Investment Commentary: Small Cap Q3 2023

Quality Stands Out In A Weak Category

As of September 30, our small cap strategy is +7.9% year to date, compared to 2.5% for the Russell 2000 and 1.7% for the S&P 600 small cap index. Since inception (nearly 8 years), we have delivered an annual return of +10.6%, compared to 6.6% Russell and 8.1% S&P. We have achieved this performance by focusing on quality, which is the topic of this quarter's commentary.

Before we get to small caps, let's look at the largest companies in the US, as this helps demonstrate what kind of market we are in. We dug into the S&P 500 and compared the YTD stock performance of the top and bottom quintiles for 5 different factors, including market capitalization and four of our top quality factors (ROIs, leverage, default probability, dividend yield and dividend growth). With all the buzz about the Magnificent 7 this year, it's no surprise that the largest companies have outperformed their smaller counterparts. By a lot (spread of 24.3%). But it's not just about size. These mega-cap companies also happen to be amongst the highest ***quality*** companies in the US. The most profitable 100 companies in the S&P (as measured by Cash Flow ROIs) have outperformed the bottom 100 by a whopping 19.2% so far this year. And the most significant factor in today's rising rate environment has been default probability*. The top S&P quintile (lowest default probability) has outperformed the bottom quintile by 27.1% year to date! The message is clear. Investors have dumped any/everything speculative in favor of strong balance sheets and cashflows. And they have been willing to pay higher prices to get them. Valuation has not been a factor (in fact, the highest P/E stocks have done the best). This has been true for some time.

The one traditional quality measure that has not worked this year is dividend yield. As we've written in the past, dividend yields alone are not great predictors of shareholder value. Many dividend payers also carry leverage, and a dividend yield can be "accidentally" high if a cut is looming, Dividend ***growth*** is much more strongly correlated with stock performance, which is why we focus on it more than just yield.

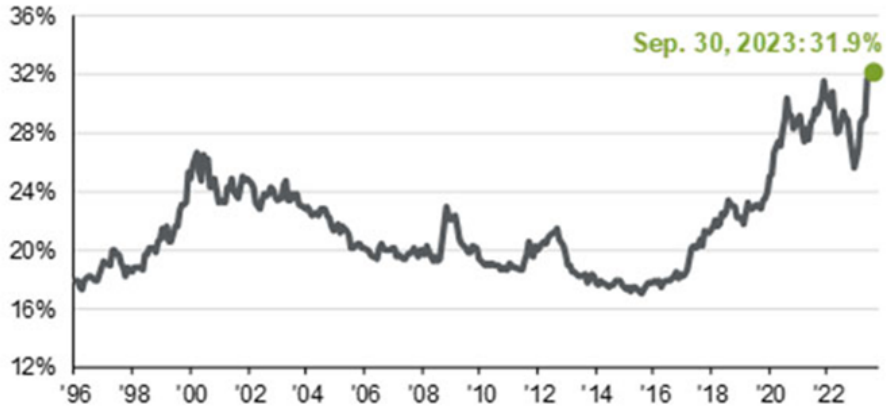
2023 YTD Performance			
	Top Quintile	**Bottom Quintile**	**Spread**
Market Cap	14.7%	-9.5%	24.3%
Cash Flow ROI	15.7%	-3.6%	19.2%
Leverage	12.3%	-2.4%	14.7%
Default Prob %*	18.9%	-8.2%	27.1%
Dividend Yield	-10.8%	14.0%	-24.8%
Dividend Growth	3.3%	0.1%	3.2%

Note: Default probability estimates are from the Merton model, which incorporates the Black-Sholes option pricing model to quantify corporate default risk. This statistical model helps quantify how capable a company is at meeting financial obligations, servicing its debt, and weighing the general possibility that it will go into credit default.

Large Cap vs Small Cap

We've written about market concentration quite a bit so will not dive deep on that here, except to point out that the weighting of the top 10 stocks has hit a new 50 year high. Clearly, this trend has been detrimental to small cap stocks, particularly since 2015.

