Investment Commentary: Small Cap Q1 2023

Strong Performance In The Face Of A Banking Crisis

Overview

There was huge dispersion in Q1, with clear winners and losers. Just in the month of March, the tech sector was up 10.9%, while the financial sector returned -9.6%. In fact, just 10 stocks (mostly tech) accounted for 90% of the performance of the S&P 500.

Our small-cap strategy, which emphasizes quality above all else, returned **+9.3%** (net of fees) for the quarter. This compares very favorably to the Russell 2000 and S&P 600 Small Cap indices, which returned +2.7% & +2.6%, respectively. We were underweight financials coming into the quarter, but we did (and still do) hold two regional banks in the portfolio, which we are watching closely. These names (AX & CBSH) have strong balance sheets and have among the highest Cash Flow ROEs in the space.

Portfolio Highlights

Our top performers were a diversified group in Q1. And our top name was actually a financial (FOCS), which was acquired by a group of private equity firms. But not surprisingly, our worst performer was a regional bank (CBSH). As far as individual trades, we sold JAZZ and FIZZ during the quarter and trimmed ETSY, all on technical weakness concerns. We also trimmed TXRH, for a different reason…its strong stock performance has started to stretch its valuation.

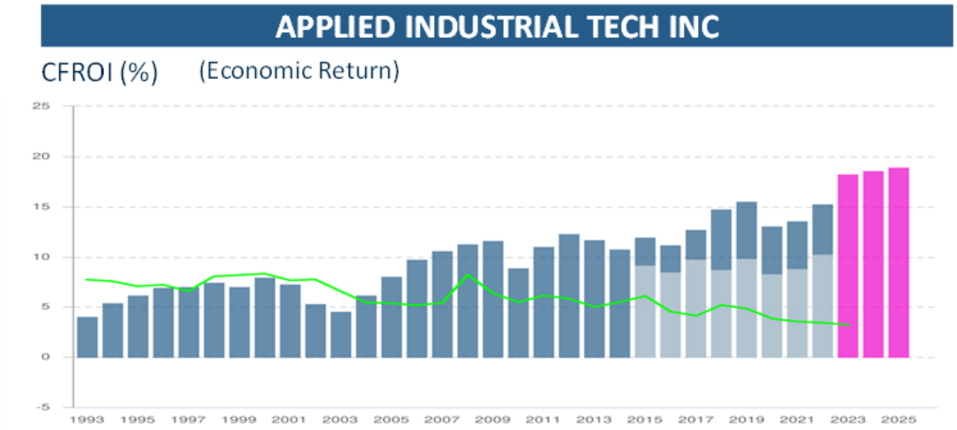
TOP 5 PERFORMERS

		Return	Description	Actions/Notes
FOCS	Focus Financial	33.6%	Investment advisory	*Acquired*
PNR	Pentair	22.6%	Flow technologies	*Added*
CSWI	CSW Industrials	20.0%	Building products	
TXRH	Texas Roadhouse	19.0%	Restaurants	*Trimmed*
FELE	Franklin Electric	18.3%	Water & fuel pump systems	

