Investment Commentary: Small Cap Q4 2023

Quality Drives Strong Results in 2023 & Beyond

Stocks finished the year in epic fashion, with the S&P 500 following up its third quarter's -3.3% return with +11.7% in Q4 and the Russell 2000 following up its -5.1% Q3 return with a whopping +14.0%! The theme of Q4 was a Fed pivot, as markets quickly began pricing in 2024 rate cuts. It wasn't the highest quality rally, but we held our own nonetheless, turning in a +13.7% return for the fourth quarter.

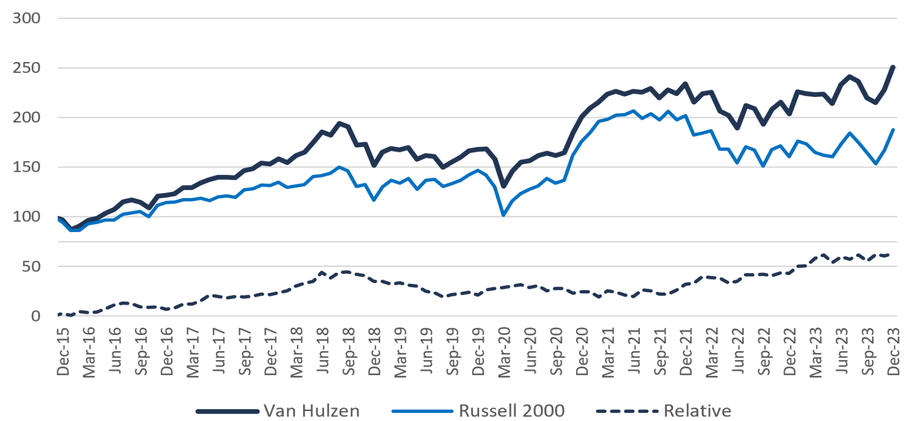
For the full year, our small cap strategy returned +22.7% (gross of fees), versus 16.9% for the Russell 2000. In the two years since the market top (Dec 2021), we are +6.9% versus -7.0% for the Russell. And our standard deviation remains consistently lower than that of the index (18.6% vs 21.3%).

It has also been a strong start to 2024, although the category has been weak as investors have piled back into Big Tech this year. Through the first 3 weeks of the new year, we are 201 bp ahead of the Russell.

Long Term Relative Performance

Since inception (December 2015), our strategy has delivered a 12.0% return (gross), versus 8.1% for the Russell 2000. At a 13% lower standard deviation, this equates to an annual **Alpha of 4.5%**.

PERFORMANCE *(net of 0.70% fee)*



PERFORMANCE & RISK STATISTICS

Performance	**VAM Gross**	**VAM Net**	**Russell 2000**	**S&P 600**
Month	9.7%	9.6%	12.2%	12.8%
3 Months	13.7%	13.5%	14.0%	15.1%
Year To Date	22.7%	21.8%	16.9%	17.0%
1 Year	22.7%	21.8%	16.9%	17.0%
3 Years (annualized)	7.6%	6.9%	2.2%	7.6%
5 Years (annualized)	10.5%	9.7%	9.9%	11.2%
Inception (annualzed)	**12.0%**	**11.2%**	**8.1%**	**9.8%**

Risk Statistics *(since inception)*			
Standard Deviation	18.6%	21.3%	21.3%
Alpha (relative to Russell 2000)	**4.5%**		
Beta	0.8		
Sharpe Ratio	0.4		
Information Ratio	0.5		
Tracking Error	7.9%		

Upside/Downside Capture	
Up capture	92%
Down capture	79%
Ratio	**1.2**

Portfolio Highlights

The fourth quarter differentiated itself from the rest of the year with its wider market breadth, in large cap land as well as small cap land. We saw broad sector representation amongst our top performers, as shown below. Only five of our 39 holdings had a negative return in Q4. They are shown below, as well. This expanded participation could potentially bode well for the overall market going forward.

