Investment Commentary: Small Cap Q1 2024

Navigating The Small Cap Minefield

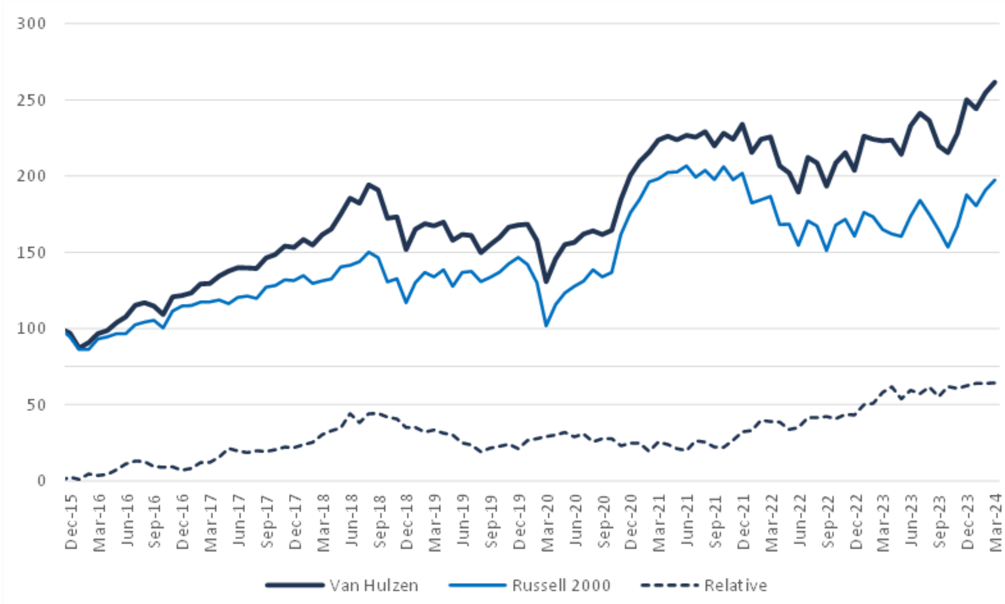
We've discussed the challenges of small cap investing in past commentaries. We've noted that 42% of Russell 2000 companies are unprofitable, many are grossly over-levered, and bankruptcies are rising. And we've concluded that **Quality Is not Optional** in this market environment. We will revisit these themes later in this commentary as well.

But first we want to focus on another factor that is less widely known: Just as S&P 500 performance has been driven largely by the AI stocks over the past 18 months, the performance of the Russell 2000 has been heavily skewed by its top 2 holdings. As of March 2024, the top two stocks in the Russell 2000 are Super Micro Computer (SMCI) and MicroStrategy (MSTR). These two stocks, which are effectively proxies for AI and bitcoin, are 3.6x larger than the third and fourth stocks in the index and are up +257% and +164% year to date so far in 2024. Over the past two years, these two stocks are +1,130% and +1,015%, respectively.

So while the Russell 2000 (market cap weighted) turned in 5.2% return in Q1, the index is actually negative YTD once you remove SMCI and MSTR, which have contributed approximately 6% to the index return. This is supported by the YTD performance of the Russell 2000 equal weight index: -0.5%. In contrast, our strategy (which owns neither of these large, speculative stocks) turned in a **+4.6% return in Q1**. Our insistence on quality has driven this strong performance.

Long Term Relative Performance

Since inception (December 2015), our strategy has delivered a 12.2% return (gross), versus 8.5% for the Russell 2000. Once you incorporate our lower standard deviation (18.4% vs 21.2% for the Russell), this equates to an annual **Alpha of 4.4%**.



Portfolio Highlights

Market breadth continued to improve in Q1, in large cap land as well as small cap land. We saw broad sector representation amongst our top performers, as shown below. Our top five performers include companies in the MedTech, footwear, building materials, restaurant, and energy sectors. Our weakest names were in the biopharma and retail sectors, which is consistent with broader sector themes for 2024. While small caps in general continue to show weakness, the expanded participation we see amongst our top winners could potentially bode well for the overall market going forward.