BOTTOM 5 PERFORMERS

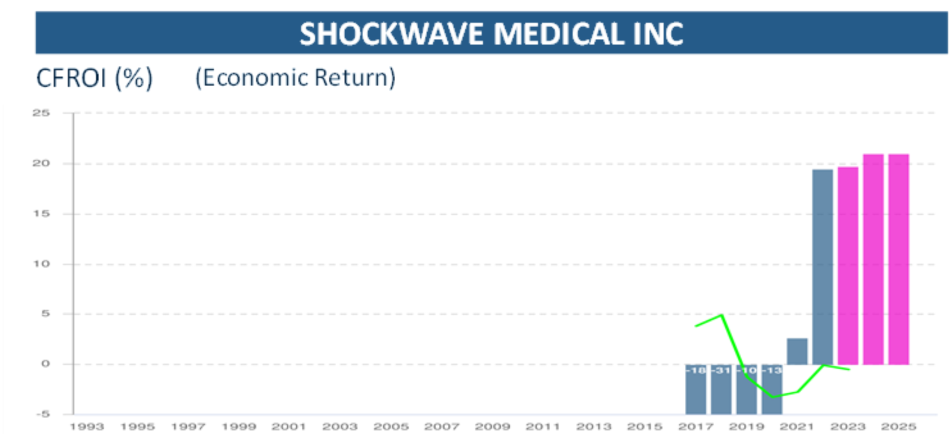
		Return	Description	Actions/Notes
CBSH	Commerce Bancshares	-11.0%	Vacation rental management	
JAZZ	Jazz Pharma	-8.5%	Pharmaceutical	*Sold*
FIZZ	National Beverage	-7.1%	Beverages	*Sold*
ETSY	Etsy	-6.9%	Online retail	*Trimmed*
TLRY	Tilray	-5.9%	Cannabis	

BOUGHT on fundamental strength: Applied Industrial Tech (AIT)



Applied Industrial Tech (AIT)

- Emerging leader in the motion, fluid and power control industry
- Strong, improving Cash Flow ROIs (see chart above)
- Below average leverage, 0% default risk (based on the Merton model)
- Six positive earnings revisions in the past 12 months; strong record of beating estimates
- 1.0% dividend yield, which has grown for 5 consecutive years



Shockwave Medical (SWAV)

- Medical technologies for vascular & coronary disease
- Five positive earnings revisions in 2022; have beaten estimates in 4 straight quarters.
- Zero debt. $300 million of cash on hand.
- Added to the portfolio in January

Banking Crisis…We've Been Here Before

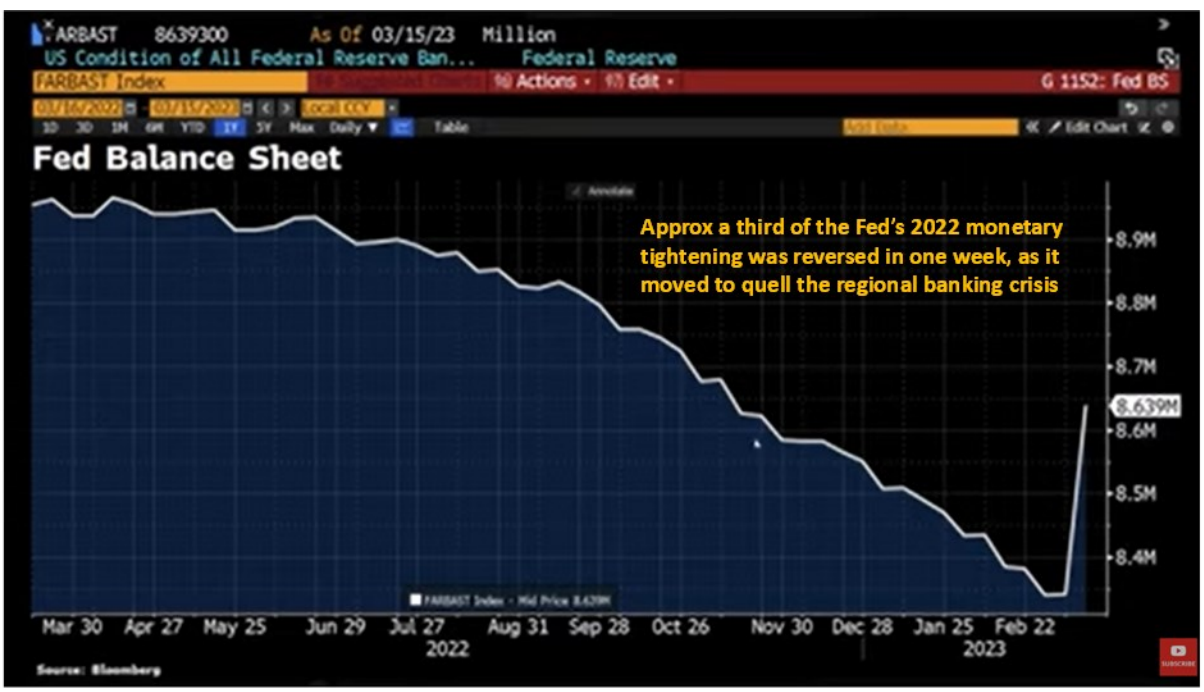
Aspects of today's regional banking crisis are eerily similar to the S&L crisis of the 1980s. But before we get to that, let's look at the fallout so far. There has been a mass exodus of bank deposits in the past year. There's no question that deposits were artificially inflated due to covid stimulus programs, but the decline ever since has been even more alarming. See below.

