NIS

Small Cap Commentary

July, 2019

After a sluggish start to the quarter, hope for a trade truce between the US and China and talk of an insurance cut by the Fed triggered a record rally in equities in June, which lifted the indices into positive territory for the quarter. On a relative basis, after holding up better during the pullback in April and May, the portfolios did not keep pace in June, leaving us behind the benchmark for the quarter.

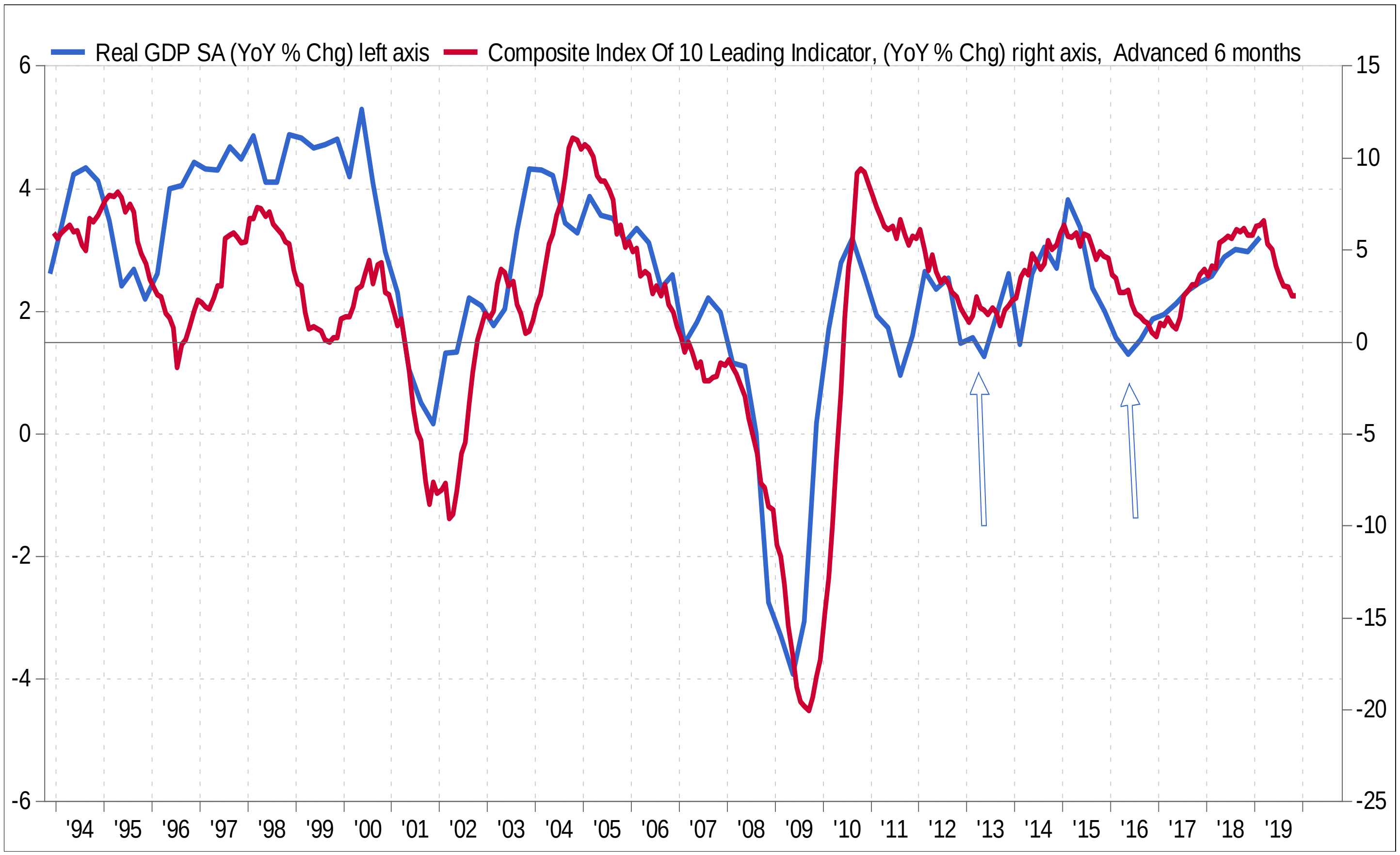
In terms of our macro or market view, not much has changed in the past three months. As a reminder, we focus on Leading Economic Indicators (LEIs) because they LEAD coincident indicators like industrial production, retail sales, corporate profits and GDP. This influences how we tilt the portfolio in terms of the types of stocks and industries we want to own. We are currently in the third cycle for LEIs for this expansion, and the recent path of the LEIs are pointing to another slowdown in growth. It could be argued that last year's stock market losses, the decline in interest rates and the equity market's leadership already discount or reflect this expected slowdown. This may be true to some degree, but the future path of the LEIs is obviously not clear yet, and that is what will dictate markets. A key difference between today and the two previous cycles is the Fed tightening that has occurred since late 2015. Historically, Fed policy has been a differentiator between a mild slow down, such as the two we have already witnessed during this expansion and a broader decline or recession. While short term rates are not high relative to past cycles, they are at or near the Fed's estimated neutral rate and that has typically not been a good thing for risk assets and the broader cycle.

This cyclical risk, coupled with expensive growth stocks, presents a challenging offering in our view. To be honest, we have had to loosen our value discipline and buy or hold some stocks that we would label as "expensive." In some cases, we have sold only to see these expensive stocks become more richly valued. Two expensive stocks we sold during the second quarter were West Pharmaceuticals (WST) and Tetra Tech (TTEK). We had owned these stocks for several years and they each were great performers. Valuation was not the only factor leading to these decisions, but WST's multiple had risen about 60% since we first bought the shares in 2015-2016 and TTEK's multiple had doubled from 8x to 16x.

We made several changes to the portfolio, too many to recount in the update, but we would be happy to share our thoughts on each of them if you would like. In May we added a position in Cavco Industries (CVCO), which is the 3rd largest manufactured home builder in the US. Unlike the single-family housing market, this is a fairly concentrated market with Berkshire Hathaway's Clayton Homes being the industry's largest builder. As growth in the single-family housing market has stumbled, the more affordable manufactured home market is addressing the needs for young families and Boomers looking to downsize. An additional catalyst that is just beginning to develop is the potential for easier financing terms, helped by the return of Fannie Mae and Freddie Mac to this market who had exited the manufactured homme loan market around 2000. Since then, manufactured housing has dramatically ceded share to single family housing. Despite several strong years of activity, industry deliveries are still just one-third of what they were in the 80's and 90's. The stock became more attractively priced this spring and we jumped on it.

With the shift in Fed policy, and the quick drop in rates, we wanted to broaden our more defensive holdings, so for the first time in as long as

we can remember, we bought two gold-oriented stocks. One stock is Sandstorm Gold (SAND), which is a Canadian based gold royal company with royalties or investments in more than 180 projects around the world. The other gold stock is A-Mark Precious Metals (AMRK), which offers a wide suite of services from wholesale trading, to storage and logistics and collateralized lending. Additionally, AMRK is the largest distributor from the US and Royal Canadian Mints. The past three times that the Fed has paused, gold has either risen or remained flat. Given the substantial outperformance of stocks and bonds over the past several years, adding some diversity to our more defensive holdings make sense to us.



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