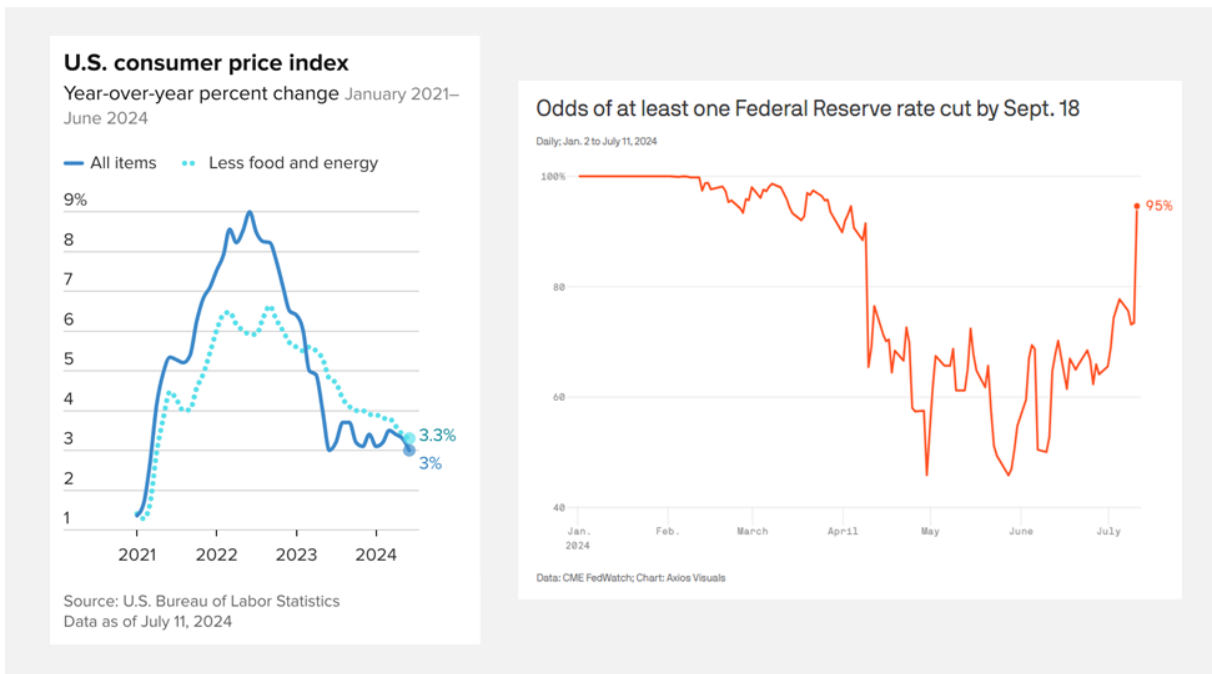


Investment Commentary: Small Cap Q2 2024

Will the Small Cap Rally Hold?

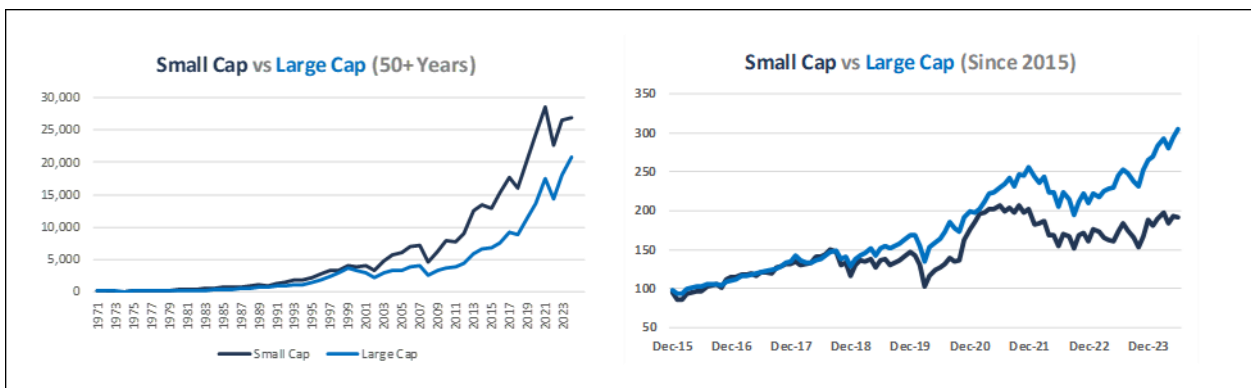
A positive inflation report in early July provided rocket fuel for small caps, as the odds of the Fed cutting rates in the coming months skyrocketed to 95%. The Russell 2000 gained 11% in a matter of days, with many of the most over-levered stocks leading the charge. Generally speaking, large caps did not participate in this early July rally. Large caps, and particularly the big tech names, have outperformed small caps by such a huge margin in recent years that many hoped this was the “catch-up” trade the market needed. We shall see.