Growth In Bank Deposits (% Change)

<u>The problem</u>: **If banks don't have deposits, they can't make loans…and economic growth grinds to a halt**

<u>Fed To The Rescue</u>!? Liquidity is Back.

Just like that, approximately a third of the Fed's 2022 monetary tightening was reversed.



The 2023 regional banking crisis is centered around long term ("risk-free") treasury bonds, which are on the balance sheets of many banks. These bonds have cratered in value as a result of the Fed's rate hikes.

The irony here, of course, is that you could argue that the Fed was at least partially to blame for this crisis in the first place. The Fed's easy money policies, combined with massive stimulus in 2020, created excess bank deposits that needed to be invested. And the Fed's message that it "wasn't even thinking about thinking about raising rates" gave banks the confidence to move further out the yield curve in order to find decent yields. The value of these "risk-free" investments then cratered when the Fed hiked rates by nearly 500 basis points in a year. And as deposits have left the regional banks, lending activity has significantly contracted.

<u>Not Our First Rodeo</u>

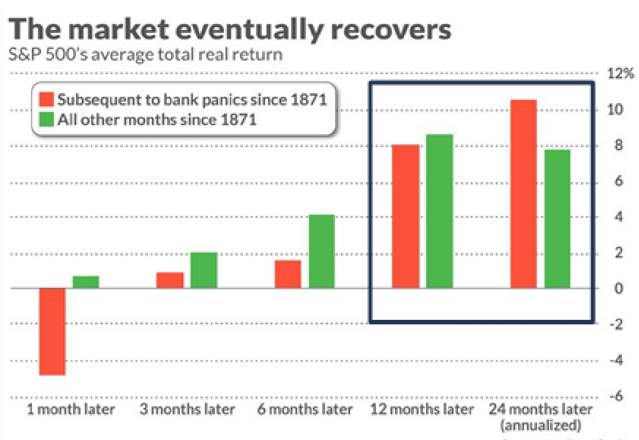
This is hardly our first banking crisis. There have been nine major banking crises in the past 200 years. *According to MIT research (2021), the average banking crisis leads to a decline in GDP of approx. 3%. That's not an insignificant hit, and it would certainly drive today's GDP into negative territory.

Perhaps the crisis that was most similar to today's was the S&L crisis of the 1980s and early 1990s. The FDIC backed up most deposits, as they have today; nonetheless, well over 1,000 savings and loan banks failed. Like today, the S&L crisis began when the Fed raised rates higher than the yields being collected by the banks. The S&L crisis took nearly a decade to peak, however, as there was little oversight of the banks and the S&Ls took advantage of a new security, called the "junk" bond, to get financing (they also invested heavily in junk bonds, in order to increase their yields). Many banks took liberties with the accounting rules, as well. All this added to the price of the ultimate bailouts of the early 1990s.