TOP 5 PERFORMERS

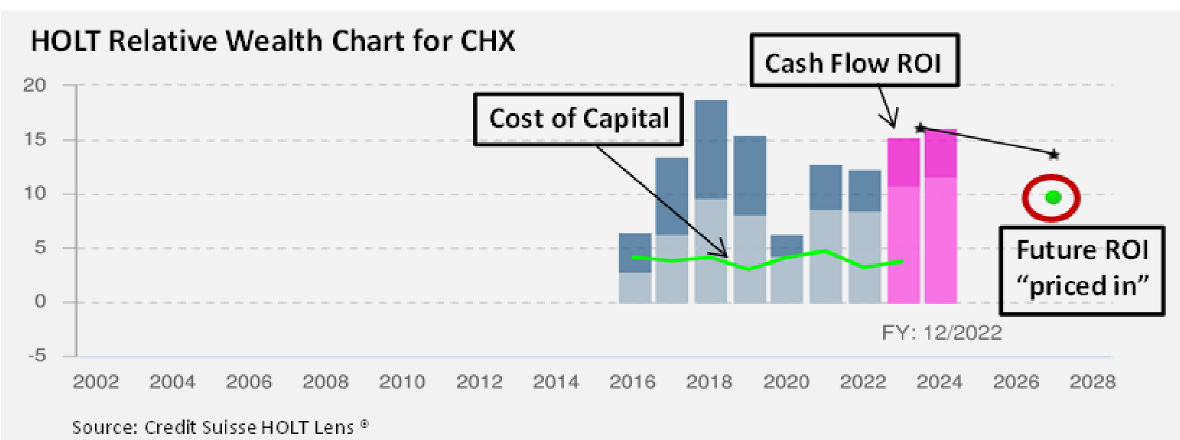
		Return	Description	Actions/Notes
ACAD	Acadia Pharma	51.8%	Biopharma	*Added in Q4*
AX	Axos Financial	43.2%	Regional banking	*Trimmed in Q4*
SP	SP Plus	42.7%	Parking services	*Acquired in Q4*
FIVE	Five Below	32.5%	Retail stores	*N/A*
AZEK	AZEK Company	28.8%	Building materials	*Trimmed in Q4*

BOTTOM 5 PERFORMERS

		Return	Description	Actions/Notes
CHX	ChampionX Corp	-17.8%	Oil & gas equipment	
MTCH	Match Group	-7.5%	Online dating	*Trimmed in Q4*
SWAV	Shockwave	-4.5%	Medical technologies	*Trimmed in Q4*
DGII	Digi International	-3.7%	Open source IOT apps	
SITE	SiteOne Landscaping	-0.6%	Landscape supply	

Deep Dive on ChampionX (CHX)

Our worst performer in Q4 was ChampionX Corporation (CHX). ChampionX provides production chemicals, corrosion technologies and engineered equipment to the oil & gas industry. The company has a "best in class" ROI (significantly higher than even SLB & HAL), thanks to its excellent capital efficiency. The entire energy sector had a tough Q4 as oil prices dropped by more than 25% in the quarter. But we see this as a buying opportunity for a name like CHX and are adding to our position in Q1. The historical and projected ROIs are presented below, along with the ROI that is currently "priced into" the stock at today's price. Expectations look incredibly low compared to the Company's historical track record.

