Investment Commentary: Small Cap Q4 2022

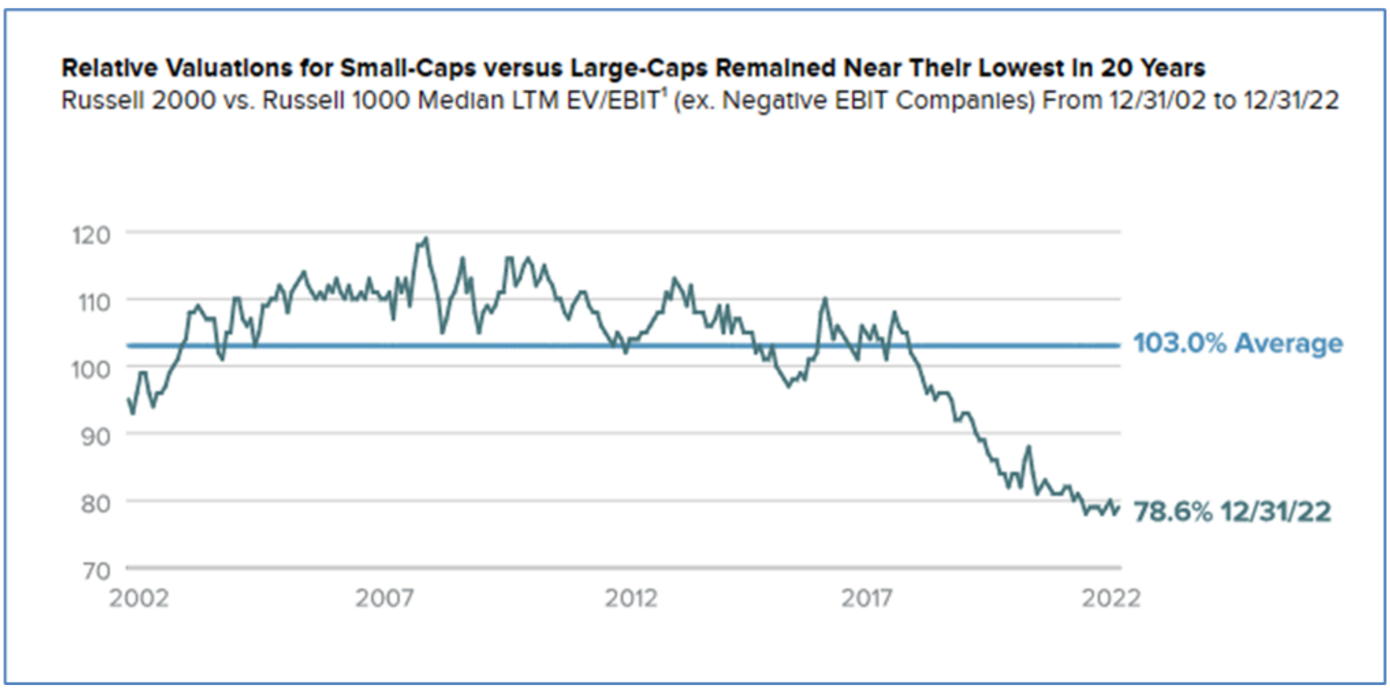
Valuations Becoming Compelling

Another Roller Coaster Quarter

Stocks had another roller coaster experience in Q4. Small caps surged almost 14% in October and November, only to lose more than half of those gains by year end. When the bell rang on the new year, the Russell 2000 had returned +6.2% in Q4 but had logged a sizeable loss (-20.5%) for the full 12 months. Small caps underperformed large caps again in 2022, as they've done consistently over the past 5 years.