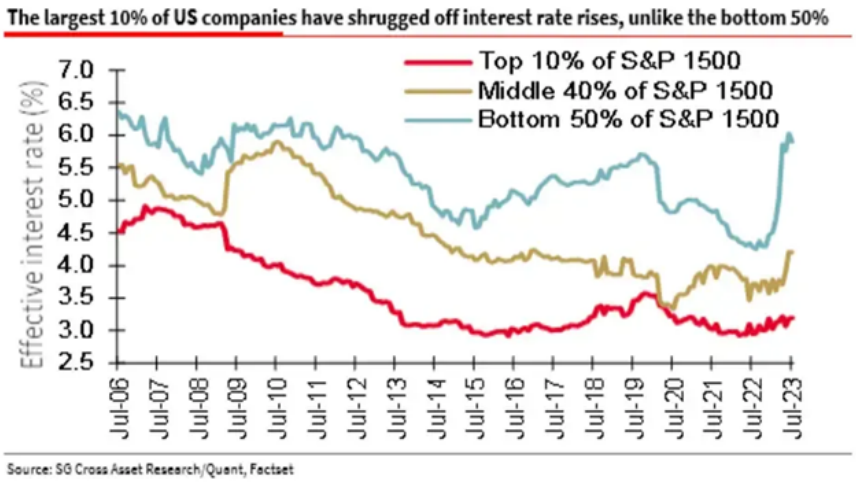
Weighting of Top 10 Stock in the S&P 500



Spread Between S&P 500 and Russell 2000

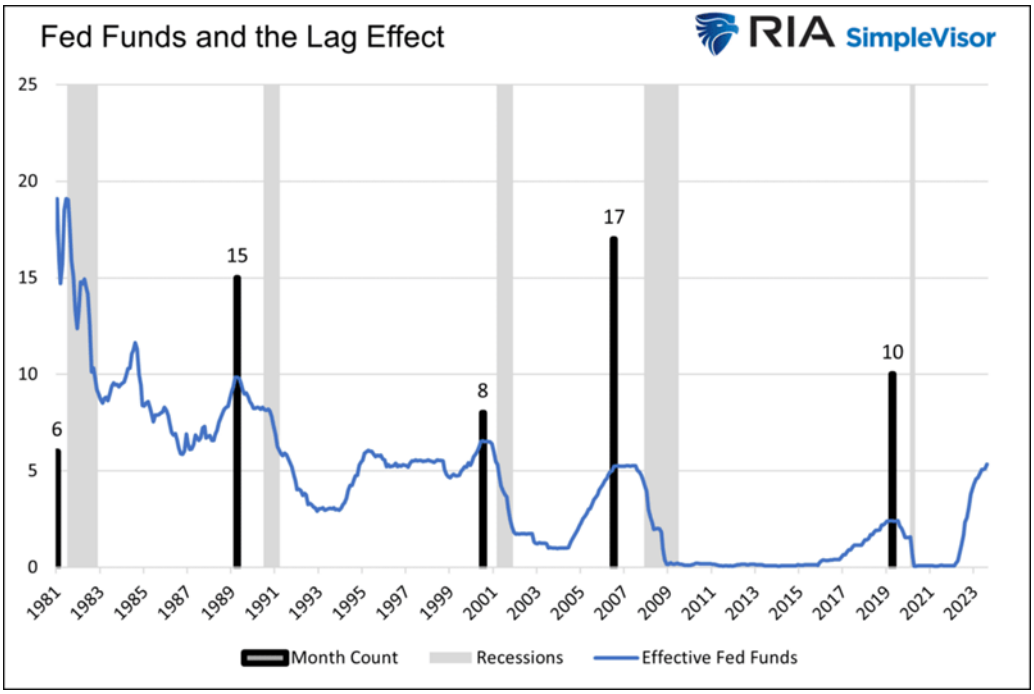
Rate Hikes Hitting Smaller Companies Much Harder

Smaller companies are feeling the effects of higher rates much more than large companies.



