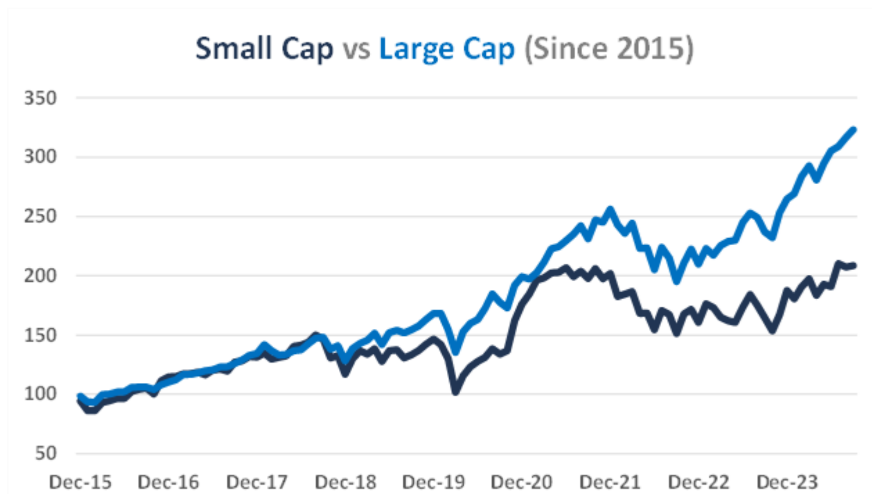
Investment Commentary: Small Cap Q3 2024

Opportunities Abound in Small Cap Land

We believe small caps are attractive relative to large caps, for three simple reasons:

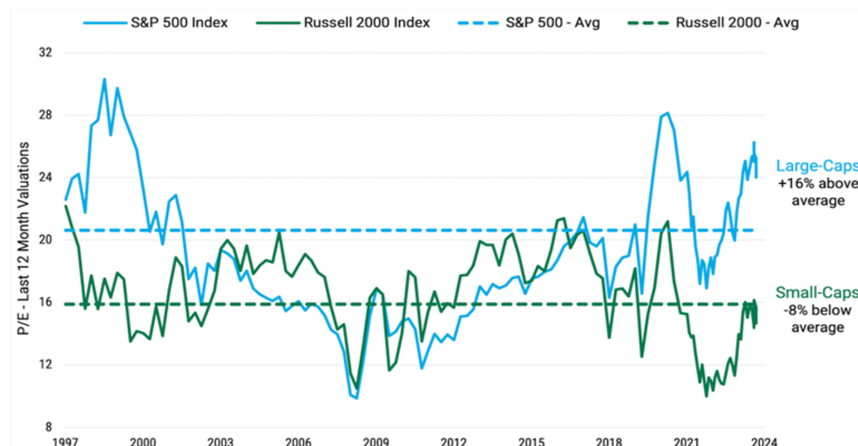
1. There is an extreme disconnect between small cap and large cap valuations
2. We are now in a rate cut cycle, which has historically benefited small caps
3. Deglobalization and onshoring should support smaller US companies



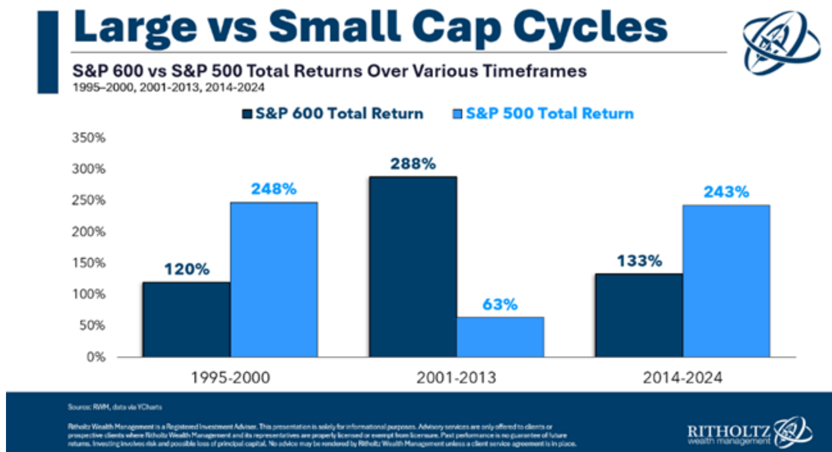
We will discuss each of these below, as well as some key risk factors and how our strategy is advantaged in this environment compared to other small cap strategies.