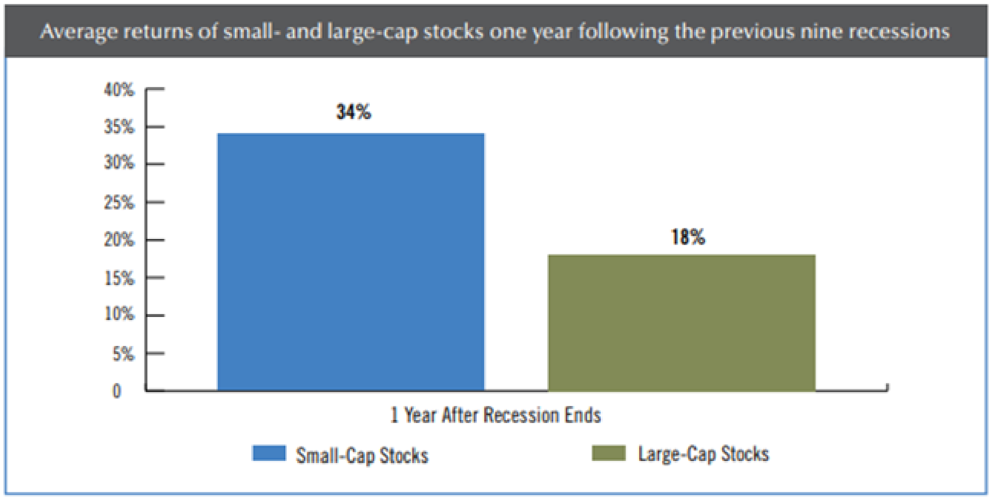
The Small Cap Discount

Small cap valuations have been declining relative to large caps for approximately 15 years. This is unusual, as the reverse has been true over the past 50 years, with small caps leading to the tune of about 100bp per year. But the recent large cap domination has resulted in a massive valuation discount for small caps. Although the timing is uncertain, there is clearly an opportunity here.



Leaders Out Of A Recession

As we pointed out last quarter, small caps almost always lead the market out of recessions. There is much debate about if/when a recession will hit in 2023, but given the record discount shown above, we believe small caps could rise and shine on the back end of any significant downturn. Just looking at history, small caps have significantly outperformed large-company stocks in the first year following **all** of the last 9 recessions. This is compelling.



Q4 Review

Our small cap strategy delivered a +5.3% return in Q4, bringing our annual performance for 2022 to -13.9%. This compares very favorably to the -20.5% return of the Russell 2000. Clearly, our focus on quality has paid off.

Value stocks generally did better than growth stocks in Q4, and our worst performers for the quarter were all tech stocks. But we saw broad representation amongst the top winners. It is certainly a stock picker's market. CROX was our best performer, after turning in the second-best performance last quarter. We continue to be overweight high quality discretionary names, as well as materials and industrials. We are underweight financials. Overall, we believe our portfolio is undervalued and well positioned. Our best and worst performers for the quarter are presented below.

TOP 5 PERFORMERS

		Return	Description	Actions/Notes
CROX	Crocs	57.9%	Casual footwear	
STLD	Steel Dynamics	38.3%	Steel	
FIVE	Five Below	28.7%	Discount retail	Trimmed
AZEK	AZEK Company	22.3%	Recycled building materials	
FIZZ	National Beverage	20.7%	Soft drinks	