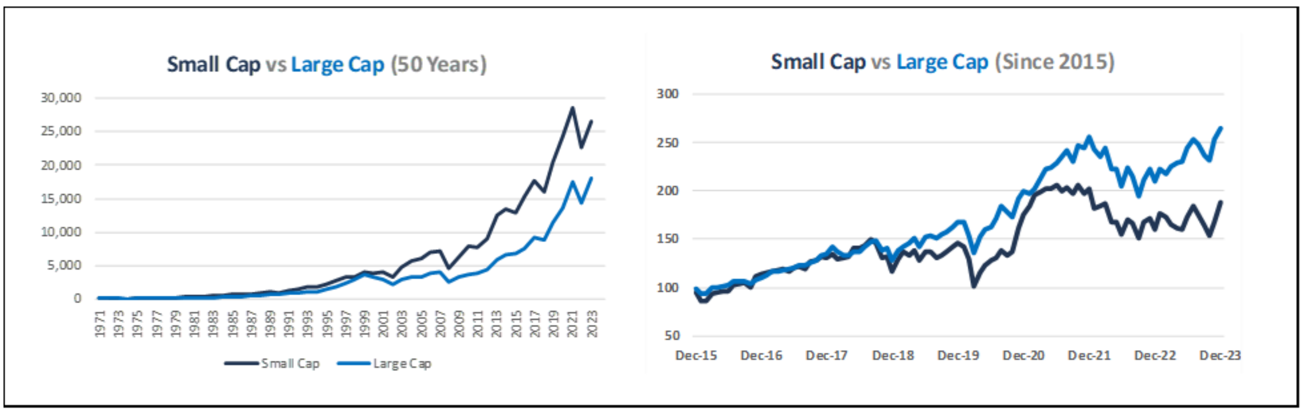


Macro Outlook: Quality Matters More Than Ever

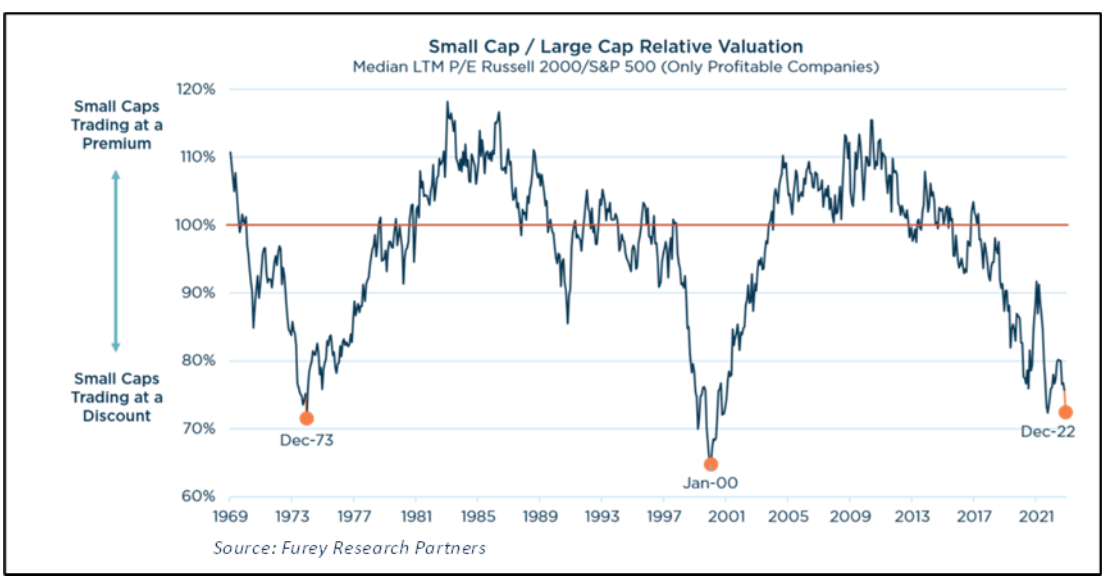
There's no question that fundamentals are weakening. This is especially true for smaller companies, which often carry more debt than their larger counterparts and have less pricing power. This means stock selection is more important than ever.

Small Cap Valuations

Before we get into the challenging environment, we want to highlight the opportunity that small caps have in the coming decade. While small caps have outperformed large caps over the long run, they have significantly underperformed over the past decade. The following chart shows the Russell 2000 compared to the S&P 500 over the last 50 years as well as since the inception of our strategy (December 2015). Over the past 8 years, the Russell has delivered an 8.1% return versus 12.8% for the S&P. This is an unusually large spread, and history suggests this kind of divergence typically mean-reverts rather quickly. So there is an opportunity in small caps for sure. But with higher rates a near certainty (next decade vs last decade), not all companies will fare well. Many will likely do very poorly.

