INVESTMENT COMMENTARY: SMALL CAP Q3 2018

October | 2018

Overview

Small caps were red hot in the first half of this year, turning in a 7.7% return and out-performing large caps by nearly 5% through June 30. Q3 was payback time. Large caps came back strong, out-performing small caps by 4.0% in Q3 (7.6% versus 3.6%), as some trade fears subsided. We delivered solid performance in Q3, with a net return of +2.6%. Through September 30, we are +23.7% (net) versus 11.5% for the Russell 2000.

September was actually a highlight for us this quarter, despite being a tough month for small caps in general. We delivered a -1.8% compared to -2.4% for the Russell. This is notable as we have received a lot of questions about how we expect to perform during a pullback, given that the backdrop for our strong track record has been a (mostly) rising market. The Russell also saw a big sell-off in the first two weeks of October, and our strategy saw out-performance of roughly 30 basis points during that period.

Downside Analysis

Through September there have been 13 "down months" (out of 34 total months) since we launched the strategy. Our average return during those months is -1.2% compared to -2.0% for the Russell. Including the first two weeks of October, those numbers become -1.8% and -2.5%. We are defining a down month as one where either our strategy or the Russell had a negative return. There have been 10 months where both were negative.

The max drawdown for the strategy (which occurred during the first three months of the track record) is -12.3% compared to -13.8% for the Russell 2000 and -15.9% for the Russell 2000 Growth Index.

We have certainly demonstrated our upside capture advantage over the past three years. But we also believe our focus on quality and "profitable" growth give us a downside capture advantage.

Macro Factors

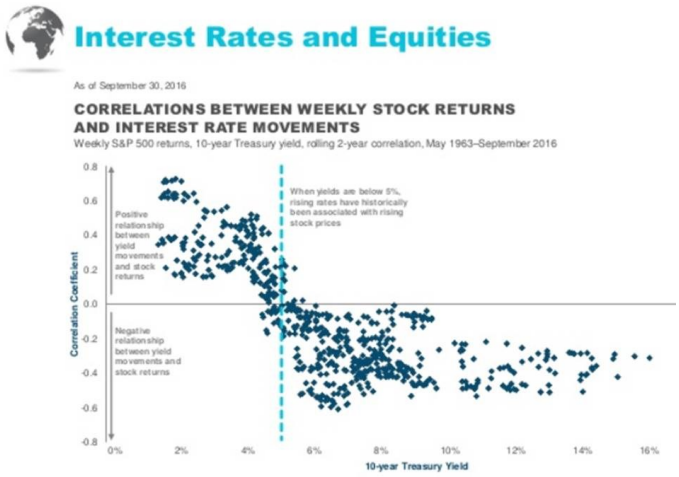
There is a lot of talk of the impact the US-China trade war is having on equities, and there's no question it is a factor. Companies that sell into foreign markets are seeing top line challenges. However, this affects large cap stocks more than small caps, where foreign input costs are a bigger issue than muted foreign sales. After all, only 15% of Russell 2000 sales come from overseas, compared to roughly 40% for the S&P 500. We believe this explains the large cap under-performance in the first half of 2018 as trade wars escalated, and then the "catch up trade" once some of those fears subsided.

But perhaps the biggest macro risk today is the potential for interest rates to rise significantly. We tend to be less worried about this than most, as our portfolio is focused on quality and has much lower average debt ratios than the index. And we believe that stronger balance sheets will be rewarded, on a relative basis, as rates rise. However, we always prefer to look to empirical data rather than relying on a gut feel.

The chart below (left) shows the history of 10 year Treasury yields since 1790. When the 2008 financial crisis hit, interest rates were already in year 26 of their steady decline from the early 1980s peak. This crisis was countered with the largest monetary intervention in history, which included cutting short term rates to near-zero levels. And this rippled its way through the long-term yield curve as well.

After years of anticipation, rates are in fact finally starting to rise (chart, above right). And there is consensus that rising rates will create headwinds for the bond market. They already have. But there is less consensus around the impact on the stock market. Many believe higher rates will weigh on stock returns, as they did in the 1970s, because they increase the overall cost of capital. But it's important to consider that we had runaway inflation in the 1970s, which we do not now. According to a 2016 T. Rowe Price study, when Treasuries are below 5% (as they are now), rising rates have actually been associated with rising stock prices. It's when rates rise above this 5% threshold that additional increases start to negatively impact the stock market. This is interesting food for thought.