Rate cut odds surged as inflation concerns waned



Growing disconnect between large caps & small caps

Prior to this July rally, the Russell 2000 index had turned in a paltry 1.7% return in the first half, compared to 15.3% for large caps. And, while small caps have traditionally outperformed large caps over the long run (see below, left), it has been a very different story over the past 6-7 years (below, right).



Market Strategists Abandon S&P 500 Targets, calling them “no longer useful”

Market commentators love to make predictions. But Piper Sandler & Co recently eliminated its price target for the S&P 500, saying the index is being driven by just a handful of heavily weighted stocks and targets are therefore no longer very useful. And Bloomberg analyst Jonathan Levin hopes more firms follow suit.

We are not market timers, but headlines like this are a little concerning and often do not bode well for markets. Let's take a deeper look...

Big Tech Dominance

Chart 3: Magnificent 7 account for 31% of S&P 500 market cap
“Magnificent 7” market cap, as a % of S&P 500



Source: BofA Global Investment Strategy, Bloomberg. Magnificent 7 = Apple, Amazon, Google, Meta, Microsoft, Nvidia, and Tesla

BofA GLOBAL RESEARCH

Big Tech continues its dominance, with the Top 7 stocks now accounting for 31% of the market cap of the S&P 500. That's an average weighting of 4.4% for these top 7 names, versus 0.1% for the other 493 stocks in the index. NVDA is a huge driver of this trend, of course, with its 150% YTD return and 7% S&P weighting.

