The Song Remains the Same…

Second Quarter Review and Outlook

Halfway through 2021, we would like to revisit some of the topics we have discussed during the past year, including:

- The Russell Reconstitution
- Our take on AMC, the largest small cap in recent history
- The state of the COViD cycle and the effect on our strategy
- Performance Reviews for US and International Small Cap

Russell 2000 Reconstitution Recap

In last quarter's note the team observed that the upcoming Russell Reconstitution could be one of the largest for the Russell 2000 in recent years and would drive relative performance of small caps during the second quarter.

We were half right.

The amount of rebalancing ended up being typical – about 11%. Over the quarter, many of the high-flying small cap stocks driving the high rebalancing level reversed ground and returned to small cap market capitalization levels.

Said reversal helped make our second prediction accurate: stocks exiting the Russell 2000 underperformed those entering the Russell 2000 by 2.1% from June 4th on.[1] It paid to target the new index instead of the old. This spread could have been larger if not for a late run-up in 'meme' stocks, high short interest stocks squeezed by retail investors to 'stick it to hedge funds'[2], that constitute many of the Russell 2000 to 1000 graduates.

AMC: We've Seen This Movie Before

One interesting anomaly came out of the Russell Reconstitution, related to the 'meme' stocks: AMC.

Back in January and February, AMC was Gamestop-lite, rising from $2 to $20 in a retail fueled short squeeze. The stock stabilized at around the $10 level and remained here through May.

At this level the movie theatre chain was worth about $4 billion, and when Russell released their first list of

AMC Entertainment Holdings, Inc. (AMC)

[1] Source: Jefferies

[2] Be assured, in the end it will be the hedge funds who have the last laugh, and the retail investors who will suffer the pain.

index constituents on May 7, was below the top end of the small cap range (around $7 billion) and slated to remain in the Russell 2000.

Starting June 1st, meme socks began another short-squeeze rally, and this time AMC was at the vanguard. The price rose to over $55, and the market cap topped out at $30 billion, far beyond even the top range of mid cap stocks.

This $25 billion market cap, very volatile stock remains in the small cap benchmark, nearly 3 times as large as the next largest position. (Arrowhead Pharmaceuticals (at $8.9 billion)) It represents the biggest decision small cap managers must make: hold it, or not?

Our team is pleased to see it remain. We do not think it is going to perform well, and at that size, we can benefit considerably if we are right by not holding it. Given the size and volatility, overweighting the stock would be very risky – a manager would be wagering much of their relative performance on one stock.

Fortunately, we do not find ourselves in this situation. Our process divides the analysis of a particular firm into three pillars:

- Management – analyzing management behavior for an inside perspective on the future of their firm.
- Investors – assessing to what degree informed shareholders provide an outside perspective on firm prospects.
- Analysts – using specific knowledge about the value of the firm to determine potential upside for the stock price.

AMC's first quarter conference call provided mixed messages. Sentiment was positive, reflecting the degree to which the higher stock price had allowed the firm to relieve their debt burden. But management's presentation and answers to analyst's questions did not provide the confidence we would like to see in the firm future.

The analysis might have been more positive if management had added shares to their personal holdings during the stock price increase. Instead, they did the opposite, selling in volume during each price spike.

Investors seem to agree – In our measures of informed investor sentiment, AMC has consistently ranked as one of the lowest stocks in the small cap universe[3]

Of course, given the twenty-fold increase in the stock price, we see little further upside in the firm value. Even before it became a meme stock, COViD has drawn great doubt over the firm's sustainability over the long term.[4] Target valuations remain in the $10-12 range, a far cry from the end-of-quarter price of $56.68.

Finally, when we assess potential risks to the stock, we see all sorts of red flags. We see a stock whose price is driven by retail flows and options trading with little regard for fundamentals. We see a underlying firm with a vulnerable balance sheet, weak margins, and price volatility of over 150%. When such characteristics are present in a firm at such extremes, it signals to us that we want no part of it.