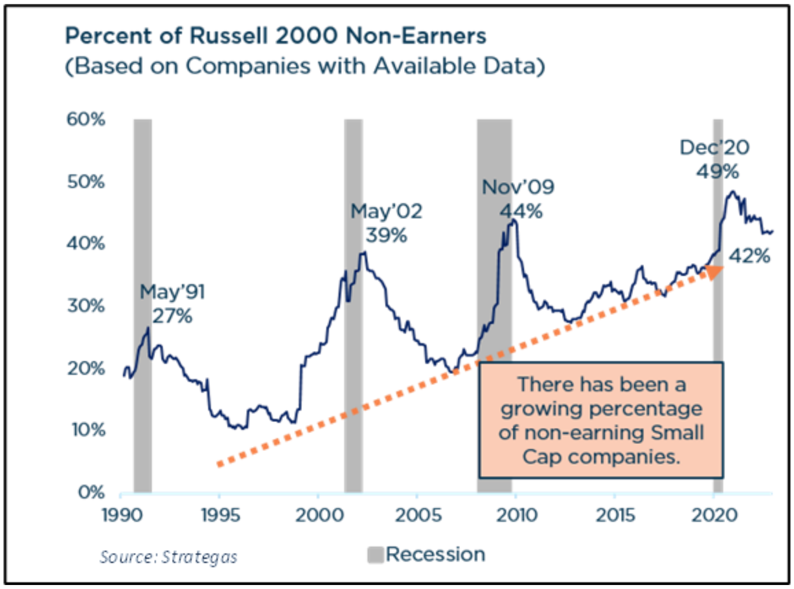


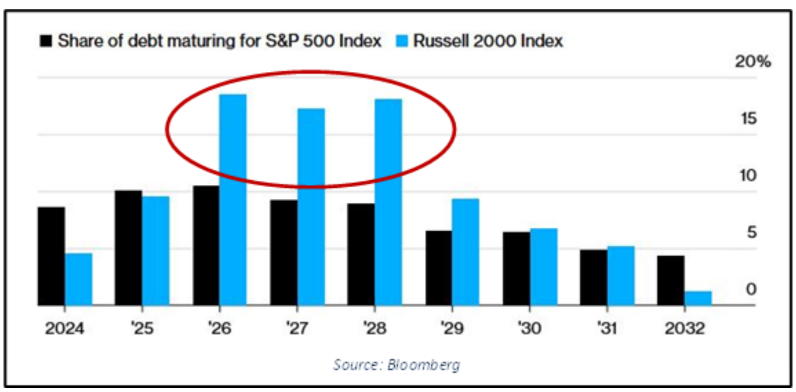
Presented another way, it becomes clear that small caps are about as cheap (relative to large caps) as they have been in the last 50 years. In fact, only at the peak of the 2000 tech bubble were they cheaper on a relative basis. Historically, small caps have done incredibly well in the decade following these levels of divergence. This is an opportunity.



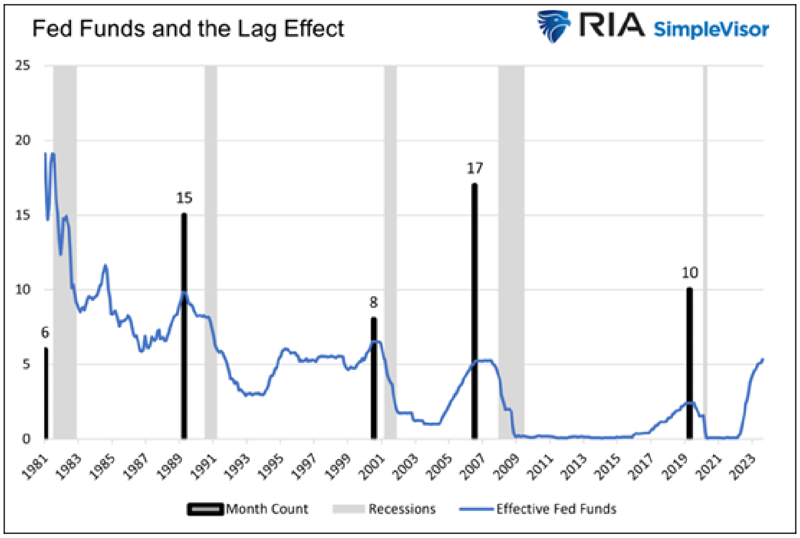
Challenging Macro Environment

1. **Small Cap Profitability**. More than 30% of the companies in the Russell 2000 are unprofitable. As shown in the chart below, this percentage ebbs and flows based on economic cycles and is actually poised to increase in the coming years. The number of "zombie companies" (companies that cannot afford their interest expense) is expected to explode higher as companies are forced to refinance their debt at higher rates. This has already begun, but the largest wave is expected between 2026-2028 (second chart below).