The Infamous "Lag Effect"

Where is the recession everyone has been calling for over the last year? Despite surging interest rates, there are few signs of distress amongst corporate borrowers. This is because most companies locked in low rates over the past three years and have not had to scramble to refinance…yet. There is often a delay, called ***the lag effect***, between higher interest rates and economic weakness. The graph below shows the Fed Funds rate and the time, in months, from the last rate hike preceding each recession since 1981. The average delay between the final rate increase and recession has been 11 months. The last Fed hike was in July 2023. Assuming that was the Fed's final rate increase for this cycle, we may not see a recession until mid-2024. Or, given how many companies locked in low rates just 1-2 years ago, even longer. But it will come eventually.

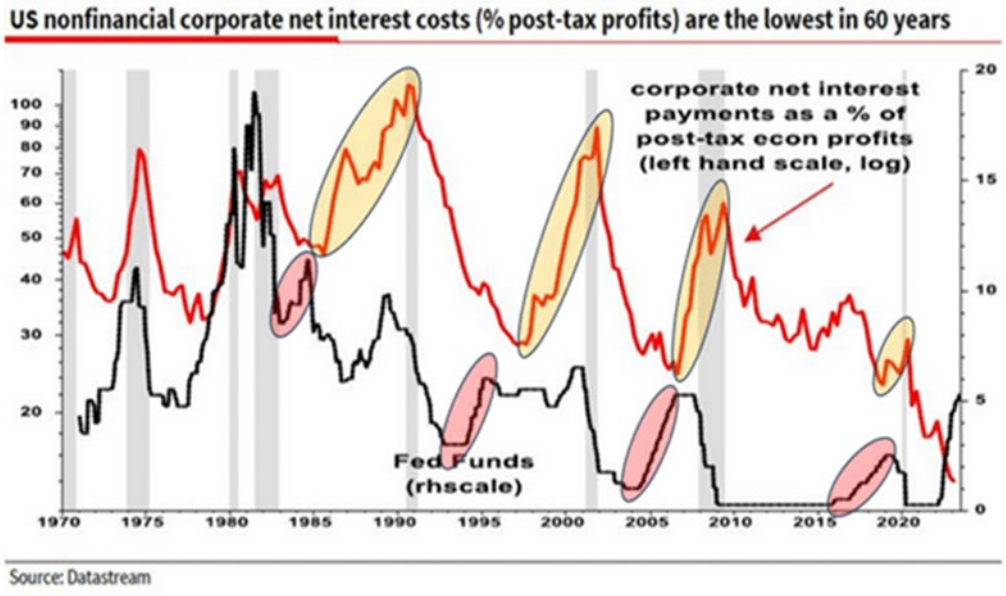


The Wealth Divide Continues To Widen, In Corporate America Too!

It's been well documented that the easy money policies of the past three years disproportionally benefited the wealthy, as asset values exploded and wealthy Americans own the majority of the assets. And the recent interest rate hikes are exacerbating the wealth divide even further, because while rate hikes can be **very bad for borrowers**, they are **very good for savers**. While the average American has seen their marginal borrowing rates explode, the wealthiest among us are now collecting 5.5% on their cash balances, which are large.

This is just as true in corporate America as it is on Main Street. Net interest payments (interest expense less interest income) have actually plummeted as rates have risen. This is because corporate America has record cash balances on their books, earning 5%+, while the average rate on their debt remains very low (another lag effect). Companies with loads of cash are thriving, while companies that are cash-strapped are (or will soon be) scrambling.

