in Q3. The small cap index surged 18.5% during the first half of the quarter, only to give it all back (plus some) during the second half.



It's been an especially difficult year for risk assets. The tech-heavy Nasdaq has lagged the S&P 500 by more than 10%. However, unlike the first two quarters, both the Nasdaq and the Russell 2000 outperformed the S&P during Q3 (see below):

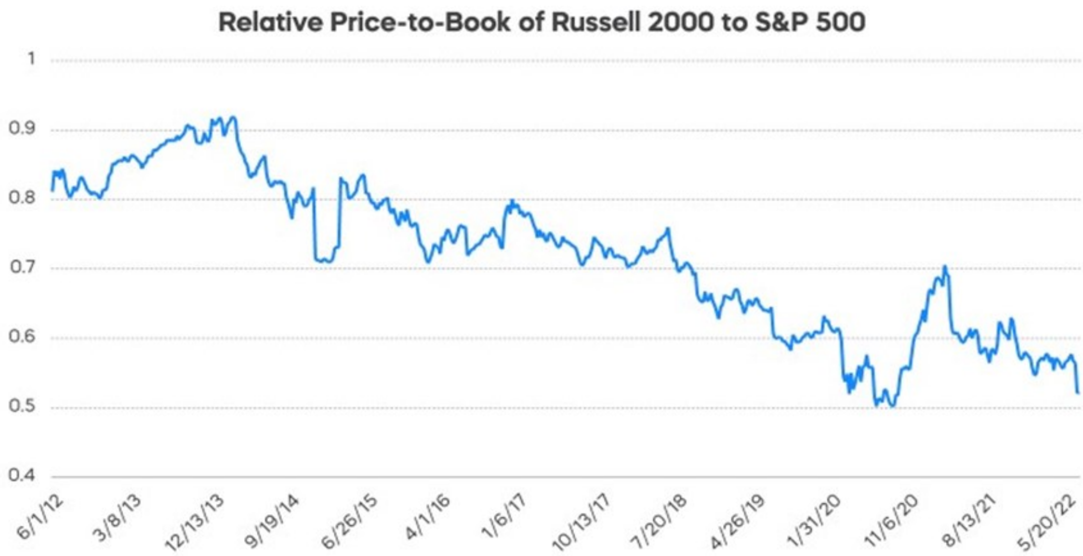
The Russell and the Nasdaq typically lead on the way down as well as the way up. Could this mean we're in the late stages of this bear market? We are hopeful but cautious. Let's be clear. This is **not** a growth market. So much depends on the Fed. Even a slight pause could unleash a huge upside rally in risk assets once again. As a "core" strategy, our holdings will withstand a prolonged recession (if one emerges) but will also benefit significantly from a pause in rate hikes..

US Equity Indexes	Q3 Return	YTD
S&P 500	-4.88%	-23.87%
DJ Industrial Average	-6.17%	-19.72%
NASDAQ 100	-4.42%	-32.35%
S&P MidCap 400	-2.46%	-21.52%
Russell 2000	-2.19%	-25.10%

Source: YCharts

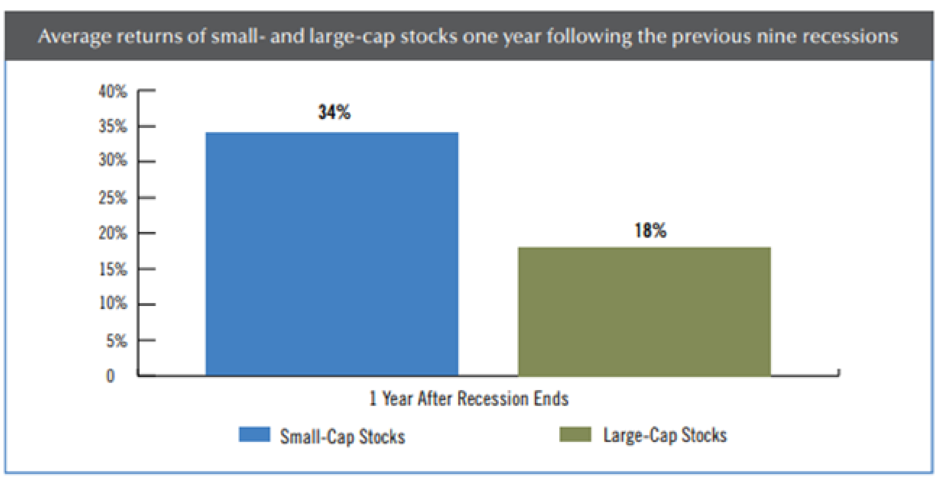
Small Cap Discount Bottoming

Small cap valuations have been declining relative to large caps for more than a decade. While small caps have outperformed large caps by about 100bp per year over the past 50 years, large caps have dominated in more recent history. This has resulted in a Price/Book discount for small caps of nearly 50%! Although the timing is uncertain, there is clearly an opportunity to consider increasing small-cap allocations relative to large-caps.