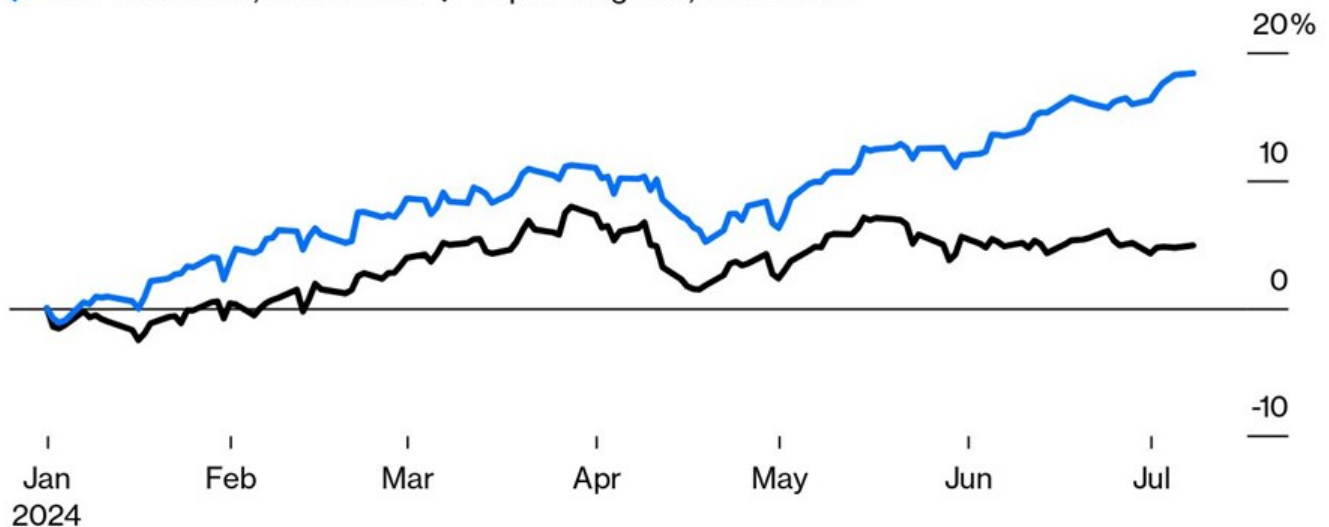
Market Cap Weighted vs Equal Weighted

Based on the above, you would expect the market cap weighted S&P 500 index would outperform the equal weighted index. And it has...to the tune of 10.2% through June 30 (15.3% vs 5.1%).

Top Heavy

The capitalization-weighted S&P 500 is outperforming its average stock

— S&P 500 Index, total return — Equal-weighted, total return



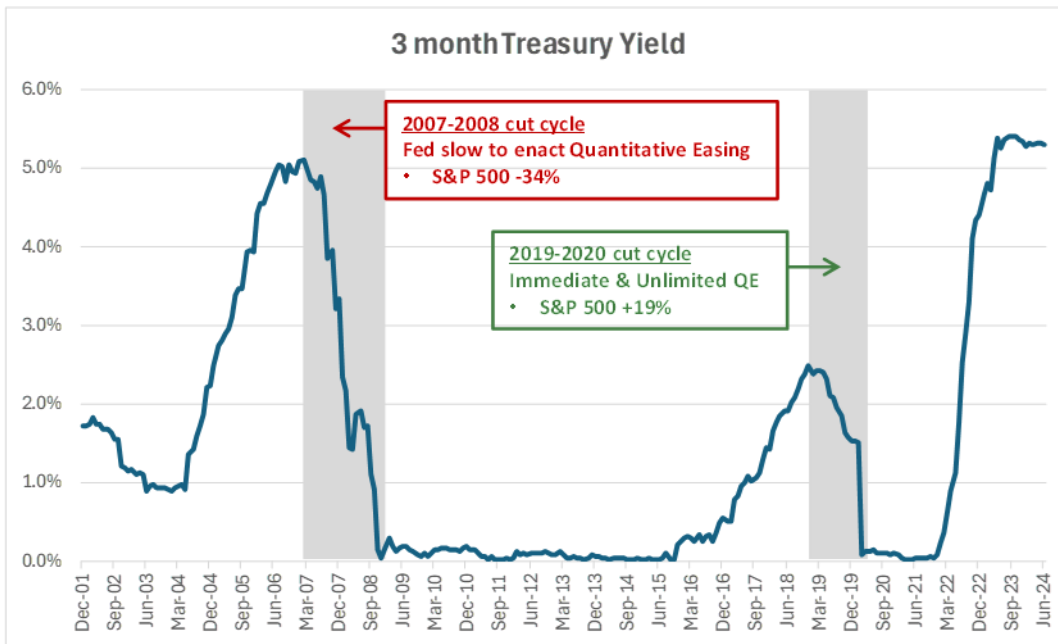
Source: Bloomberg

Bloomberg Opinion

Outlook: Rate Cuts On The Horizon

There's no doubt that much of the current rally can be attributed to the expectation of rate cuts and potential quantitative easing. Inflation came in at 3.0% this month, very close to achieving the 2 handle the Fed wants to see. And the jobs market is slowing, strengthening the case for cuts. After the inflation reading, the probability of a rate cut by September soared to 95%.