We did some more digging and found several studies showing that equities, and particularly small caps, have actually done quite well during periods of rising rates. One such study, performed by Perritt Capital Management, focused on small caps and looked at the entire history of the Russell 2000 (which was created in 1979):



- There has typically been a 3-month breather (-3.1% avg return) after the Fed began raising rates
- The first full year after rates began rising tends to be very strong (+18% on average)
- There is often another short breather/consolidation period (approx. -6%) after that strong first year

In all cases but one, small caps have performed very well for a solid 3 years after rates began rising

These results are not completely surprising, as rising rates tend to be associated with periods of strong economic growth. And even if rates rise a bit, they are still near historical lows. The key seems to be moderation. If we experience runaway inflation and the Fed has to take drastic action, then all bets are off. But outside of that, our guess is higher rates will likely cause higher volatility and perhaps muted short-term returns, but total equity returns should do just fine over the long run. We expect small caps to lead the way. Particularly high-quality small caps.

RUSSELL 2000 INDEX RETURNS FOLLOWING FED FUNDS RATE INCREASE

Hike Date	3 months after	12 months after	18 months after	36 months after
2/1/83	n/a	26.97%	5.20%	49.22%
10/1/86	1.75%	29.02%	7.47%	40.02%
2/4/94	-2.54%	-2.69%	16.85%	47.57%
6/30/99	-6.32%	14.32%	7.60%	1.71%
6/30/04	-2.86%	9.45%	15.88%	48.00%
12/15/15	-5.36 %	22.63%	17.55%	n/a
Averages	-3.07%	18.03%	11.70%	46.96%*

Portfolio Attribution

Q3 saw a good bit of dispersion between individual holdings, which is usually an indicator of a stock-pickers market. We did see broad sector participation amongst the gainers (and losers) in Q3. The top five performers (listed below) included two tech names, one consumer staple, one consumer discretionary, and one healthcare name. The bottom five included two tech names, one staple, one discretionary and one financial.

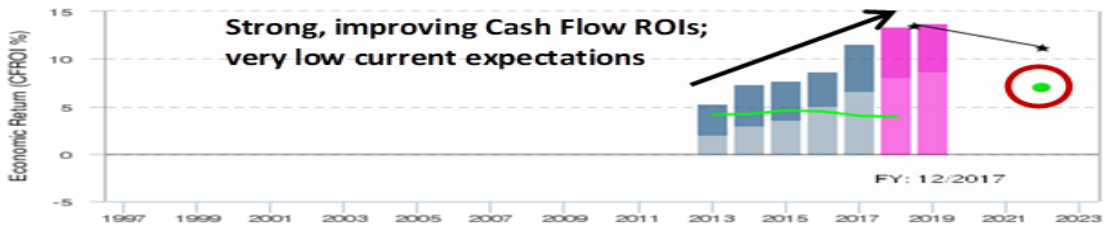
Biggest Gainers This Quarter		Biggest Losers This Quarter	
iRobot Corp (trimmed)	63.5%	Applied Optoelectronics	-45.1%
BioTelemetry	43.2%	TopBuild	-27.5%
Control4 Corp	41.2%	PetMed Express	-24.5%
Five Below (trimmed)	39.1%	Axos Financial (formerly BOFI)	-15.9%
Sprouts Farmers Market	25.3%	LogMeIn	-13.4%

Past performance is no guarantee of future results. Indexes are not available for direct investment. Please see disclosures at the end of this presentation for more information.

As always, we have reviewed our winners and losers, particularly scrutinizing our losers.