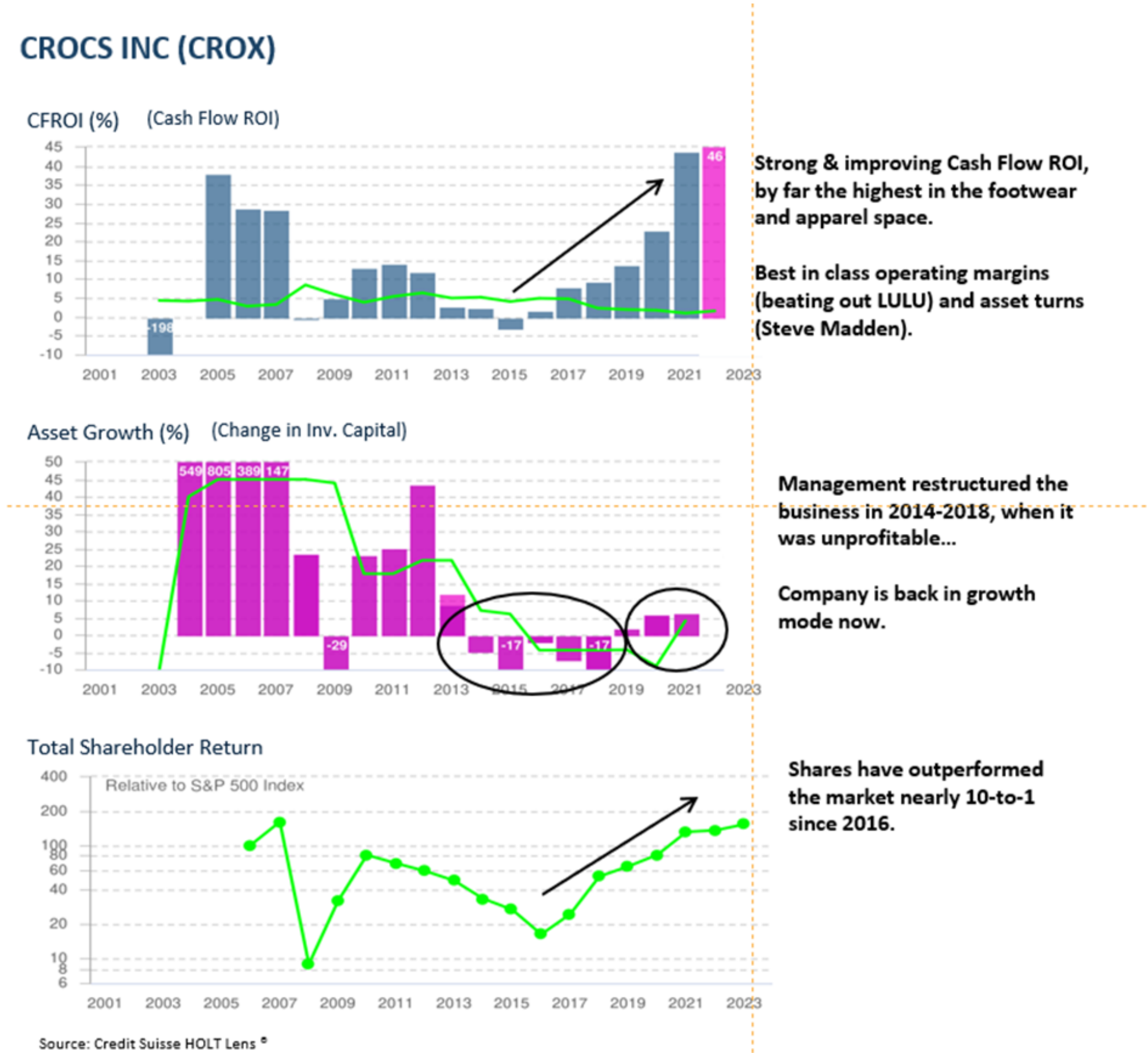
BOTTOM 5 PERFORMERS

		Return	Description	Actions/Notes
VCSA	Vacasa	-56.9%	Vacation rental management	*Tax loss sale*
PCRX	Pacira Pharma	-27.4%	Pain medications	
LITE	Lumentum Holdings	-23.8%	Optical lasers	*Tax loss sale*
QLYS	Qualys	-19.5%	Cyber security	
UPST	Upstart	-14.2%	Consumer lending	*Tax loss sale*

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

Portfolio Highlight: CROX

CROX was added to the portfolio in July 2022, after the shares dropped to 75% below its 2021 high. The business has undergone a huge transformation in recent years and now has the highest Cash Flow ROIs in the industry. This position is up 78% since our original purchase.