There is still much debate about how this will affect markets, however. Some analysts say cuts only arrive in response to economic weakness/recession, and that's bad for markets. Others say it's a signal that the Fed is willing to step in and save the day. Both have been true in recent years (see chart below). In our view, it's all about how the Fed responds to the slowing economy. And by this we mean QE, not the actual rates themselves. When we dipped into recession in 2008-09, the Fed was slow to enact QE (quantitative easing) and the market **declined 34%** during the 21-month rate cut cycle. In contrast, the Fed turned the spigots on immediately when the economy shut down in 2020 and the market **rallied 19%** as a result. See below.



- It's still all about the Fed
- Liquidity (QE) actually matters more than rates
- Slow QE in 2008 crushed stocks, while immediate QE in 2020 fueled rally
- Moderate inflation is typically good for stocks and bad for bonds

Q2 Performance

Our small cap strategy outperformed its benchmark handily in the second quarter. The strategy turned in a +0.2% return for the second quarter, versus -3.3% for the Russell 2000. Year to date, our return was +4.8% through June 30, compared to just 1.7% for the Russell. We are pleased with this result, particularly given the two largest members of the Russell 2000 (SMCI and MSTR) were **both** up more than 180% (!!) in the first half. SMCI is an AI company and MSTR is a proxy for bitcoin. Both names fell out of the Russell at the end of June as the index was rebalanced, but not before they offset much of the true weakness in the category in the first half.

Portfolio Highlights

The portfolio had broad representation in the top 5 and the bottom 5 this quarter. Our weakest name was Five Below, a discount retailer that has been hit by high input costs and the threat of China tariffs. We sold most of this position earlier this year and closed out the remaining 1% in Q2.

TOP 5 PERFORMERS

		Return	Description	Actions/Notes
ACLS	Axcelis Technologies	26.6%	Semi conductors	<i>Added in Q2</i>
LMAT	LeMaitre Vascular	31.4%	Vascular treatments	-
HWKN	Hawkins Inc	18.7%	Specialty chemicals	-
CSWI	CSW Industrials	13.2%	Building products	-
TBBK	The Bancorp (DE)	13.0%	Regional bank	<i>Added in Q2</i>