TOP 5 PERFORMERS

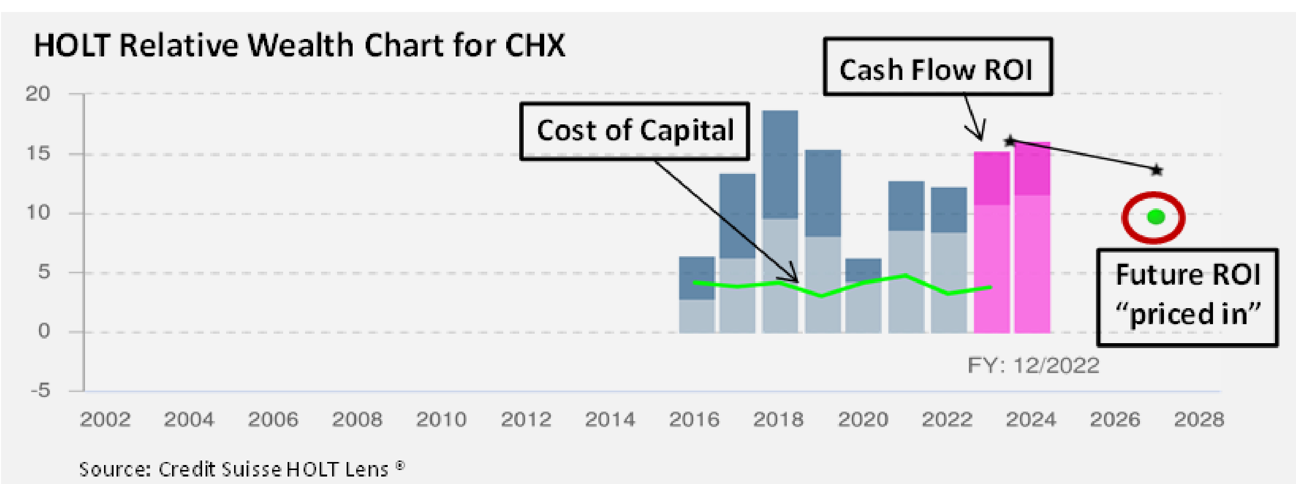
		Return	Description	Actions/Notes
SWAV	Shockwave	71.9%	Medical technologies	*JNJ in discussions to acquire*
CROX	Crocs	53.9%	Casual footwear	-
AZEK	AZEK Company	31.3%	Building materials	-
TXRH	Texas Roadhouse	27.1%	Restaurants	*Trimmed in Q1*
CHX	ChampionX Corp	23.3%	Oil & gas equipment	*Schlumberger to acquire*

BOTTOM 5 PERFORMERS

		Return	Description	Actions/Notes
ACAD	Acadia Pharma	-40.9%	Biopharma	-
PCRX	Pacira Pharma	-17.0%	Non-opiod pain medications	-
FIVE	Five Below	-16.3%	Discount retail	*Trimmed in Q1*
ETSY	Etsy	-15.2%	Online retail	-
QLYS	Qualys	-14.9%	Cyber security	-

ChampionX (CHX) Lookback

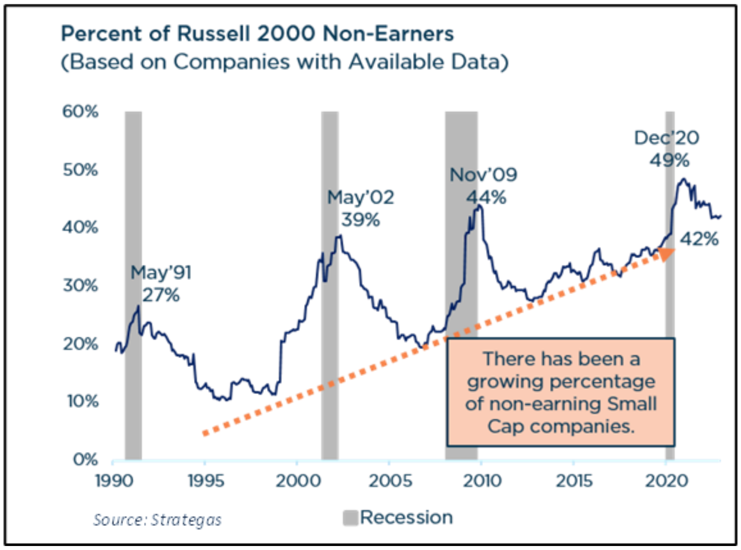
We did a deep dive on CHX last quarter, highlighting its "best in class" ROI (significantly higher than even SLB & HAL) and attractive valuation. See screen shot below. Well, we weren't the only ones who noticed this, as just two days ago Schlumberger announced an agreement to acquire the business. And another holding (SWAV) recently received an acquisition bid from JNJ. We believe this highlights the relevance of our process in the acquisition space, as acquiring companies are likely using similar quality parameters in their process.