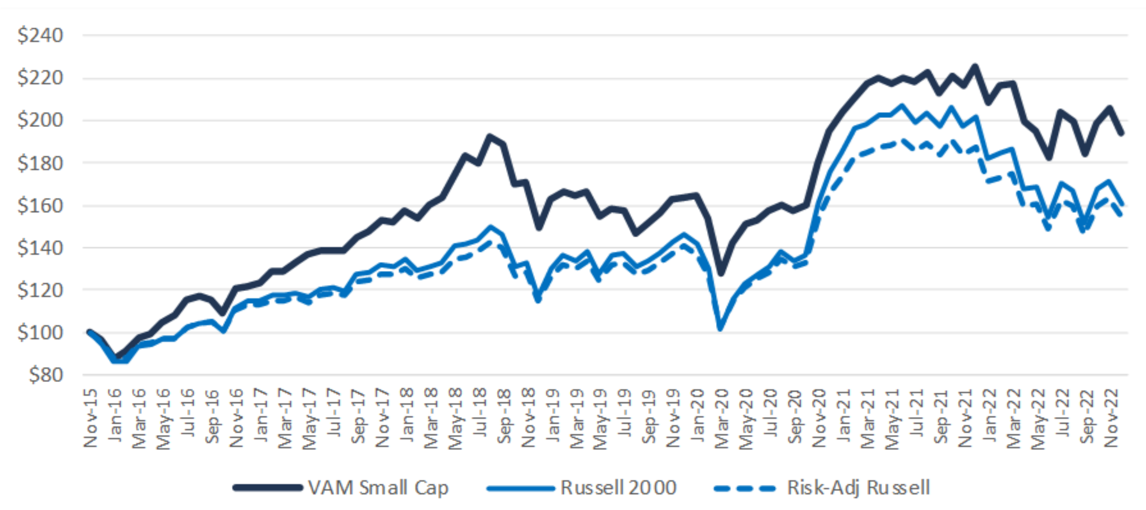


2023 Outlook

As we look towards the new year, financial markets and the economy are still facing numerous challenges. However, some of last year's biggest headwinds (inflation, China shutdown, ongoing Fed rate hikes, and geopolitical instability) have turned a corner. The biggest unknown today is how bad the Fed-induced slowdown will be. Will earnings hold up? Most are expecting forward estimates to come down 10-15%. Is this priced in already? Possibly. But we still believe quality will continue to matter above all else, for the foreseeable future. Companies with sizeable debt balances have seen their interest costs explode and will be stretched for the foreseeable future. But while the outlook for the riskiest assets remains challenged, valuations on many quality companies have approached pre-pandemic levels. There are some compelling opportunities out there. The time to index has passed. A staggering 40% of the Russell 2000 companies are unprofitable, and many are significantly over-levered. Do you really want to own this index? Stock selection is back.
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 asset, not a threat, as it creates opportunities for outperformance through stock selection. Even extended bouts of volatility like we experienced last 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.

<u>FULL TRACK RECORD</u>

We are in our eighth year of this small cap strategy and have outperformed the Russell 2000 by an average of 2.9% per year, at 13% lower risk (as measured by standard deviation).