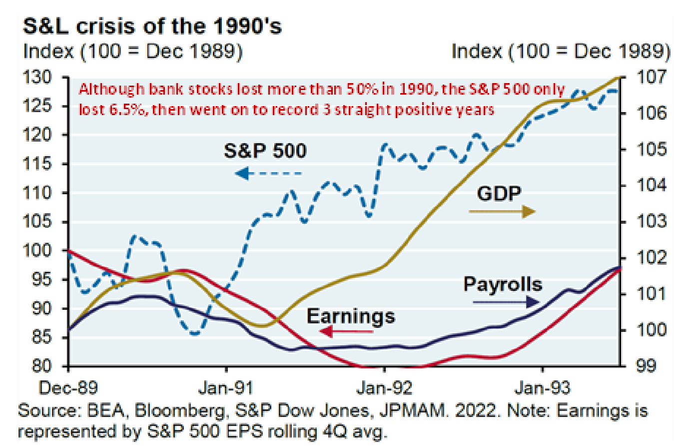
Mark Hulbert (of Hulbert Ratings) studied all the bank panics since 1870 and found that, on average, the stock market damage tends to be temporary. See the chart below, left. By 12 months out, stock market returns were nearly in line with "normal" periods, and returns were actually slightly higher after 24 months.

Of course, few of these periods had to reckon with multiple bubbles deflating at the same time (bonds, tech, crypto, commercial real estate). It's always possible that this time is different. And this study focused on the broad stock market. The financial sector is a different animal. It tends to fall further and underperform for longer. At the peak of the S&L crisis (1990), banks lost more than 50% of their value, while the broader market only dropped 6.5%.