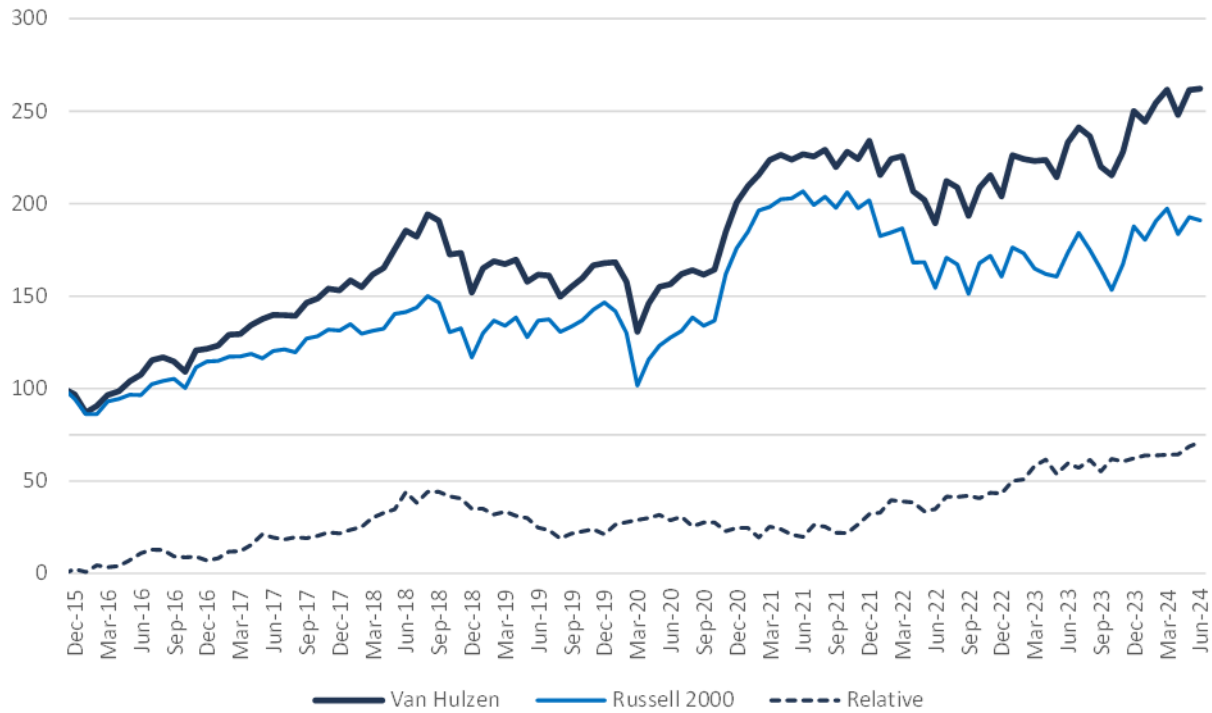
BOTTOM 5 PERFORMERS

		Return	Description	Actions/Notes
FIVE	Five Below	-34.5%	Discount retail	<i>Trimmed in Q1, sold in Q2</i>
DGII	Digi International	-28.2%	Open source IOT apps	-
IPAR	Inter Parfums	-16.9%	Perfumes	-
MTCH	Match Group	-16.2%	Online dating	-
AZEK	AZEK Company	-16.1%	Building materials	<i>Up 31% in Q1</i>

Key Takeaways

- We turned in a strong second quarter in 2024, outpacing our benchmark at lower risk.
- Small caps are due for a catch-up to large caps, and we may have just witnessed the beginning of this new trend. Or maybe not...
- Either way, our continued focus on quality and our disciplined approach to management put us in a great position to succeed in today's uncertain environment.
- Bankruptcies are trending up and expected to continue to rise as companies (particularly small cap companies) are forced to refinance their debts into higher rate debt. Many businesses will struggle in the coming years, but our insistence on quality and aversion to credit risk positions us well.
- We will continue to stick to our knitting. Our portfolio holdings are high quality companies with strong cash flows, low debt and above average growth rates. This approach has created strong alpha (5.2%) for us over the past 8½ years.
- We are ready for whatever the market throws at us.

Long Term Track Record



Alpha

$$a = R_p - [R_f + (R_m - R_f) \beta]$$

R_p = Realized return of portfolio

R_m = Market return

R_f = risk-free rate

β = Beta

Alpha (relative to RUT)

	Russell 2000	S&P 600
R_p	11.9%	11.9%
R_m	7.8%	9.1%
R_f	1.8%	1.8%
β	0.81	0.81
Alpha (relative to RUT)	5.2%	4.2%

Performance	VAM Gross	VAM Net	Russell 2000	S&P 600
Month	0.3%	0.2%	-0.9%	-2.3%
3 Months	0.2%	0.0%	-3.3%	-3.1%
Year To Date	4.8%	4.5%	1.7%	-0.7%
1 Year	12.5%	11.7%	10.0%	8.6%
3 Years (annualized)	5.0%	4.2%	-2.6%	0.0%
5 Years (annualized)	10.2%	9.4%	6.9%	8.2%
Inception (annualized)	11.9%	11.1%	7.8%	9.1%

Risk Statistics (since inception)

Standard Deviation	18.3%		21.1%	21.0%
Alpha (relative to Russell 2000)	4.6%			
Beta	0.8			
Sharpe Ratio	0.4			
Information Ratio	0.5			
Tracking Error	7.8%			

Upside/Downside Capture

Up capture	92%
Down capture	79%
Ratio	1.2

Note: There is no assurance that the Strategy will achieve its investment objectives. Past performance may not be indicative of future results

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.



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

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