With any luck our signals will be right, and Russell has given us an extra year to find out.

The COViD Cycle

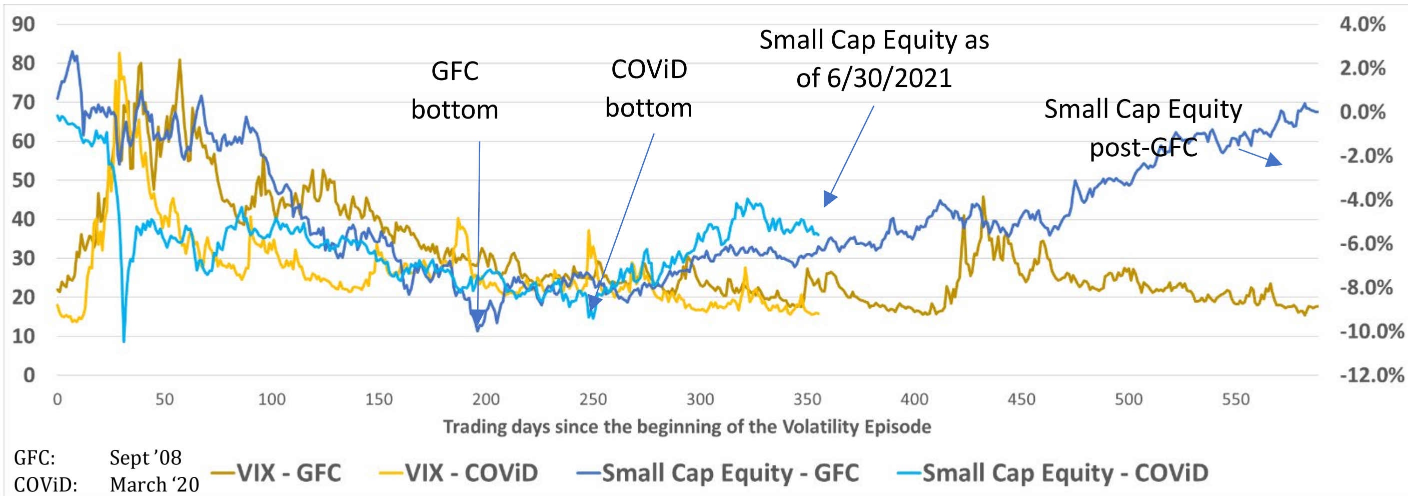
In one of our reports last year, we discussed the dramatic market cycle triggered by COViD and the effect on our portfolio. As volatility spiked and margin levels fell, many of our methods of analysis underperformed.

It had not been the first time a liquidity crisis had dealt strategy a setback. We had experienced it several times before. In each case, once the crisis abated and volatility levels subsided, our performance recovered and often exceeded the drawdown.

[3] No surprise – it is one of the reasons it has become a meme stock – high short interest. In cases like these we de-emphasize this measure in our analysis. It did not change the overall view on the firm.

[4] Management has done a good job of taking advantage of their celebrity status to raise billions of dollars of capital and shore up their balance sheet. At this point though, it just looks like throwing good money after bad.

Great Financial Crisis versus the COViD Crisis – Cycle Comparison



So far we have seen similarities between the strategy's behavior during the Great Financial Crisis (GFC) and COViD crisis. In both cases, the crisis triggered a liquidity crunch, ultimately relieve by dramatic action from the Federal Reserve.

During the GFC, elevated volatility levels continued through the second quarter of 2009, more than 6 months after the Lehman bankruptcy. A short but intense 'junk' rally of low-quality stocks followed. Our performance bottomed in June of 2009, as the 'junk' rally subsided, and our signals began to hit their marks.

In the COViD crisis, the rise and fall of volatility levels was more rapid but hope for a resolution became visible in late 2020. Similarly, there was a 3-month 'junk' rally that continued through early February when interest rates began to rise.[5] Our strategy performance bottomed at the end of January of 2021 and has climbed steadily since. If past experiences are any guide, we are at most only 1/3 of the way back.

