Small Cap Equity Commentary

April 8th, 2020

We started our March 24 letter off by commenting on the lack of liquidity in the market and economy. Businesses were scrambling to draw upon their lines of credit and the Fed was rolling out new programs almost daily to address possible hot spots in the markets. This lack of liquidity in the markets resulted in the S&P 500's second biggest daily decline since 1940. Today, April 8, a little over two weeks later, we have seen a significant rebound in the market, which included the S&P 500's biggest daily gain since 1933. We would attribute much of this turn in the markets to the prompt response by the Fed and Congress to create programs targeting the specific issues of liquidity for consumers, businesses and markets. The market also appears to be responding favorably to the slower rates of change in the number of new COVID-19 cases. The chart below is from the Global Technical Strategy team at J.P. Morgan[1]. It looks at the number of countries that are experiencing greater than 10% new case growth. This data series is overlaid with the VIX Index, which measures volatility in the US equity markets. In March we set a new-cycle high in the VIX. Generally speaking, volatility is inversely correlated with equity prices, at least in times of stress. These two data series appear closely aligned and are now in a declining trend. Does the trend continue? What happens when we begin to return to normal levels of activity? What activities will not return to normal? These are challenging questions that we do not have clear answers to today.

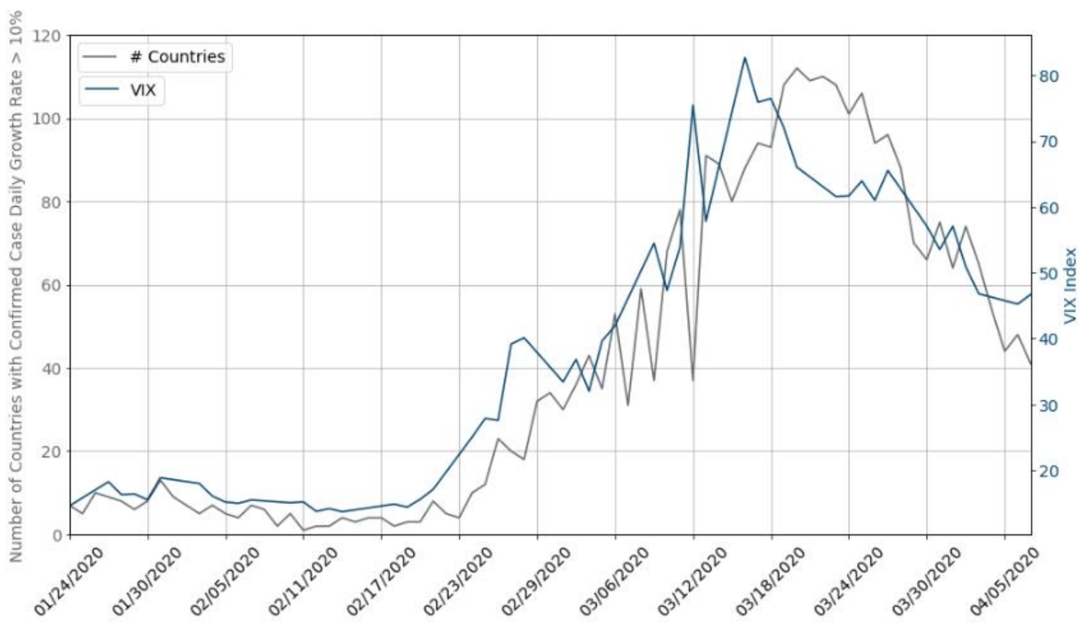
After most quarters we could say something to the effect that, "a lot has happened in the past 3 months." I think this quarter tops most, if not all, of the more recent quarters in terms of new events. You could even shorten the period to say that a lot has happened since February 19, the day that marked the top in the S&P 500. The world has changed faster than most honest people could have imagined it occurring. On January 23, China sealed off the city of Wuhan as they dealt with their crisis. Today, more than two months later, the city is re-opening. Back in January we looked at some of the more recent virus outbreaks and how they affected markets (SARS 2003, Swine Flu 2009). Needless to say, despite some similarities to these outbreaks, COVID-19 has captivated the globe (in more ways than one), the response to the virus has been more extreme, and the effect on the global economy and markets is incomparable. For perspective, roughly 13,000 US deaths occurred as a result of the 2009 swine flu. While the number will certainly rise, as of April 8, the US has seen more than 14,000 deaths. You have to go back to the 1958 Asian flu and the 1968 Hong Kong flu, to find pandemics that resulted in substantially more US deaths. While the US population was roughly 40% smaller than today's count, US deaths from the '58 and '68 pandemics were more than 100,000. The economy did not shut down and nor did the stock market experience anything like what we just witnessed.

Our Small-Cap strategy fell more than 30% during the quarter, but managed to stay slightly ahead of the benchmark. From a strategic stand-point, we were not well positioned for this event in that we were fully invested, and had been adding cyclical stocks to the portfolio and selling what we viewed as "expensive defensives". To put some numbers around it, at the end of September 2019 our cumulative position in cash plus the Utilities, Consumer Staples, and REIT sectors totaled more than 32% of the portfolio. We entered the New Year with half of that exposure. We added several positions to the portfolio early in the quarter, most of which we would characterize as "cheap cyclicals" such as the metal fabricator Mayville Engineering (MEC), the mobile home builder Skyline Champion (SKY) and the regional bank Webster Financial (WBS). We would be happy to provide a more complete list of the new additions and recent sales if you would like, but the shift was consistent with our outlook at the time. These stocks had been out of favor for a while, cheap on most valuation metrics, and a likely beneficiary of a reacceleration in the economy as we believed the rate cuts in 2019 and less trade tension would lift confidence and activity levels in 2020. Despite being on the wrong foot at the time of this event, our consistent focus on higher quality companies has helped. We did have a few stand out winners in the quarter. The trading firm, A-Mark Precious Metals (AMRK) rose 48%, helped by higher gold prices. Our insurance broker, eHealth (EHTH) recorded another record breaking quarterly result and the stock climbed 46%. We have owned Virtu Financial

(VIRT) off and on for several years, so many of you will recognize the name. The stock gained 30% in the quarter as they are benefitting from the record volatility and volume in many markets. We have recently reduced our position as the volatility and volume statistics subside.

As we shared with you in late March, we were not selling. In fact, we added to positions like the gaming headset maker, Turtle Beach (HEAR), the industrial gas equipment manufacture Chart Industries (GTLS) who is benefiting from the expansion of LNG through the world and the antenna manufacturer PCTEL (PCTI) that is levered to the roll-out of 5G networks.

This is the third correspondence we have sent out in the past month. We hope we are providing you with helpful perspective, answering questions that you may have regarding the portfolio and how we are navigating the events. Again, we would be happy to speak with each and every one of you if you have specific questions.



Tyler Pullen, CFA
Portfolio Manager

[1] Technical Strategy, US COVID-19 Chartbook, Jason Hunter, JP Morgan Global Technical Strategy, 4/8/20

[2] https://www.cdc.gov/flu/pandemic-resources/basics/past-pandemics.html