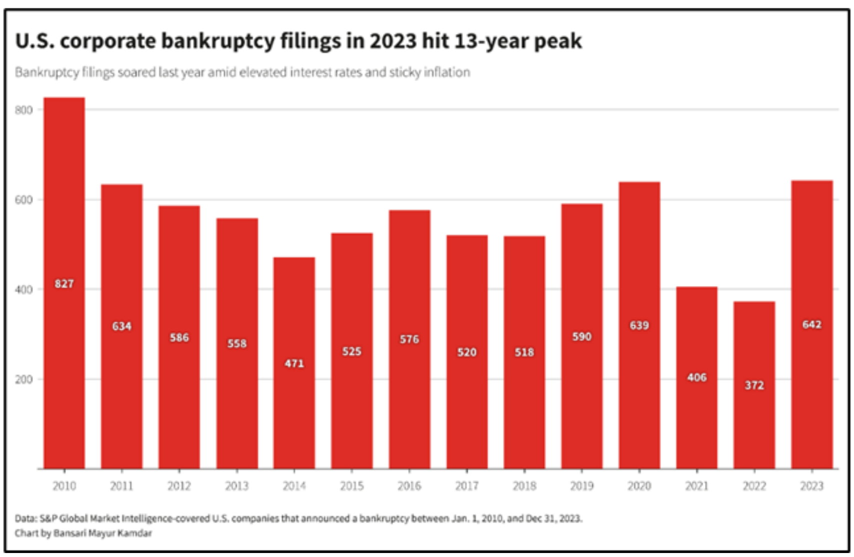




2. **Recession Looming?** Where is the recession everyone has been calling for over the last year? Despite surging interest rates, there were few signs of distress amongst corporate borrowers in 2023. This is because most companies locked in low rates over the past three years and have not had to scramble 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. This implies we may see a recession in **mid-2024**. Or, given how many companies locked in low rates just 2-3 years ago, even later. But it will come eventually.



3. **Bankruptcies.** A key component of an oncoming recession is corporate bankruptcies. Bankruptcies surged in 2023 and have now surpassed peak levels from the COVID pandemic of 2020, when the world shut down. See below. This is a space to watch carefully.



Implications

Does this mean you should avoid the small cap category? On the contrary, many names in the small cap space could be poised for spectacular performance. But **quality is not optional** in this environment. It's a matter of finding the gems and avoiding the higher risk companies that are unprofitable and/or highly speculative. This is not easy. It requires a higher level of due diligence than most large cap strategies. Managers need a disciplined process to differentiate between the strong and the weak. As you know by now, we have such a process. We do not speculate and insist on rock solid balance sheets in our holdings, with no tolerance for credit risk.

Over the past 8 years, we have demonstrated that we can outperform in both strong and weak markets, delivering an average annual alpha of 4.5%. And we are very well positioned for the next decade.

TOP TEN HOLDINGS

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

Company	Business description	Weight	Cap ($mm)
Qualys (QLYS)	Cyber security	5.6%	7,000
Gibraltar Industries (ROCK)	Building products for solar	5.4%	2,400
Addus HomeCare (ADUS)	Personal home care	4.8%	1,500
Applied Industrial (AIT)	Motion, fluid & power control	4.5%	6,600
Acadia Pharma (ACAD)	Biotech	4.4%	5,000
Pentair (PNR)	Flow technologies	3.3%	11,700
Etsy (ETSY)	Online retail	3.3%	9,700
Texas Roadhouse (TXRH)	Restaurants	3.2%	7,900
CSW Industrials (CSWI)	Building products	3.2%	3,200
Bancorp, DE (TBBK)	Regional banking	3.2%	2,100

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 $1-5 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.

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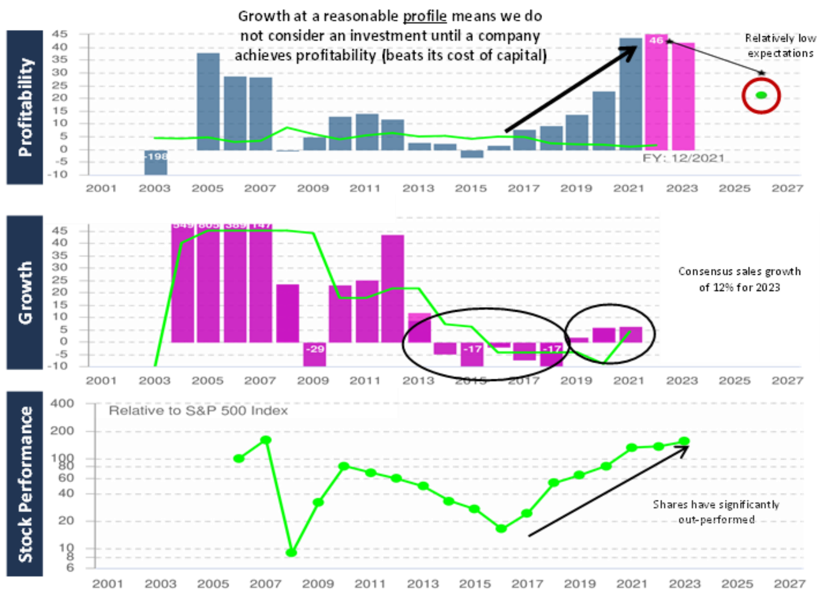
Investment Process: Small Cap Example (CROX)



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

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