- **Applied Optoelectronics (AAOI)** was our strongest performer in Q2 (+73%) but lost a lot of ground in Q3. This name has become a favorite short idea in the hedge fund community, with a short interest of 40% (5 days to cover). Last year, AAOI turned in the highest margins among its direct transceiver peers (FNSR, LITE, MTSI, OCLR) and among the highest in the broader semiconductor space. It's market share with AMZN has declined but they have a new contract with FB that more than offsets that decline. They do face some tariff pressure because 30% of products are manufactured in China, which makes them unique for the small cap space. We still like this name and expect a rebound. However, we are not adding to AAOI because of the short interest risk.
- **PetMed Express (PETS)** is another name that has attracted a fair amount of short interest (28%) due to increased competition in the pet supplies space (top competitors are Chewy, Petsmart and Freshpet). But 50% of PetMed's sales are pet medications as opposed to pet supplies, and they have a solid competitive advantage in that space. We are standing strong with this and might add if the stock pulls back to the mid-$20s.
- **TopBuild (BLD)** manufactures insulation and other home building products such as gutters, garage doors and fireplaces. This is an outstanding business that has been caught up in the homebuilder sell-off. And is oversold in our opinion. We are underweight real estate, with BLD being our only real exposure in that sector. TopBuild has always been a small position for us. It may see more pressure, which may present an opportunity to add. See CFROI chart below.

TopBuild: ROIs versus Cost of Capital



Top Ten Holdings

Our top 10 holdings currently include three tech names, two financials, one healthcare, one consumer staple, one consumer discretionary, one industrial, and one materials name. The median market cap is approx. $900 million.

Company	Business description	Weight	Mkt Cap ($mm)
Supernus Pharma (SUPN)	Specialty pharma (CNS)	5.7%	2,561
Trinseo SA	Rubber & latex products	5.4%	3,366
Control4 Corp (CTRL)	Smart home/IoT technology	5.2%	875
Axos Financial (AX)	Consumer banking	4.9%	2,151
ZIX Corporation (ZIXI)	Email encryption services	4.8%	296
CalAMP (CAMP)	Wireless technology for autos	4.5%	777
Global Brass & Copper (BRSS)	Metal fabrication	4.0%	796
Hain Celestial (HAIN)	Organic foods	4.0%	2,834
Care.com (CRCM)	Regional bank	3.3%	681
Tri-State Capital	Regional bank	3.3%	783

Conclusion

We believe there continues to be a nice opportunity to capture alpha in the small cap space. With mostly US sales and nice tax cut tailwinds, we believe this category will continue to out-perform large caps and global stocks. Small caps should also continue to be largely immune to trade war issues.

We also believe our rigorous approach to stock selection and strong track record of alpha generation make us an attractive allocation for clients. It's not hard to find small cap managers who are willing to speculate, but we believe quality always wins in the end.

It is worth mentioning that US small-cap is notorious for having good managers who are "closed" to new investors and average / weak managers who are open to new investors. This has always been the case with small -cap equities. Our strategy will also have limits on what can be managed. It is not a problem now, but every small -cap manager must face the decision of when to close the strategy to protect the integrity of the portfolio.

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Strategy Overview

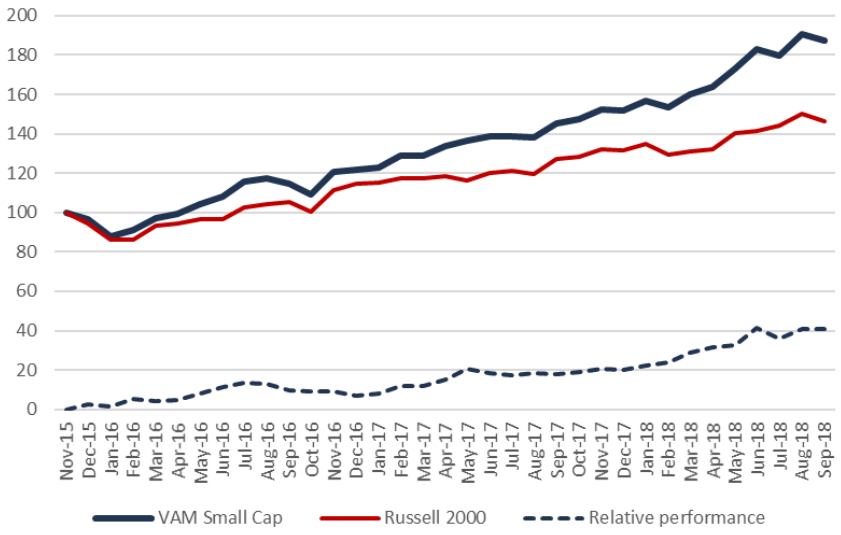
We are quickly approaching the 3 year mark and seeing nice growth in AUM. As mentioned in our Q2 update, we have performed very well and are now beginning to broaden our distribution efforts.