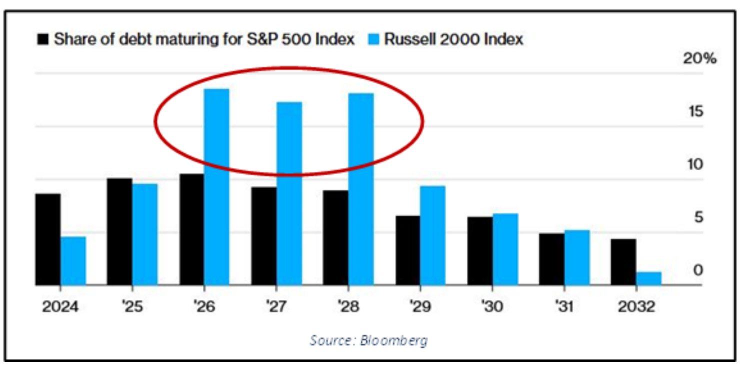


Small Cap Outlook: The "Minefield"

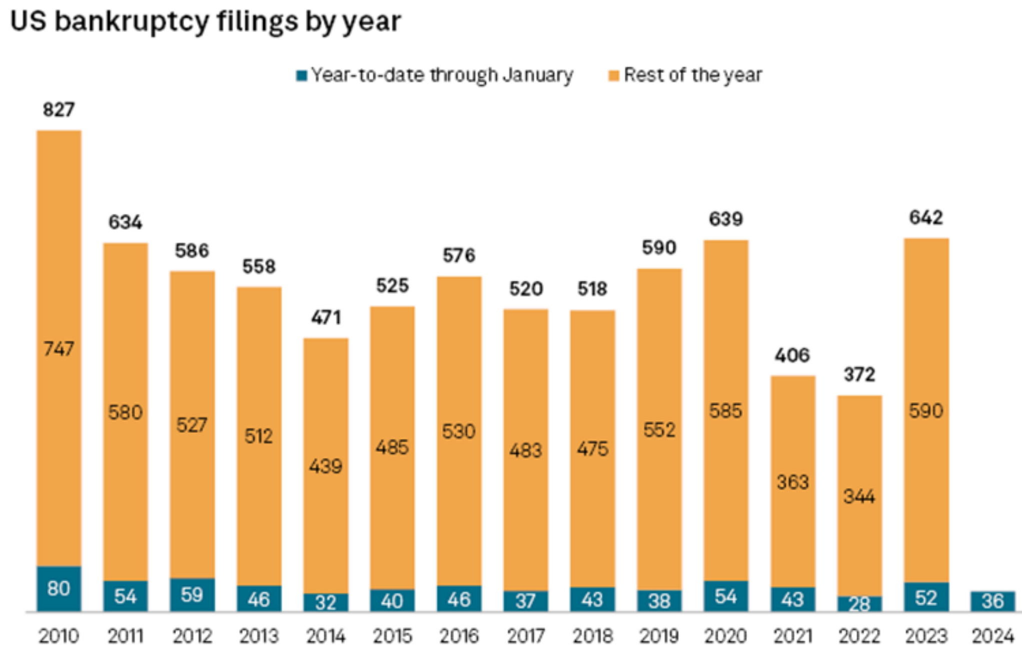
We've established that small cap stock performance has been sub-par, particularly once you remove the top two stocks in the index (AI & bitcoin plays). And there's no question that fundamentals in the small cap space leave a lot to be desired. Smaller companies often carry more debt than their larger counterparts and have less pricing power. This means stock selection is more important than ever.