Impact of Bank Crises on Stock Returns



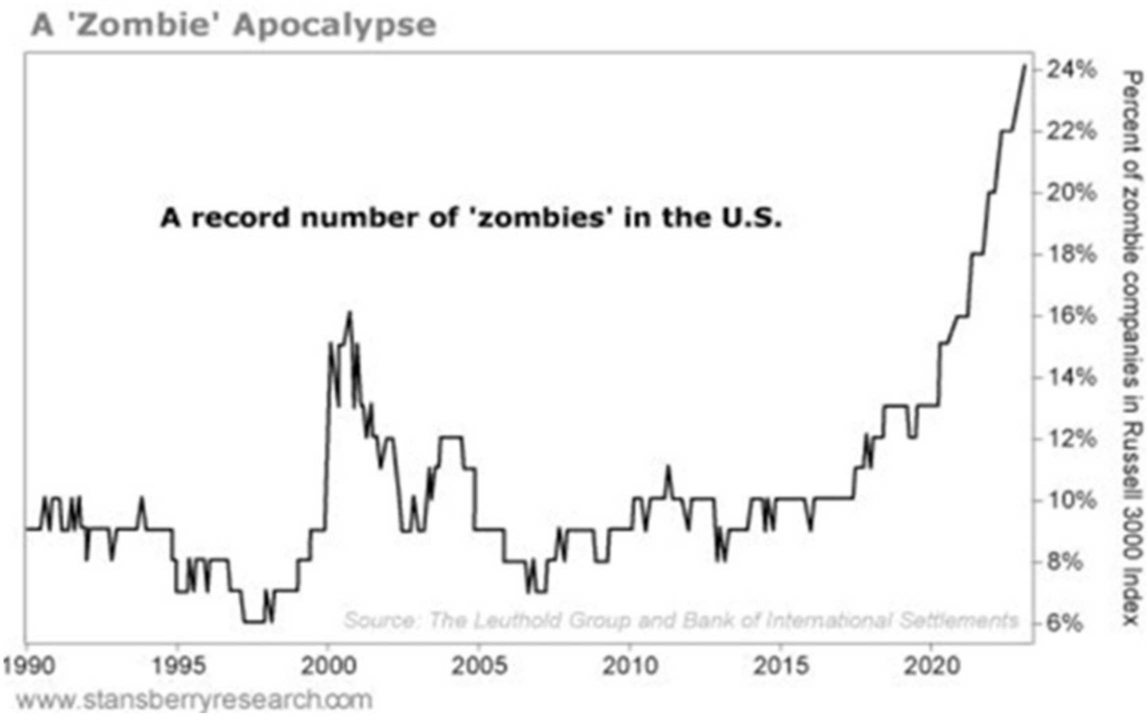
S&P Crisis of the 1980s



**A Brief History of Bank Failures*, The American Deposit Management Co, March 2023

No Shortage of Walking Dead

Banks are not the only issue we face today. Zombie companies have become a hot topic lately, as rates have increased significantly over the past year, and more and more companies are stretched. Most define a zombie as a company that doesn't produce enough profit to service its debts. There are a bunch of companies that fit that description…about 3x the number that existed just 15 years ago (see chart below). You can use interest coverage and other metrics to find them. Notable names are Bed Bath & Beyond, Carvana, GameStop, and AMC. But outside of the obvious ones, it's a challenging question to answer because zombies don't typically walk around in the open. Interest rates have only recently gone up, so the crunch has just begun. In our opinion, the number of zombies is set to multiply this year and next as companies roll over their debt maturities.



The HOLT framework is a great tool to help us find high-risk names to avoid. There are lots of variables we can use to assess leverage risk. We ran some analysis on both the S&P 600 and the Russell 2000 and compared various risk factors for both indices to Van Hulzen's small-cap portfolio. We estimate that as many as **24%** of small-cap companies in **BOTH of the major indices** (Russell 2000 and S&P 600) could end up being zombies in the next year or two. This is a huge number. Clearly, this is a dangerous time to take credit risk.

But Van Hulzen's small-cap strategy stands out in comparison. See the summary below for how many companies in each index fail each of the risk parameters we have identified compared to our own small-cap strategy. On average, only one of Van Hulzen's holdings trips these risk variables. But these are not accidents…we understand these risks well and analyze them on a case-by-case basis. For example, **Pan American Silver** has ROIs below its cost of capital (one of our risk variables), but it has below average debt and is a beneficiary of the boom we're seeing in precious metals.

We believe this is going to be a big topic going forward. There is a lot of fear out there. But the answer is not to hide away and avoid small caps altogether. Van Hulzen's small-cap strategy is a great way to add some high-quality growth to your clients' portfolios by understanding, confronting, and overcoming the zombie threat.

