



Small Cap Select Opportunities

Portfolio Comments

December 31, 2019

Distinguishing Features

GIM builds the [Small Cap Select](#) portfolio from the bottom-up; sector weightings are secondary to stock selection. As of 12/31/2019, the portfolio's overweight position to the information technology sector has increased by 3% since last quarter, now 33% versus 17% for the Russell 2000 Growth Index. The portfolio continues to have a sizable overweight position in the energy sector, 7% versus 1% for the Index. Communication services are also overweighted to the benchmark, 5% versus 2%. The portfolio retains its overweighting to the real estate sector, 6% to 4.5%. Consumer discretionary is now slightly overweight the benchmark, 13% to 12%. Industrials remains the largest underweighting, 7% versus 19% for Index. Healthcare moved from equal-weight to underweight versus the Index, 23% to 30%, as we trimmed some here. Financials are 2% underweight the Index, 4% versus 6%. The portfolio has no exposure to the materials, consumer staples, and utilities sectors, where the benchmark weighting are 3%, 3% and 1.5%, respectively.

Commentary

Market Environment

The fourth quarter saw continued strength and sentiment of the US consumer, as well as a Fed rate cut in October. In December, trade tensions were somewhat eased as the US and China announced they had agreed on the first phase of a trade deal just ahead of planned tariff increases. In this environment, the Russell 2000 Growth returned a robust +11.4%, with a total return for 2019 of +28.5%.

Performance Discussion

For the 4th quarter, the Small Cap Select strategy composite soundly outperformed the benchmark with a return of +19.6% net-of-fees. Year-to-date, the strategy is also well ahead of the benchmark with a return of +55.3% net-of-fees. In the quarter, strong stock selection in the real estate, info tech, and healthcare sectors drove the outperformance, assisted by good selection in industrials, energy, and financials. Our overweight positions in real estate, info tech, and energy modestly dampened the selection effect, as did our underweight position in healthcare. The portfolio's underweighting in the industrials sector also added to relative performance. The portfolio's lack of exposure to the materials, consumer staples, and utilities sectors was a positive. Stock selection in consumer discretionary and communication services weighed on performance.

With respect to LifeCycles, the portfolio's Pioneer and Special Situation holdings led performance with a strong showing for both the quarter and the year, while Core Growth names lagged the overall benchmark. Two healthcare Pioneers were among the top five in the quarter: Medicines Company and Immunomedics. Two Special Situations were also in the top five: Newmark Group (real estate) and Ring Energy (energy). Enphase Energy (Core Growth, info tech) rounds out the top five.

On the negative side, Vonage (Special Situation, utilities) was the largest detractor in the quarter. Rubicon Project (Pioneer, consumer discretionary), a top performer for the year, was in the bottom five for the 4th quarter. Two Core Growth names were also in the bottom five: Etsy (consumer discretionary) and Exact Sciences (healthcare). DMC Global (Special Situation, energy) was also a detractor.



Positioning

Despite 2019 being a very strong year for returns, we continue to see good stock opportunities for 2020. Some of the the portfolio's winners in 2019 were companies that detracted from performance in 2018, including Medicines Company and Newmark Group. In each of these cases, we used weakness in the stock price as an opportunity to increase our weighting in the name, as we found no indication that our investment case was compromised in any way. We often refer to this process as “using volatility as our friend.” In 2018, the large down draft in the 4th quarter helped our opportunity set for 2019. This year we see a different dynamic – we own some stocks that lost their footing in 2019. Even as these companies subsequently had material improvements in their businesses, there continues to be a significant price dislocation in the stocks from where they were a year or two ago, and we believe the stock prices will catch up to the fundamentals. Companies in the portfolio that are good examples of this dynamic are Ring Energy, Limelight Networks, Plurasight, Sharpspring and Cloudera.

Importantly, our outlook for the names that were successful in 2019 continues to be positive for 2020. An exception to this is Medicines Company, which was acquired the first week of 2020 by Novartis in a cash deal. Medicines Company was one of our largest positions before the deal was announced in November. During the 4th quarter we reduced our healthcare weighting as some of our important positions had very strong performance and were far less attractive on a valuation basis. One of these names, Insulet, was sold as this paradigm was combined with a market cap that grew to over \$10-billion in the quarter. As we sold down some of our health care positions, including Medicines Company on the first trading day of the new year, proceeds were allocated outside of healthcare and into stocks across several sectors, thus materially reducing our healthcare weight and increasing our weight in these other sectors. During the quarter, specifically, our move away from healthcare stocks represented primarily Core Growth holdings with the proceeds re-allocated to two Special Situations stocks – Gray Television (consumer discretionary) and Adesto Technologies (Info Tech). Both of these companies appear to have a nice combination of strong growth ahead of them in 2020 coupled with attractive valuation levels.

Outlook

The most obvious risks to the markets in 2020 are the US election and that there will be significant profit-taking after the outsized stock market gains of 2019.

There is also the “wall of worry” that includes US/Iran tensions and fear of broader escalation, the decline in the Institute of Supply Management readings, and concern that tariffs will cause a recession. The "phase one" trade deal between America and China can be considered a marginal positive because more tariff hikes were avoided and some existing tariffs were moderated.

Interestingly, even with the strong equity returns in 2019, cash flows out of equity funds were a net negative. According to Furey Research Partners, “when trailing-year fund flows have been this low in the past 10 years, forward stock market performance has been quite good.” (Furey Research Partners, 4Q19 quarter-end letter).

Earnings growth in our portfolios continues to be very strong – particularly in healthcare, info tech and industrials. Even as growth has moderated from the extremely high levels we saw in our portfolios mid-2019, it still remains higher than historical levels. That said, there are indications that earnings growth for the Russell 2000 Growth Index troughed in the third quarter, perhaps precipitating the rally at year's end. While the resulting valuations for small cap stocks moved up, their valuations relative to large cap stocks are much more attractive, particularly when excluding loss-making companies.

The last two quarters highlighted how investor sentiment can shift dramatically in a short time period. We frequently comment that we have no crystal ball (nor do we believe that there is a reliable one out there).



Instead, we are focused on executing our process as tightly as possible – separating companies from stocks as we seek strong well-positioned companies and use our tools to invest in the stocks of these companies when risk/reward is attractive. As bottom up investors, stock selection drives performance across sectors and LifeCycles.

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