1. **Small Cap Profitability**. More than 42% 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 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).





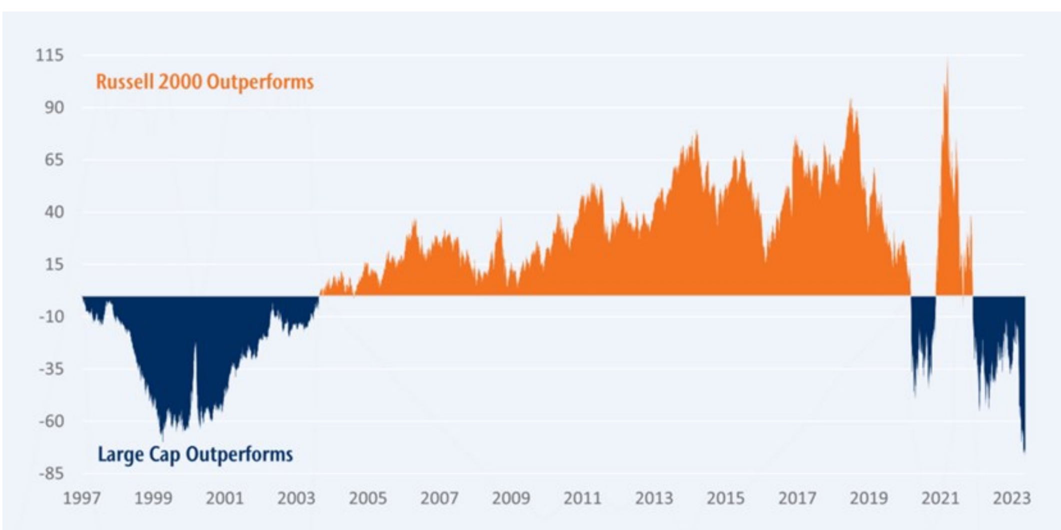
2. **Bankruptcies**. A key component of an oncoming recession is corporate bankruptcies. Bankruptcies surged in 2023 and surpassed peak levels from the COVID pandemic of 2020, when the world shut down. See below. The first few months of 2024 have been better than 2023, but clearly this is a space to continue to watch carefully.



Source: S&P Global

The Opportunity: Small Cap Valuations More Depressed Than In 1999

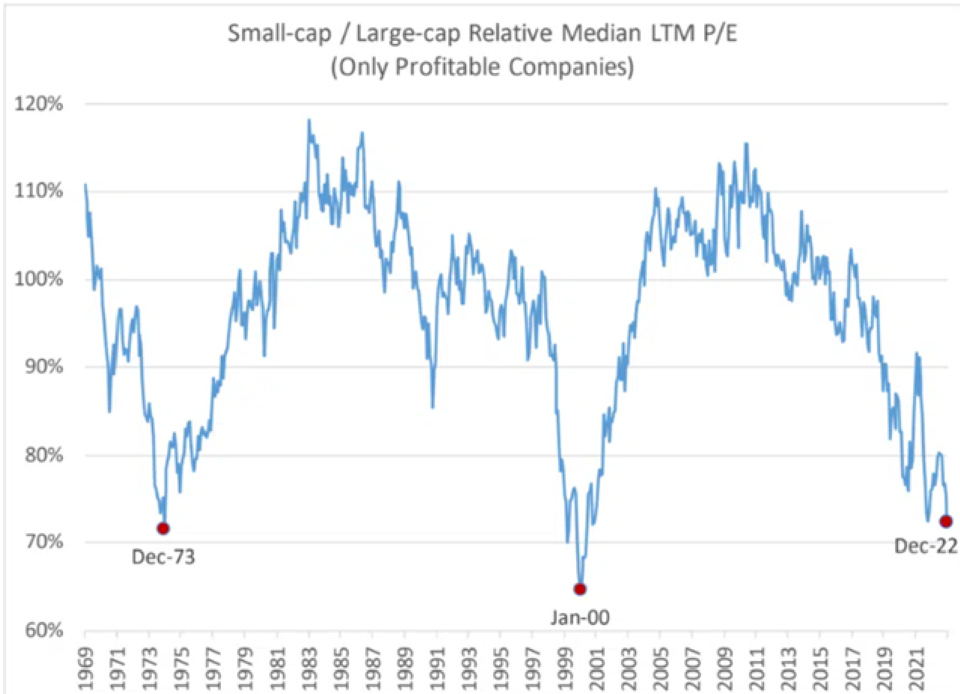
Despite the challenging fundamentals, there is a real opportunity in the small cap market in the coming decade. While small caps have outperformed large caps over the very long run, they have significantly underperformed since 2019. According to the following charts, large caps seem due to underperform, creating an opportune environment for small-cap leadership. It seems only a matter of time before another transition occurs. But with higher rates a near certainty (next decade vs last decade), not all companies will fare well. Many will likely do very poorly.