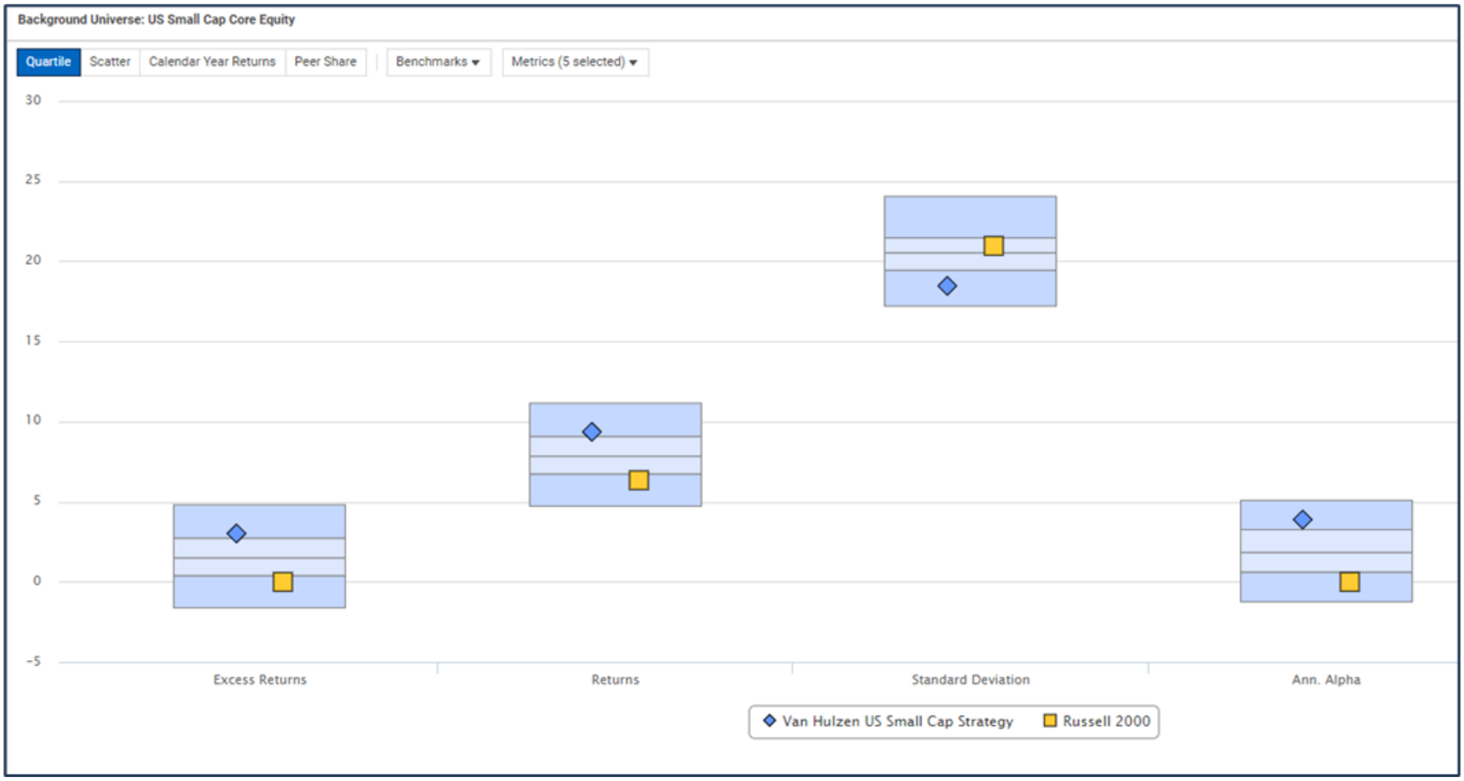


	Annualized	Std Dev
Van Hulzen Small Cap	9.8%	18.4%
Russell 2000	6.9%	21.0%
Russell 2000 Growth	6.0%	21.5%

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

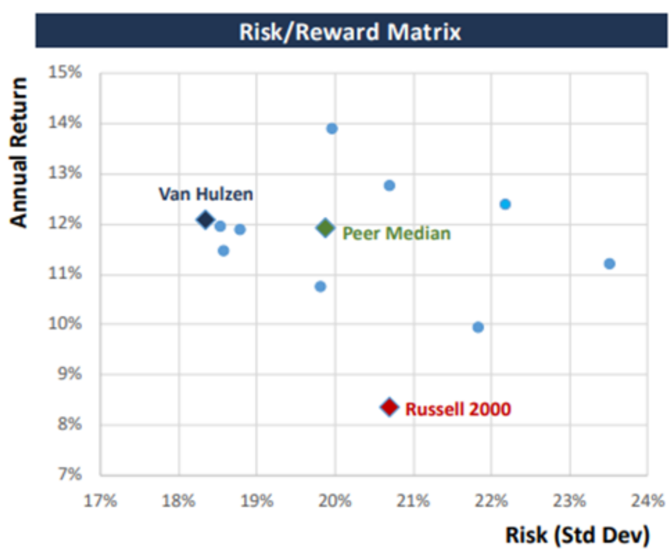
PEER ANALYSIS

We recently subscribed to the eVestment data analytics platform, which gives us visibility into the entire US small cap universe. And we're pleased to report that, since inception, we are in the top decile of all Small Cap Core managers in the US. In fact, we stack up very well against the 10 largest small cap strategies in the US (ranked by AUM). The average AUM of these top firms is nearly $8 billion. We are just getting started.



Competitive Landscape

Comparison To Top 10 US Small Cap Strategies



Top 10 US Small Cap Strategies

Firm	AUM ($mm)	Style	Return	Std Dev
T. Rowe Price	$ 18,000	Core	12.4%	18.3%
Wm Blair	$ 10,650	Growth	11.9%	18.8%
Baron	$ 8,100	Growth	13.9%	20.0%
Macquarie: Core	$ 8,040	Core	10.7%	19.8%
Macquarie: Value	$ 7,960	Core	10.0%	21.8%
Fuller & Thaler	$ 7,280	Value	12.0%	18.5%
Sycamore	$ 7,750	Value	11.2%	23.5%
JP Morgan	$ 6,480	Core	11.5%	18.6%
American Century	$ 7,010	Value	12.4%	22.2%
Fisher	$ 6,280	Value	12.8%	20.7%
Median	**$ 7,895**		**11.9%**	**19.9%**
Van Hulzen	**$ 65**	Core	**12.1%**	**18.4%**
Russell 2000			**8.4%**	**20.7%**

Note: Performance data is since Van Hulzen's inception (Dec 2015 - July 2022)

Data source: Morningstar

TOP TEN HOLDINGS

As of December 31, 2022, the top 10 holdings are as follows:

Company	Business description	Weight	Size ($mm)
Etsy (ETSY)	Internet retail	6.0%	14,900
Crocs (CROX)	Footwear	6.0%	6,800
Gibraltar Industries (ROCK)	Building products for solar	5.5%	1,400
Addus Homecare (ADUS)	Hospice/personal home care	5.1%	1,600
AZEK Company (AZEK)	Recycled materials	5.0%	3,300
Texas Roadhouse (TXRH)	Restaurants	5.0%	6,200
SP Plus (SP)	Parking & travel svcs	4.3%	700
Five Below (FIVE)	Discount retail	4.1%	10,000
Pentair (PNR)	Flow technologies	3.4%	7,500
Pacira Pharma (PCRX)	Non-opiod pain meds	3.4%	1,700

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.

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