SUMMARY STATS FROM RISK STUDY

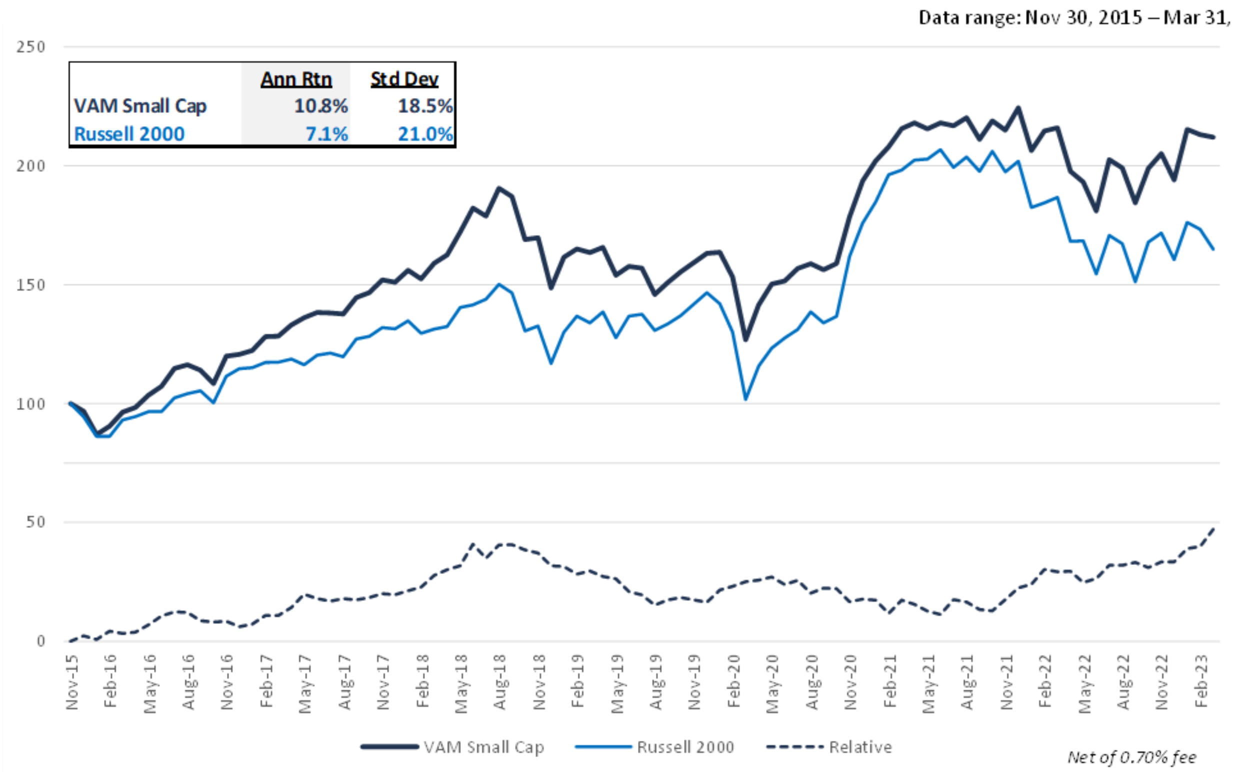
	Russell 2000		S&P 600		VAM Small Cap	
RISK VARIABLE	**Russell**	**% of Index**	**S&P600**	**% of Index**	**VAM SC**	**% Portfolio**
CFROI < cost of capital	928	46%	256	43%	2	6%
CFROI < 0%	496	25%	76	13%	0	0%
5yr Sales gr < 0%	221	11%	91	15%	1	3%
Dividend cutters	180	9%	113	19%	1	3%
Leverage > 40%	378	19%	158	26%	1	3%
Default Prob > 5%	543	27%	178	30%	1	3%
	458	23%	145	24%	1	3%
Dividend Payers		721		310		19
Total Holdings		2000		600		36
Pct divdiend payers		36%		52%		53%

SUMMARY STATS	**Russell 2000**	**S&P 600**	**VAM Small Cap**
Cash Flow ROI (2023E)	5.1	6.5	**12.5**
Sales Growth (5yr)	7.2	6.6	**12.6**
Leverage (Debt%)	17.4	25.6	**15.8**
Default Probability	1.9	2.0	**0.1**
TSR (YTD)	(2.1)	0.5	**5.7**
TSR (6mo)	(6.6)	(0.9)	**5.6**
TSR (2yr)	(23.5)	(15.9)	**(6.6)**
TSR (3yr)	0.1	5.3	**8.7**
TSR (5yr)	20.9	19.8	**69.3**
TSR (10yr)	47.8	38.8	**152.1**

Key Takeaways

- Banking crisis: This too shall pass, and studies show most of the pain will likely be in the banking sector.
- BUT, quality has never mattered more. Our process avoids zombie companies.
- As Big Tech continues to consolidate, we believe high quality small cap stocks will take a leadership role and perform better than they have in recent years.
- We are underweight banks, with non-bank financials filling most of our financial allocation. We are slightly overweight tech and industrials.

LONG TERM TRACK RECORD



PERFORMANCE & RISK STATISTICS

Performance	VAM Gross	VAM Net	Russell 2000	S&P 600
Month	-0.5%	-0.5%	-4.8%	-5.2%
3 Months	9.5%	9.3%	2.7%	2.6%
Year To Date	9.5%	9.3%	2.7%	2.6%
1 Year	-1.1%	-1.8%	-11.6%	-8.8%
3 Years (annualized)	19.5%	18.7%	17.5%	21.7%
5 Years (annualized)	6.7%	5.9%	4.7%	6.3%
Inception (annualzed)	**11.6%**	**10.8%**	**7.1%**	**8.8%**