Source: Global Alpha Capital

SMALL-CAPS ARE CHEAP RIGHT NOW

The Russell 2000 is trading one standard deviation below its average valuation over the last 35 years. It is also trading at historically low levels vs large-caps. This past October, small-cap stocks traded at 72% of the value of large-cap stocks on LTM P/E, which is very close to the previous small-cap lows at similar levels in 1973 and 2000.



Source: Riverwater Partners

Implications

Given the spike in bankruptcies and the number of unprofitable "zombie" companies, one might be tempted to avoid the small cap category altogether. We believe this would be a mistake. But we do believe you must be choosy in your stock selection. There are many names in the small cap space that we believe are 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. No zombies. No bankruptcies. Just competitively advantaged businesses with above average profits and growth. Tomorrow's large caps.

Over the past 8 years, we have demonstrated that we can outperform in both strong and weak markets, delivering an average annual alpha of 4.4%. And we are very well positioned for the next decade.

PERFORMANCE & RISK STATISTICS

Through March 2024

Performance	VAM Gross	VAM Net	Russell 2000	S&P 600
Month	2.8%	2.7%	3.6%	3.2%
3 Months	4.6%	4.4%	5.2%	2.5%
Year To Date	4.6%	4.4%	5.2%	2.5%
1 Year	17.3%	16.4%	19.7%	16.9%
3 Years (annualized)	5.4%	4.6%	-0.1%	2.6%
5 Years (annualized)	9.3%	8.6%	8.1%	9.3%
Inception (annualzed)	**12.2%**	**11.5%**	**8.5%**	**9.8%**

Risk Statistics *(since inception)*	VAM Gross	VAM Net	Russell 2000	S&P 600
Standard Deviation	18.4%		21.2%	21.1%
Alpha (relative to Russell 2000)	**4.4%**			
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**

Performance period: 11/30/2015 – 3/31/2024
Net returns are net of 0.70% average management fee

TOP TEN HOLDINGS

As of March 31, 2024, the top 10 holdings are as follows:

Company	Business description	Weight	Cap ($mm)
ChampionX (CHX)	Oil & gas equipment	5.4%	7,440
Addus HomeCare (ADUS)	Personal home care	5.2%	1,660
Qualys (QLYS)	Cyber security	4.6%	6,130
Applied Industrial (AIT)	Motion/fluid/power control	4.0%	7,530
Crocs (CROX)	Casual footwear	4.0%	8,380
Inter Parfums (IPAR)	Perfumes	3.8%	4,160
Gibraltar Industries (ROCK)	Building products for solar	3.8%	2,390
Digi Intl (DGII)	Open source software	3.6%	1,160
CSW Industrials (CSWI)	Building products	3.5%	3,570
ShockWave Miedical (SWAV)	MedTech vascular/coronary	3.2%	11,090

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.

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