Small Cap Discoveries

Portfolio Comments

September 30, 2019

Distinguishing Features

GIM builds the portfolio from the bottom-up; sector weightings are secondary to stock selection. As of 9/30/2019, the Small Cap Discoveries portfolio continues its significant overweight position in the producer durables compared to that of the Russell Microcap Growth benchmark, 22% versus 14%. The overweighting in the materials sectors has been reduced; the current weighting is 6% versus 3% for the benchmark. Both healthcare and energy have moved to overweights (44% versus 41%, and 4% versus 2%, respectively), due to relative performance in these weak sectors for the Index. Technology remains under-weighted to the benchmark (12% versus 15%). Consumer discretionary and financial services continue their significant underweight positions: 3% versus 9% for consumer discretionary, and 3% versus 12% for financials. The portfolio is about equal-weight to the Index utilities, while the portfolio continues to have no exposure to the small consumer staples sectors.

Commentary

Market Environment

During the third quarter of 2019, the US market underwent a significant rotation that might be summed up as "Risk Off." Investors may be worried given the uncertainties about economic issues (trade wars, and whether a recession is imminent) and political issues (US Election, Brexit). The market ended the quarter down, with the Russell MicroCap Growth benchmark posting -10.05%. The secondary benchmark, Russell 2000 Growth, was also down, -4.17%. The year-to-date return for the Russell MicroCap benchmark is +4.79%, while the Russell 2000 Growth has returned +15.34%.

Performance Discussion

For the quarter, the Small Cap Discoveries composite was down -8.05% net-of-fees, ahead of the Russell MicroCap Growth but lagging the Russell 2000 Growth. Year-to-date through September, the composite remains ahead of both benchmarks, up 15.50%, net-of-fees.

In the quarter, outperformance to the Russell MicroCap Growth benchmark was due to stock selection, led by healthcare, technology, consumer discretionary, and energy. Strong selection in healthcare was slightly offset by our overweight position, as was the positive selection in energy. Conversely, our underweighting of technology and consumer discretionary slightly weighed on our good selection in these sectors. Good selection in energy was partially offset by our overweighting of this weak sector. Our overweighting in materials helped performance. Selection in producer durables and financial services were a drag on performance, and the underweight position in financial services was also a negative.

The Special Situation LifeCycle categories led in the quarter, and the Core Growth category performed in line with the benchmark. Pioneer holdings hurt relative performance overall. Four of the top five performers in the quarter were Special Situations: Harvard Bioscience (healthcare), Computer Task Group (technology), Profire Energy (energy), and Tower International (consumer discretionary). A Pioneer healthcare holding, Oxford Immunotec Global, rounded out the top five.

Two healthcare Pioneers were in the quarter's bottom five detractors – Fluidigm Corporation and Enanta Pharmaceutials. The remaining three bottom five represented the Special Situation category – Luxfer Holdings and Titan Machinery (both producer durables), and DMC Global (energy).

Outlook

According to small cap strategist, Furey Research Partners, U.S. small caps have significantly underperformed large caps, and the relative valuation is now at a 20-year low. Having said that, within the small cap sector, growth has significantly outperformed value for several years – until just recently. Much has been written about the recent market moves as a possible rotation from growth to value. However, historically, such a rotation needs much stronger GDP growth, higher interest rates, and rising inflation … or a recession. We believe the current economic environment continues to be positive for well-positioned growth companies, and that the macro-economic backdrop, while relevant, is not as important as our adherence to our proven processes.

As bottom up investors, stock selection drives performance, so we closely monitor the fundamentals to make sure we aren't missing anything from a company level. As we evaluate the stocks of these well-positioned companies, we continue to make portfolio adjustments based on valuation, conviction, risk/reward, and portfolio diversification, including across LifeCycles.

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