Small Cap Advantage

Portfolio Comments

September 30, 2020

Distinguishing Features

The Russell Indices expanded the number of sectors represented from 9 to 12. Given the new sector distribution, as of 9/30/2020, the Small Cap Advantage portfolio remains overweight in technology compared to the Russell 2000 Growth benchmark, 26% versus 17%. The portfolio is also overweight to the Index in producer durables (3% to 1%) as well as financial services (2% to 0%) and energy (2.7% to 0.9%). Consumer discretionary, real estate, industrials, basic materials, and financials are all within 1% of the Index weighting. The healthcare sector is the largest underweight (27% versus 34%). The portfolio currently has no exposure to the small telecom, utilities, and consumer staples sectors.

Commentary

Market Environment

Markets in the 3rd quarter of 2020 continued their upward climb off the March lows, and the Russell 2000 Growth returned 7.2% in the period. The year-to-date benchmark return is now back in positive territory at 3.9%. Weekly unemployment claims fell below one million for the first time since the pandemic struck in March, as the economy slowly opens up from the pandemic restrictions. Promising news on potential vaccines for COVID-19, and better treatments for those that are infected, has helped buoy confidence as well. While corporate earnings fell sharply in Q2 from the year earlier, the pain for most companies was less severe than analysts had feared.

Performance Discussion

The Small Cap Advantage portfolio returned +8.3% net-of-fees in the 3rd quarter, ahead of the +7.2% return of its Russell 2000 Growth benchmark. Year-to-date, the portfolio has a net-of-fee return of +21.3% versus +3.9% for the Index. In the quarter, positive stock selection in the healthcare and technology sectors led performance. Real estate, energy, and producer durables also had positive selection. The portfolio's overweight positions in energy and producer durables boosted relative performance, as did the underweight position in healthcare. The overweight position in technology partially offset the positive selection here. Selection in consumer discretionary, financials, industrials, basic materials, and financial services weighed on performance, though the overweighting in consumer discretionary partly offset the negative selection. No exposure to utilities was a negative, while zero exposure to telecommunications was a plus.

With respect to LifeCycles, Special Situations led in the quarter. Pioneers also outperformed the Index, while the Core Growth category lagged. The quarter's top performer was **Immunomedics** (healthcare, Pioneer), bought out by Gilead Sciences. **Enphase Energy** (energy, Core Growth) was also a top performer. Technology names rounded out the top five: **LivePerson** (Special Situation), **Sprout Social** (Pioneer), and **Virtusa Corporation** (Core Growth).

On the negative side, the two largest detractors were from the Core Growth LifeCycle category: **Strategic Education** (consumer discretionary) and **Axon Enterprise** (industrials). Three Pioneers were also in the bottom five: **EverQuote** (technology), **eHealth** (financials), and **Esperion Therapeutics** (healthcare).

Outlook

There has been much talk about the performance divergence of small cap growth (SCG) stocks relative to small cap value (SCV) stocks, much like that of the Tech Bubble. While reiterating that we do not have a crystal ball, SCG relative valuation is elevated, though it is nowhere near what it was at the peak of the Tech Bubble. SCG is posting better numbers than SCV with respect to sales growth, ROE, and cash flow margins, which is different than the Tech Bubble fundamental case. In today's environment, SCG cash flow margins are +2% higher than SCV (and rising), and the average SCG stock is generating $15m more cash flow over a 12-month period than the average SCV stock. SCG sales growth and ROE are also superior to SCV, which was not the case in 2000. As always, GIM continues to focus on the SCG companies that demonstrate these superior fundamental factors, while using our disciplined tools to invest in the stocks of these companies when risk/reward is attractive.

Disclosure:

The information provided in this commentary should not be considered a recommendation to purchase or sell any particular security. There is no assurance that any securities discussed herein will remain in an account's portfolio at the time you receive this report or that securities sold have not been repurchased. The securities discussed do not represent an account's entire portfolio and in the aggregate may represent only a small percentage of an account's portfolio holdings.

It should not be assumed that any of the securities transactions or holdings discussed were or will prove to be profitable, or that the investment recommendations or decisions we make in the future will be profitable or will equal the investment performance of the securities discussed herein.