Some Quick Highlights about this strategy:

- Fundamental stock selection process uses the same framework as our other (large-cap) work
- This framework (HOLT) is ideally suited to finding value in smaller, undiscovered companies
- Results have been GIPS verified as of 12/31/17 (track record is real, not pro forma)
- Strategy has remained fully allocated (90-100%) over the entire track record measurement period and has held a similar risk profile as the benchmark throughout the time horizon

Full Track Record

We have achieved excellent results thus far, out-performing the Russell 2000 by approx. 10.4% annually over our first 34 months (41.0% cumulative outperformance). We have not taken excessive risk in order to achieve these results (standard deviation is in line with the benchmark).



	Return
Van Hulzen Small Cap	87.5%
Russell 2000	46.3%
Russell 2000 Growth	47.6%
S&P 500	48.0%

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.

Source: Returns are net of fees (12/1/15-09/30/18)
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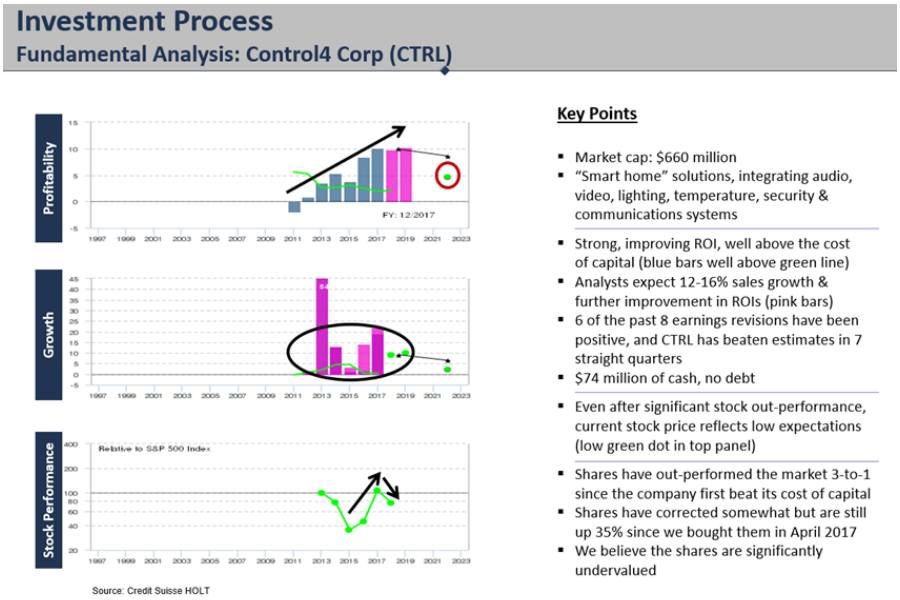
Portfolio Construction

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.

Balancing Fundamentals & Technicals

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.

We'd like to use two of our portfolio holdings (CTRL, a current holding, and SAM, a recent sell) to demonstrate our balanced investment approach. Control4 (CTRL) is a "smart home" solution provider that has provided us with a 60% return since inception but that we believe is still significantly undervalued. It is a very profitable business and is growing 12-16%. With a market cap of just $660 million, we believe it is an ideal takeover candidate.



Growth versus Value

As you may know, large cap growth stocks have significantly out-performed large cap value stocks over the past five years. This has been driven largely by a handful of "Big Tech" names and has been reported widely by us in our covered call commentaries. But what may surprise you is that this phenomenon is not present in the small cap space. Small cap value has actually out-performed small cap growth over the past 5 years. One important difference between the Russell and the S&P, of course, is the weightings of tech versus financials (S&P tech 24% vs Russell 18%; S&P financials 15% vs Russell 18%). But while these weightings clearly affect index attribution, we do not believe they affect the growth/value spread itself.

We consider our strategy a "core" strategy, which can take advantage of high quality opportunities in the value space as well as the growth space.

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