Leaders Out Of A Recession

Small caps tend to lead out of recessions and, in contrast to most every other equity index, did not make a new low in mid -October. This bodes well for the category if the momentum can continue. Since smaller companies tend to be more nimble and often react faster to changes in the business environment than larger companies, they typically bounce back more quickly and grow more rapidly in a recovery. In fact, small caps have significantly outperformed large-company stocks in the first year following **all** of the last 9 recessions. This is a compelling statistic.



Deglobalization Could Mean Small Cap Opportunities!

For decades, globalization has bolstered the profit margins of the largest global companies, driven inflation and yields down, and generally supported stock markets world-wide. Recently, however, these trends appear to be giving way to geopolitical conflict, populism, and trade wars. Has globalization peaked? And if so, what does that mean for small caps? Some senior thought leaders have weighed in confidently. ***Our conclusion: Yes, the world is deglobalizing, and this trend should support US small cap companies.***

- *The Ukraine war "has put an end to the globalization" experienced in recent decades.*
  -Larry Fink, BlackRock

- *"Just as globalization was deflationary, its unwinding will be inflationary."*
  \- Mark Carney, former governor of the Bank of England

- *"We suspect that geopolitical instability is likely to be protracted and spread to other parts of the globe—which will only underscore the need to keep manufacturing close to home…I think this shift will ultimately be a real positive for small-cap stocks."*
  \- Chuck Royce, Franklin Templeton

Q3 Review

Our small cap strategy continued its outperformance in Q3, turning in a +1.2% return compared to -2.2% for the Russell 2000. Year to date, <u>the strategy is 6.8% ahead of the Russell index</u>. Clearly, our focus on quality is paying dividends.

Once again, we saw broad representation amongst the top winners and losers this quarter. It is a stock picker's market! A couple of tech names (ENPH & ETSY) were among our winners, bucking the tech weakness in large cap land. We sold out of ENPH at a 94% gain as it catapulted out of the small cap category. Another key action for the quarter is the addition of CROX to the portfolio. CROX has clearly beaten the "fad-fade" as it continues to reinvent itself and consistently has the longest lines at the shopping mall. We are overweight high quality discretionary names, as well as tech and materials. We are underweight financials. Overall, the portfolio is full of undervalued companies and well positioned for the current environment. Our best and worst performers for the quarter are presented below.

<u>TOP 5 PERFORMERS</u>

		Return	Description	Actions/Notes
ENPH	Enphase	50.0%	Semiconductors for solar	*Closed in Q3*
CROX	Crocs	38.6%	Casual footwear	*Added in Q3*
ETSY	Etsy	36.8%	Internet retail	
FIVE	Five Below	21.4%	Discount retail	
TXRH	Texas Roadhouse	19.9%	Restaurants	

<u>BOTTOM 5 PERFORMERS</u>

		Return	Description	Actions/Notes
HELE	Helen of Troy	-40.6%	Household products	
VCSA	Vacasa	-38.7%	Vacation rental management	*Added in Q3*
MRCY	Mercury Systems	-36.9%	Defense systems	
AZEK	AZEK Company	-34.2%	Recycled building materials	
HAIN	Hain Celestial	-28.9%	Health foods	