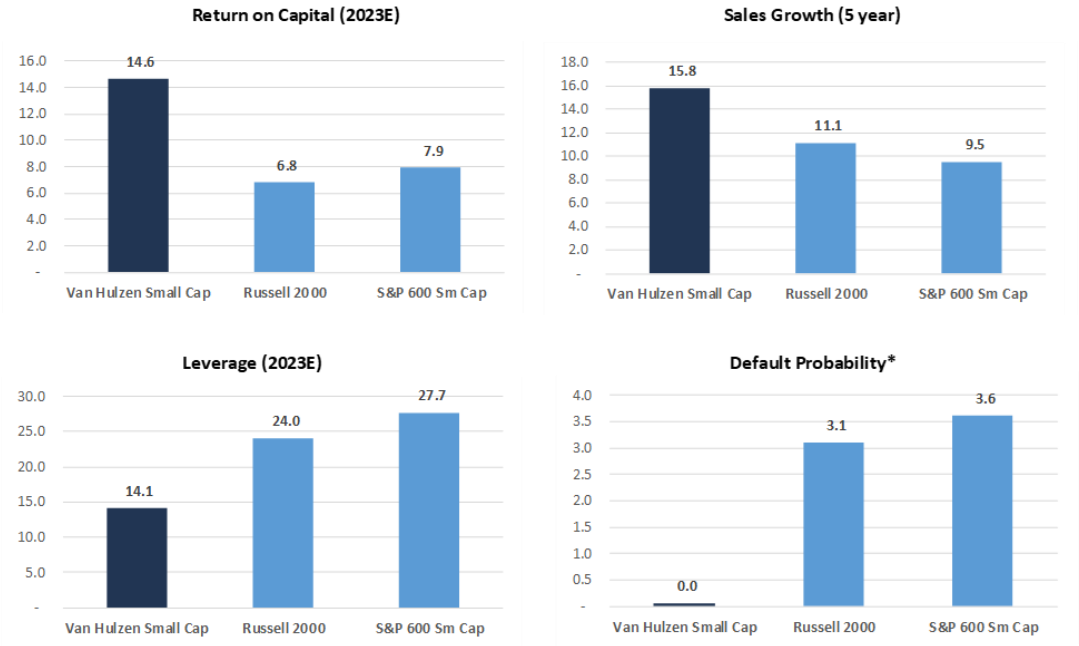
The chart below shows that net interest costs are at 60-year lows, but it also shows this metric tends to rise quickly once a recession hits.



Implications for Small Cap Investing

Simply put, small companies tend to have lower cash balances and more debt. With bankruptcies on the rise and the above-mentioned lag effect looming large, it is critically important that investors tread carefully through the minefield that is small cap land. Should you get out of the market entirely? No, not unless you have a crystal ball to tell you when to get back in. But indexing is no longer the "safe bet" that it's been over the past decade.

And this brings us back to our approach. We insist on quality. Our average holding's ROI is 14.6%, vs 6.8% and 7.9% for the two small cap indices. On top of that, our portfolio's sales growth is higher and leverage and default risk are lower.



Q3 Portfolio Highlights

We had broad representation in the top 5 performers in Q3, while the weakest performers were dominated by the healthcare sector. One of our top performers was CHX, a name we added in Q2 and has already risen 15%. In Q3, we added to our position in SWAV, which had a pullback but has improving relative strength (RSI), which is typically indicative of a turnaround.