Extreme valuation disconnect

Large caps have outperformed small caps handily over the past 6 years. See chart below.

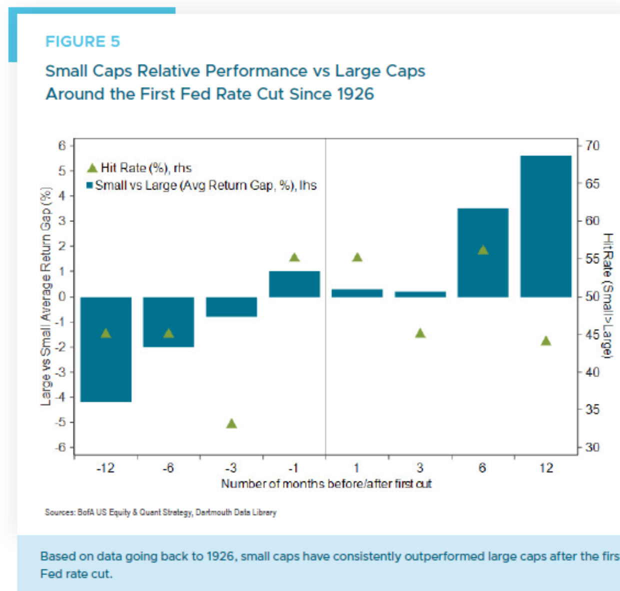


The last time the disconnect was this wide was the late 1990s, and small caps dominated large caps over the next 12 years (288% versus 63%). See below.



Rate cut cycles favor small caps

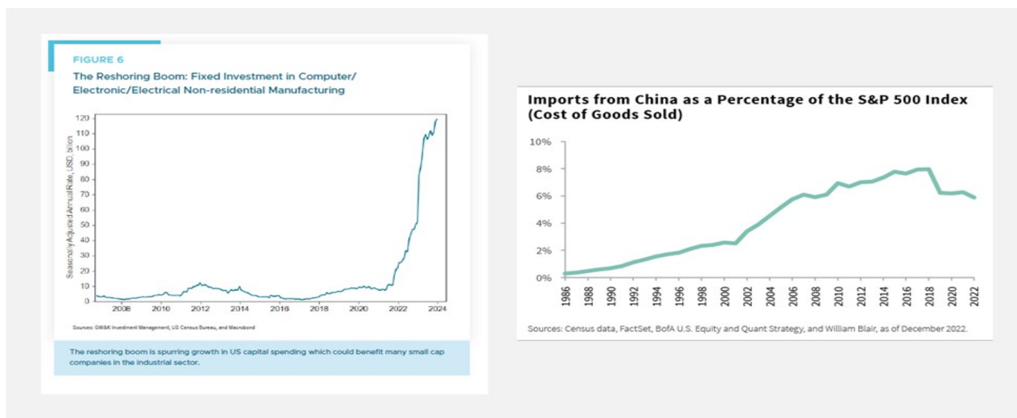
We are now officially in a rate cut cycle, and the data is clear about how this affects small cap performance. According to a BofA study of all rate cuts since 1926, small caps have typically underperformed by an average of 4% over the year preceding the first rate cut and have typically outperformed, by more than 5%, over the next 12 months.



Onshoring to benefit smaller companies

The trend of onshoring/reshoring, or bringing manufacturing back to the US, is expected to continue in the coming years. Small cap companies, particularly those in the industrial and manufacturing sectors, stand to benefit from this shift. Moreover, the anticipated increase in capital spending as businesses invest in expansion and productivity enhancements could provide a boost to small cap earnings.

The impact of this onshoring is already being felt. The chart on the left shows the spike in capital spending on electronics manufactured in the US over the past two years, and the chart on the right shows a corresponding decline in China imports.