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

Q4 Outlook

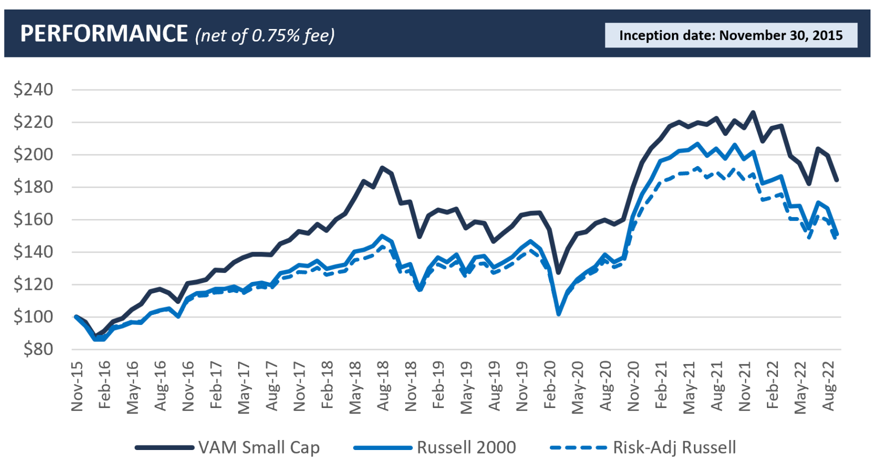
As we look towards the end of the year, an honest assessment of the macroeconomic landscape reveals that the markets and the economy are still facing numerous challenges from persistent inflation, ongoing Fed rate hikes, and geopolitical instability. Quality will continue to be as important as anything for the foreseeable future. And while the macro outlook for the riskiest assets remains challenged, valuations on many quality companies are quickly approaching pre-pandemic levels. There are some compelling opportunities out there.

A huge factor for the upcoming earnings season will be the strength of the US dollar. Expect large cap earnings to get hit hard as foreign sales in weaker currencies convert back to dollars. 40% of large cap sales comes from foreign markets. This number is 14% for the Russell 2000, and only 10% for our portfolio. We believe US-focused business models will continue to benefit as the deglobalization trend continues.

We understand the risks facing the economy, and we are committed to helping you effectively navigate this challenging investment environment. Successful investing is a long-term endeavor. We see volatility as an opportunity, not a threat, as it creates the potential for outperformance through stock selection. Even extended bouts of volatility like we've experienced so far this year will not alter our approach. In the 7 years since inception, we have outperformed in all but two. One of those years was very close (+19.0% vs +19.9%) and the other (2019) was a year of runaway growth at the expense of quality. We don't chase short term trends. We will continue our diligence with respect to security selection and risk management.

FULL TRACK RECORD

We are in our seventh year of this small cap strategy and have outperformed the Russell 2000 by an average of 3.1% per year, at 12% lower risk (as measured by standard deviation).



Performance (net)	**Van Hulzen**	**Russell 2000**	**S&P 500**
Month	-7.5%	-9.6%	-9.2%
3 Months	1.2%	-2.2%	-4.9%
Year To Date	-18.3%	-25.1%	-23.9%
1 Year	-13.4%	-23.5%	-15.6%
3 Years (annualized)	6.8%	4.3%	8.1%
5 Years (annualized)	4.9%	3.5%	9.1%
Inception (annualzed)	**9.4%**	**6.2%**	**10.3%**
Risk Statistics *(since inception)*			
Standard Deviation	18.3%	20.8%	16.0%
Alpha (relative to Russell 2000)	**3.7%**		
Beta	0.8	**Upside/Downside Capture**	
Sharpe Ratio	0.3	Up capture	94%
Information Ratio	0.4	Down capture	81%
Tracking Error	7.7%	**Ratio**	**1.2**

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

TOP TEN HOLDINGS

Our median market cap is approx. $2.9 billion. As of September 30, 2022, the top 10 holdings are as follows:

Company	Business description	Weight	Size ($mm)
Etsy (ETSY)	Internet retail	5.6%	12,700
Five Below (FIVE)	Discount retail	5.4%	7,600
Gibraltar Industries (ROCK)	Building products for solar	5.1%	1,300
Addus Homecare (ADUS)	Hospice/personal home care	4.9%	1,500
Pacira Pharma (PCRX)	Non-opiod pain meds	4.7%	2,400
Texas Roadhouse (TXRH)	Restaurants	4.7%	6,100
Pan American Silver (PAAS)	Silver mining	4.4%	3,300
Lumentum (LITE)	Optical equipment	4.3%	4,700
SP Plus (SP)	Parking & travel svcs	4.0%	700
Crocs (CROX)	Footwear	3.9%	4,000

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.

To better understand our investment approach, consider one of our holdings: Lumentum (LITE). Lumentum 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: $5.6 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

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

- Shares have out-performed nearly 2-to-1 since it went public 6 years ago
- We believe the shares are still undervalued