Risk Statistics *(since inception)*				
Standard Deviation	18.5%		21.0%	21.2%
Alpha (relative to Russell 2000)	**4.9%**			
Beta	0.8			
Sharpe Ratio	0.4			
Information Ratio	0.6			
Tracking Error	7.6%			

Upside/Downside Capture	
Up capture	95%
Down capture	80%
Ratio	**1.2**

Performance period: 11/30/2015 – 3/31/2023
Returns are net of 0.75% average management fee

TOP TEN HOLDINGS

As of March 31, 2023, the top 10 holdings are as follows:

Company	Business description	Weight	Size ($mm)
AZEK Company (AZEK)	Recycled materials	4.8%	3,400
Pentair (PNR)	Flow technologies	4.6%	8,600
Qualys (QLYS)	Cyber security	4.6%	4,600
Addus Homecare (ADUS)	Hospice/personal home care	4.5%	1,600
Five Below (FIVE)	Discount retail	4.4%	11,100
Crocs (CROX)	Footwear	4.1%	7,400
Gibraltar Industries (ROCK)	Building products for solar	4.0%	1,500
SP Plus (SP)	Parking & travel svcs	3.8%	600
Maxlinear (MXL)	Semiconductors	3.7%	2,700
Pan American Silver	Precious metals	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

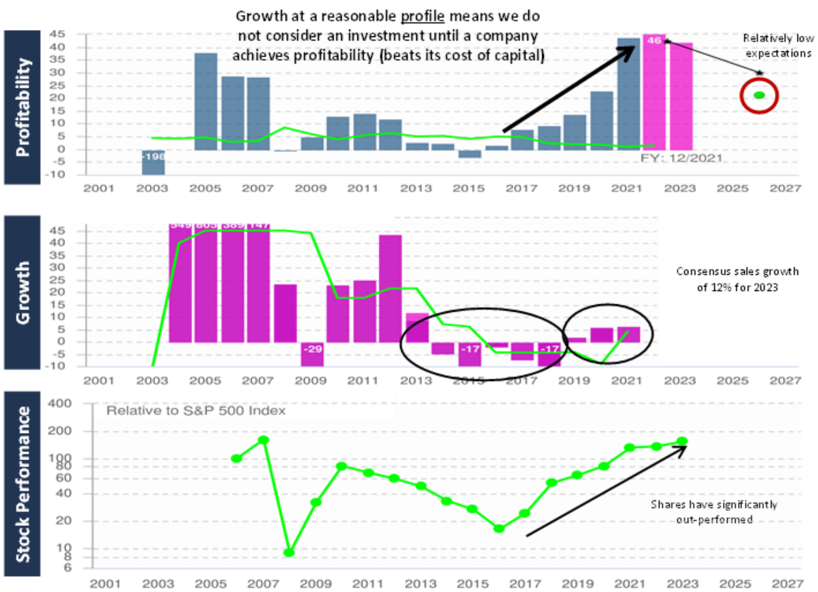
Our strategy is well diversified, with a max position size of 6% and broad representation across sectors. We believe in long term value creation based on a disciplined capital allocation process. A handful of lucky concentrated bets is not the path to achieving long-term goals. We target companies with 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.

To better understand our investment approach, consider one of our holdings: Crocs (CROX). Crocs designs, manufactures, and distributes casual lifestyle footwear and has become a market leader in the space. The company has impressive momentum in its Cash Flow ROIs, and the stock has outperformed the market 10x since 2016.

Investment Process: Small Cap Example (CROX)



Source: Credit Suisse HOLT

Key Points

- Market cap: $7.7 billion
- Strong & improving Cash Flow ROI, by far the highest in the footwear and apparel space.
- Best in class operating margins (beating out LULU) and asset turns (Steve Madden).

- Management restructured the business in 2014-2018, when it was unprofitable…
- Company is back in growth mode now.

- Current stock price reflects low expectations (low green dot in top panel)
- Shares have out-performed nearly 10-to-1 since 2016
- We believe the shares are still undervalued