TOP 5 PERFORMERS

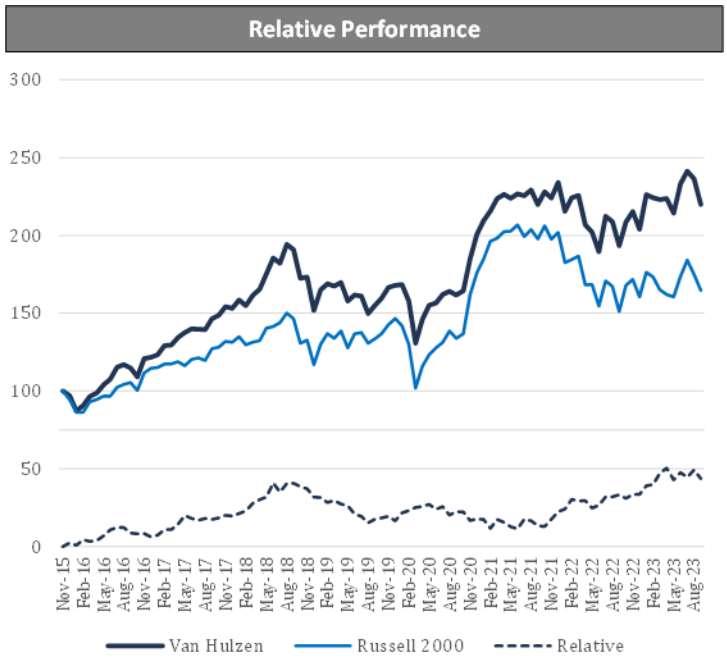
		Return	Description	Actions/Notes
QLYS	Qualys	18.1%	Cybersecurity	
CHX	ChampionX Corp	15.0%	Oil & gas equipment	*Added in Q2*
HLNE	Hamilton Lane	13.7%	Investment banking	
ROCK	Gibraltar	7.3%	Building products	
AIT	Applied Industrial	7.0%	Motion/fluid control	

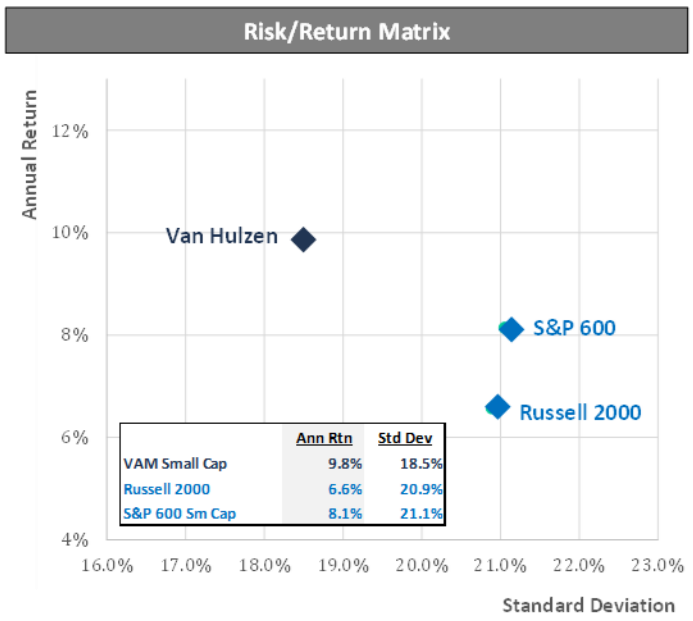
BOTTOM 5 PERFORMERS

		Return	Description	Actions/Notes
SWAV	Shockwave	-32.5%	Medical technologies	*Added in Q3 on pullback*
DGII	Digi International	-31.5%	Open source applications	
HCSG	Healthcare Svcs Corp	-30.1%	Skilled nursing facilities	
ETSY	Etsy	-23.7%	Internet retail	
PCRX	Pacira Pharma	-23.4%	Non-opiod pain meds	

LONG TERM TRACK RECORD

Our strategy is +7.9% so far in 2023, versus +2.5% for the Russell 2000 and +1.7% for the S&P 600. Our risk profile remains significantly lower than our benchmarks (see below, right). This combination results in an Alpha of 4.3%.