Key risk factor: credit risk

We do not expect it to be an equal opportunity environment for small caps in the coming years. Many small companies are over-levered and financially stretched. Bankruptcies, which have been muted over the past few years due to the “lag effect,” are beginning to rise and will once again play a role as companies have to refinance at higher rates. We avoid these types of stocks, despite the fact that they can outperform over short periods like we just saw in July.

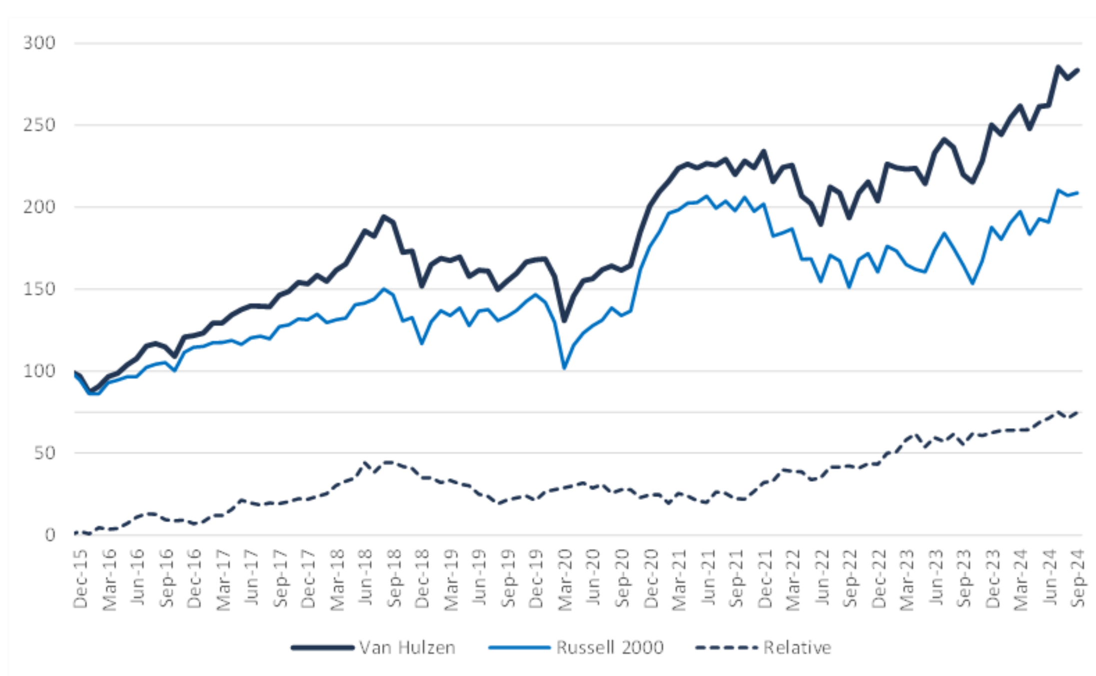
Why Van Hulzen?

The small cap space can be a bit of a mine field. The Russell 2000 is loaded with unprofitable companies, early stage biotechs and regional banks. The average leverage profile is much higher than that of the S&P 500, and a strong, disciplined process is required to navigate and succeed in this space. We have just such a process at Van Hulzen. We insist on the highest quality companies, with strong and improving ROIs, fundamental competitive advantages, and higher than average growth rates. And most importantly, our portfolio companies are profitable business with below average debt profiles and little/no default risk, a stark comparison to our benchmark. It is these factors that have allowed us to significantly outperform our benchmark (annual alpha of 5%+) over the past 8 years and, we believe, will continue to drive performance going forward.

Q3 & Year To Date Performance

Our small cap strategy delivered a return of 8.1% in the third quarter, slightly behind the Russell 2000 (+9.3%). Our underperformance occurred during the "junk rally" in July, when inflation came in lower than expected and the lowest quality small caps outperformed handily on expectations for rate cuts. Over-levered companies tend to outperform during periods like this, and we do not own companies with high leverage and credit risk.

