Small Cap Equity Commentary

July 8th, 2020

The markets came roaring back in the 2nd quarter for three main reasons. The virus proved to be less deadly than some of the early March estimates, many activities are in fact returning to normal, and the speed and scale of the response by Congress and the Federal Reserve has been powerful. These have been challenging days for all of us, and the market's path has been tied to both the fear and hopes associated with it. We have heard neighbors and politicians talk about the value of a person's life as we feel our way between more activity and a stronger economy and more cases of the virus. The debate is challenging, divisive and each solution discussed is riddled with unintended risks and discomforts.

The Q2 rally came despite a lot of cautious headlines and list of questions, some of which we shared with you a few months ago, many of which still remain unanswered. The market optimist could argue that the wall of worry is clearly constructed and now we just need to climb it. Tensions with China have ramped back up, and the recent social issues and demonstrations are sure to make for a more contentious election season this fall.

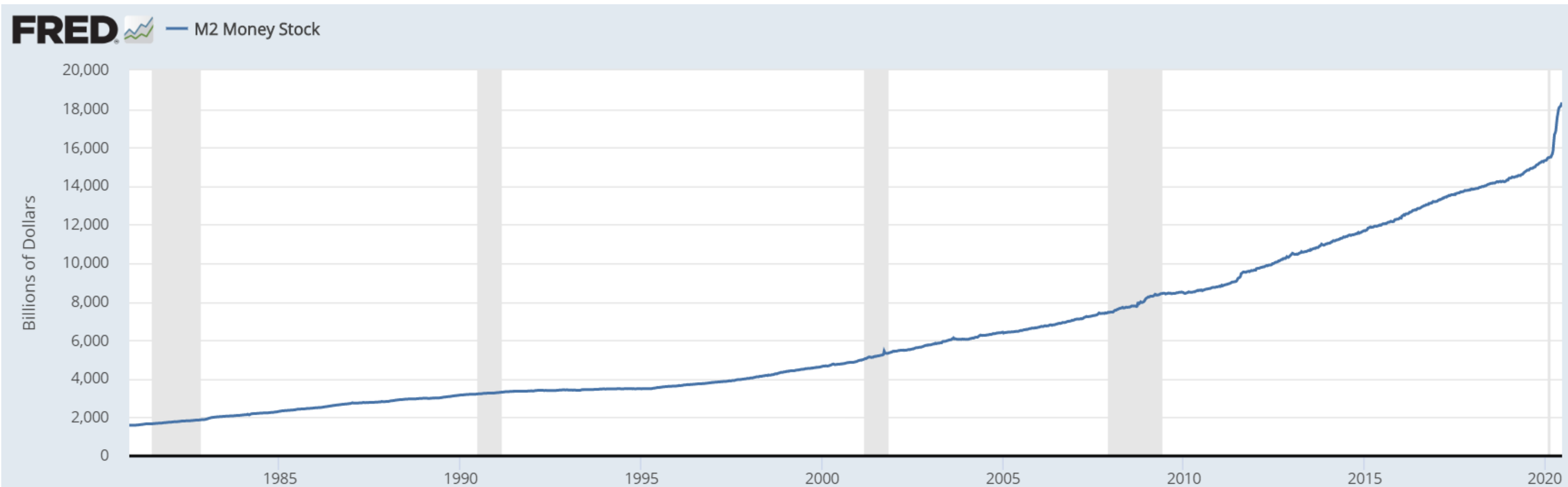
The economic data of late tells a story of a "V-bottom" recovery, but the outlook is unclear and we see how several very different scenarios could play out. The May unemployment report is a great example of how unclear and unprecedented the situation is. In early June, it was reported that more than 2 million jobs were added in the US during the month of May. Not only was this an amazingly large number, but economists collectively expected more than 7 million jobs to be lost during the month. To put that into perspective, the economy has averaged a monthly gain of less than 200 thousand for the past 10 years.

Finally, the efforts of Congress and the Fed deserve highlighting as well as praise from the market bulls. The actions of the Fed sound similar to the logic presented by many of our leaders who are trying to navigate this virus and have used the phrase, "out of an abundance of caution…" Actions taken by the Federal Reserve in the past few months dwarf anything that we have seen before. In fact, if you look at a chart of the supply of money in the US, you almost do not even notice the effect of monetary policy during the financial crisis 10 years ago. To be fair, it is not just the US that is pumping more support into the economy. The central banks of the U.S., China, the Eurozone, Japan, England, Switzerland, and Canada have injected $5.8 trillion in liquidity into their markets in the past four months according to Vincent Deluard at StoneX[1]. The Fed's balance sheet finished the quarter above $7 trillion. It could reach as much as $12 trillion and top 50% of gross domestic product by the end of the year, according to Bloomberg Economics[2]. The end result of the Fed's "no limit" policy[3] has been a spectacular rally in many markets as liquidity has returned and traders rush to buy ahead of the Fed.

Our portfolios performed well during the quarter. Sticking with our more pro-cyclical positioning helped as some of the panic selling reversed and the more defensive assets generally lagged in the quarter. We have been happy to see the rebound, but frankly we have not had much confidence behind many new ideas. The result was that we were a net seller during the quarter. We made several changes to the portfolio that we would be happy to discuss with you further, but I will touch on a few here. Some of our sales could be categorized as us recognizing that the original thesis was no longer appropriate or likely and it was best to exit after the bounce. That pertained to the sale of Braemar Hotels & Resorts (BHR), Spirit Airlines (SAVE) and Independence Contract Drilling (ICD). We also reduced a few names such as Ollie's Bargain Outlets (OLLI) and Onespan (OSPN), where valuations had become less attractive and the positions had grown to be relatively large.

Our two top performing stocks each more than doubled in the quarter as they are both likely beneficiaries of this new normal. Turtle Beach (HEAR) is the largest gaming headset maker. As kids were forced to stay inside, more time was devoted to video games, which led to record sales for gaming accessories such as Turtle Beach's headsets. Ollie's Bargain Outlets (OLLI) is a retailer that focuses solely on clearance or close out products. They buy excess product direct from the manufacturer at discounted prices and pass those savings on to their loyal customers. Many stimulus checks were likely used in Ollie's aisles and their value proposition is likely to attract more customers given the stressed finances that many are facing today. Lincoln Education (LINC) is a recent addition to the portfolio that has quickly climbed to the top of our performers list. Lincoln is very similar to another portfolio holding, Universal Technical Institute (UTI) in that both are for-profit trade schools offering technical training for students seeking careers as vehicle mechanics, welders and HVAC technicians. LINC also offers nursing degrees. These businesses are likely to see further gains in enrollment given that more people go back to school or look to strengthen their skills during periods of high unemployment. Between 2008 and 2010, enrollment at UTI increased 25%. During the quarter LINC's stock climbed 77% and we still see more upside to both company's share price today.

As always, we are working hard for you to find good values in the market. We would be happy to schedule a meeting to discuss your individual portfolio, and we look forward to speaking with you soon.



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[1] Global Macro – June 2020 StoneX, Vincent Deluard

[2] Bloomberg, 'Game-Changing' Stimulus Is Starting to Lift Even the Worst-Hit Stocks By Vildana Hajric, April 28, 2020

[3] 60 Minutes correspondent Scott Pelley interviewed Federal Reserve Chairman Jerome Powell, May 13, 2020,

Past performance does not guarantee future results. Market conditions can vary widely over time and can result in a loss of portfolio value. In accordance with the rules of the Securities and Exchange Commission, we notify you that a copy of our ADV, Part 2A filing with the SEC is available to you upon request.