Data range: Nov 30, 2015 – Sep 30, 2023
Net of 0.70% management fee

PERFORMANCE & RISK STATISTICS

Performance	VAM Gross	VAM Net	Russell 2000	S&P 600
Month	-7.0%	-7.1%	-5.9%	-6.0%
3 Months	-5.6%	-5.8%	-5.1%	-4.9%
Year To Date	7.9%	7.3%	2.5%	1.7%
1 Year	13.7%	12.9%	8.9%	11.0%
3 Years (annualized)	10.8%	10.0%	7.1%	12.4%
5 Years (annualized)	2.9%	2.2%	2.4%	3.4%
Inception (annualzed)	**10.6%**	**9.8%**	**6.6%**	**8.1%**

Risk Statistics *(since inception)*			
Standard Deviation	18.5%	20.9%	21.1%
Alpha (relative to Russell 2000)	**4.3%**		
Beta	0.8		
Sharpe Ratio	0.3		
Information Ratio	0.5		
Tracking Error	7.8%		

Upside/Downside Capture	
Up capture	94%
Down capture	80%
Ratio	**1.2**

TOP TEN HOLDINGS

As of September 30, 2023, the top 10 holdings are as follows:

Company	Business description	Weight	Size ($mm)
Gibraltar Industries (ROCK)	Building products for solar	5.0%	1,900
Qualys (QLYS)	Cyber security	6.0%	5,800
Applied Industrial (AIT)	Motion, fluid & power control	4.7%	6,300
SP Plus (SP)	Parking & travel svcs	4.5%	1,000
ChampionX Corp (CHX)	Oil & gas equipment	3.7%	6,600
Pentair (PNR)	Flow technologies	3.3%	9,600
Match (MTCH)	Online dating services	3.3%	9,400
The Bancorp (DE)	Regional bank	3.2%	1,800
CSW Industrials (CSWI)	Building products	3.2%	2,700
Addus HomeCare (ADUS)	Personal home care	3.1%	1,300

Key Takeaways

- Quality has rarely mattered more than it does today
- Small cap land is cluttered with land mines, meaning simple indexing is no longer a great solution
- After this rebound run in Big Tech, we believe small cap stocks will perform better in the next decade than they did in the past decade. The small cap category performs better over the long run, and we expect this trend to return eventually. The category is very cheap relative to large caps today, but the small cap space is full of land mines. We believe quality will continue to matter more than ever.
- Our portfolio is significantly advantaged compared to the small cap indices. Our holdings have higher ROIs, higher sales growth and lower debt.
- We are ready for whatever the market throws at us.

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

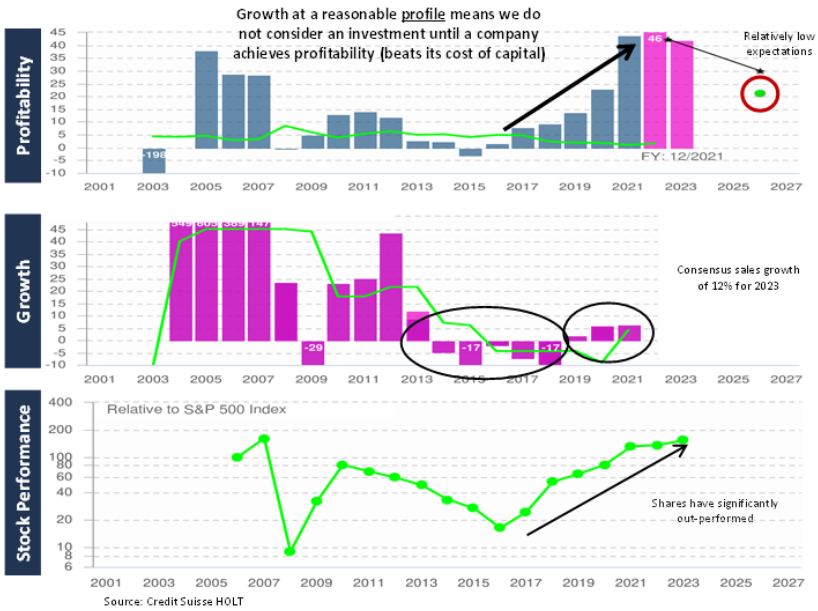
Our strategy is well diversified, with a max position size of 6% and broad representation across sectors. We believe in long term value creation based on a disciplined capital allocation process. A handful of lucky concentrated bets is not the path to achieving long-term goals. We target companies with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



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

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