Year to date, our strategy is +13.4% vs +11.1% for the Russell. Since inception, our annualized return is 12.5% vs 8.7% for the Russell. This equates to an annualized alpha of 5.1% once you factor in our lower standard deviation. We attribute our outperformance to our disciplined fundamental research process, which insists on the highest quality holdings with strong Return on Capital, above average growth, and lower than average debt and default probability.



Alpha

a = Rp – [Rf + (Rm – Rf) ß]

	Russell 2000	S&P 600
Rp = Realized return of portfolio	12.5%	12.5%
Rm = Market return	8.7%	10.0%
Rf = risk-free rate	1.8%	1.8%
ß = Beta	0.81	0.81
Alpha (relative to RUT)	**5.1%**	**4.1%**

Portfolio Highlights

Financials led the way in Q3 as expectations for rate cuts quickly got priced into the banks and insurance companies. Three of our top 5 performers in Q3 were financials, with two industrial companies rounding out the top 5. The names are listed below:

TOP 5 PERFORMERS

		Return	Description	Actions/Notes
TBBK	The Bancorp (DE)	41.7%	Regional bank	
BWIN	Baldwin Insurance	40.4%	Insurance broker	
HWKN	Hawkins Inc	40.3%	Speciaty chemicals	
CSWI	CSW Industrials	38.2%	Building products	*Trimmed in Q3*
HLNE	Hamilton Lane	36.8%	Investent bank	

BOTTOM 5 PERFORMERS

		Return	Description	Actions/Notes
PCRX	Pacira Pharma	-47.4%	Biopharma	
ACLS	Axcelis Technologies	-26.3%	Semiconductors	
HAE	Haemonetics	-11.7%	Medtech	*Added in Q3*
CROX	Crocs	-11.0%	Footwear	*Sold in Q3*
QLYS	Qualys	-9.9%	Cyber security	

Key Takeaways

- We turned in a strong third quarter and are ahead of our benchmark YTD, at lower risk
- We believe small caps are due for a period of outperformance relative to large caps, for three specifics reasons
- There is an extreme disconnect between small cap and large cap valuations
- We are now in a rate cut cycle, which has historically benefited small caps
- Deglobalization and onshoring should support smaller US companies
- 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 avoid these over-levered companies
- 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 (nearly) 9years

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.

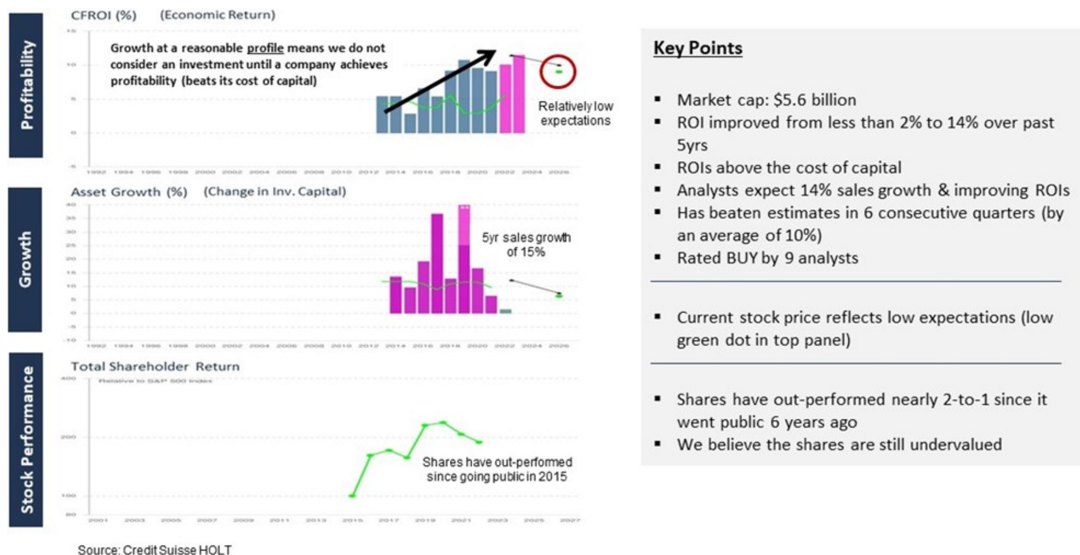
Portfolio Construction

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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