Every market is different, and the causes of the GFC were certainly different than COViD, but they both precipitated a liquidity crisis addressed forcefully by the Federal Reserve, leading to a recovery rally. If the parallels hold, the strategy stands to have another year of outperformance driven by the steady flow of liquidity from fear and volatility to fundamentals and information.

Small Cap Equity Performance Review

The Vitruvian Capital Small Cap Equity Strategy returned 5.76% (gross) in the first quarter of 2021 versus 4.29% for the Russell 2000, outperforming by 1.47%, nearly the same as last quarter. The strategy is now 3.23% ahead of the benchmark year-to-date.

	Volatility Cycle				Returns	
Episode	**Rise**	**Peak**	**End**	**VIX Peak**	**Before Peak**	**After Peak**
Global Financial Crisis	Sep 2008	Jun 2009	Dec 2010	82	-7.5%	9.0%
U.S Debt Crisis	Aug 2011	Oct 2011	Apr 2012	48	-4.4%	3.5%
China/Oil Tubulence	Sep 2015	Feb 2016	May 2016	41	-1.1%	2.0%
VIX ETN Implosion	Feb 2018	Mar 2018	Jun 2018	38	-0.5%	0.5%
COViD Crisis	Feb 2020	May 2020	??	82	-7.4%	2.4%*

[5] Also coincident with the treasury bond term premium becoming positive for the first time since December of 2018.

The predominant contribution to performance was the focus on lower volatility stocks. After a long and extended run-up in high volatility stocks during the recovery from the COViD cycle, these stocks finally ran out of steam and began to reverse.

Industries that fall into this same category include banks, biotechnology and semiconductors. We found few opportunities in these industries and were underweight. Performance came from more traditional cyclicals such as energy and capital goods, as well as the software sector.

Market and portfolio risk has declined since the early part of the year. Internally however, dispersion among stocks in the small cap universe has been higher than years past. The US Small Cap Equity portfolio realized a tracking error of about 5.5% so far in 2021, up from our target level of 4%, and much higher than the 3-3.5% levels common in the last several years.

Compare this data point with our international small cap strategy, which has realized a tracking error of 4.16% so far in 2021, within a reasonable margin of the 3.5% tracking error we have experienced over the last 3 years.

Other US small cap competitors have seen their tracking errors rise as well. The cause lies in the higher levels of volatility and lower correlations among stocks since the beginning of 2021. Small cap managers welcome such volatility, and hope it continues for the near future. [6]

International Small Cap Equity

The Vitruvian Capital International Small Cap Equity Strategy returned 6.27% in the second quarter versus 4.49% for the MSCI EAFE Small Cap Index.

Across the portfolio few large trends affected performance to any great extent. Our overweight to Japan was a slight drag on the portfolio. Otherwise, as is typical in the international small cap space, most off our performance came from individual stock selection.

Our biggest contributor is Chinasoft (354-HK) a IT outsourcing and development firm. A new revenue stream from mobile phone OS development for Huawei showed evidence of higher-than-expected growth in q2, and the stock reflected it.

Ebara Corp., a Japanese industrial machinery producer, and IMI, a fluid engineering solutions provider out of the UK, also added value.

On the downside, our biggest underperforming positions were Denka a Japanese specialty chemical firm that had a challenging first quarter, and Deutsche Pfandbriefbank, a German commercial bank that had their credit downgraded after their quarterly report.

The team believes that there is considerable value in the international small cap market, due to several factors:

- A lower percentage of technology companies has created a less concentrated market and broader opportunity set.
- Lower portion of equity markets held in passive index funds. With a smaller portion of the market driven by price takers (index funds buy at whatever the price is) versus price-makers (active managers generally have a price in mind for their holdings) provides better rewards to equity analysis
- So far non-US countries have been behind the curve in resolving their COViD issues, presenting greater rewards when they do.

[6] If this continues, it is worthy of research and discussion in a future commentary. Potential culprits: industry composition, retail investors, index fund market share.