The Circle is Now Complete…

Third Quarter Review and Outlook

In this quarter's missive:

- Performance Review…
- …and the COViD-induced liquidity cycle
- AMC follow up
- Outlook for US and International Small Caps

Performance

- Third quarter:

  Small Cap Equity returned 1.69% outperforming the Russell 2000 Index return of -4.36% by 6.03%.

  International Small Cap strategy returned 2.24% during the 3rd quarter, outperforming the 0.96% return of the MSCI EAFE Small-cap index by 1.28%

- Year-to-date:

  US Small Cap Equity returned 22.81% outperforming the Russell 2000 index return of 12.41% by 10.40%

  International Small Cap Equity returned 15.66%, outperforming the MSCI EAFE Small Cap index return of 10.35% by 5.31%.

US Small Cap Equity Performance Review

The negative return for small caps is really a function of timing. Small caps have essentially been flat since February, and the return can be negative or positive depending on when you choose your start and end points. They did underperform large caps during the quarter, with the large and mid-cap Russell 1000 managing to just remain positive at +0.21%.

Internally value stocks continued to lead performance in small caps, in contrast to large caps where big growth stocks still dominate. Stock prices displayed behavior common during periods of moderating economic growth, not unexpected given the rapid rebound experienced during late 2020. Economic growth levels are still high but have tapered since the early 2021 peaks. If this cycle resembles the recovery cycles of the past, one expects economic leading indicators to begin to weaken during the first half of 2021.

The 3rd quarter of 2021 was one of our strongest ever, and in such cases, it is important to reflect on performance just as much as after a challenging quarter.

After the rapid market recovery from the 2nd quarter 2020 lows, speculative and high volatility stocks had appreciated to excessively high valuations. As a result, in early 2021 the team found a larger than normal number of attractive stocks with stable cash flows and added more of these high-quality companies to the portfolio.

While returns to high quality firms have been positive since the end of February (with a bit of reversal in May and June), investors shifted into these stocks with enthusiasm in July. Volatility and speculation were out, cash flow and stability were in. We believe about 1/3 of our outperformance attributes to this shift.

The remaining relative performance is from stock selection. Much of our process relies on monitoring the behavior of different market participants. During a liquidity crisis like March of 2020, these participants are no longer motivated by investment merit but by the need for liquidity. Our process struggles in such environments. The effect is temporary, and as we wrote in our 1st quarter 2020

Table 1: Liquidity Cycles Over the Past 15 years

Source: VCM Records, FactSet

	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	Mar 2020	May 2020	Sep 2021	82	-7.4%	9.8%

newsletter[1], when the liquidity pressure is relieved, our strategy recovers all the underperformance and more.

COViD was the greatest liquidity crisis since the Financial Crisis, and given its magnitude, it took some time for investors to shift back to their normal investment habits.[2] While the team figured it might be 2 years to fully recover, the cycle completed in 18 months. As of the end of September, our portfolio has recovered all the liquidity crisis related performance from last year. (See Table 1)

The biggest individual contributors to portfolio performance were SPS Commerce (SPSC), Upstart(UPST), Trillium Therapeutics(TRIL), while Seres Therapeutics(MSCRB) was a significant detractor

One of our larger positions, the supply chain software provider SPS Commerce provided a textbook beat and raise quarter at the end of July. The results confirmed their role in serving the global supply chain, and triggered a 60% appreciation through the end of the quarter

Upstart Holdings developed a cloud-based artificial intelligence platform for banks and other lenders. Results have kept up with expectations, and the firm continues to have massive support from informed investors. While it just went public at the end of 2020, it is already a mid-cap stock, and will be harder for us to hold in the future.

Trillium and Seres Therapeutics are both biotechnology companies that had different experiences over the past few months. Pfizer acquired Trillium to strengthen their portfolio of cancer immunotherapy treatments at nearly triple the latest valuation. Seres fell over 50% when one of their ulcerative colitis treatments disappointed in trials. There is still value in their ongoing research, and we remain positive on the stock at these levels.[3]

AMC: No Time to Die…yet

Last quarter we reviewed AMC, the not-so-small cap movie chain that due to some timely support from the retail short-squeeze crowd, found itself atop the Russell 2000 small cap index despite having a market cap twice any other stock in the index.

We also noted that despite the relative risk involved in not holding a significant benchmark name, our analysis determined we should avoid this stock altogether.

The stock fell 32.85% in the 3rd quarter. The firm still has a market capitalization near $20 billion, far above the second highest market cap stock in the Russell 2000.

Management has done a great job of exploiting their newfound retail investor fame, raising considerable capital, and even creating a moviegoer loyalty program that ties into stock ownership. Regardless, our perspective remains the same. We value the company at far less than the current price and refuse to hold it. As customers return to theatres and a slate of long-awaited films hit the screen, the firm needs to deliver results that fall in line with the expectations reflected in the stock.

International Small Cap Performance Review

At the end of July, the International Small Cap Strategy completed its first complete year of live performance. When combined with our prototype returns from the previous three years, the strategy has one of the strongest records in the international small cap space.

We have found the international small cap space fertile ground for our investment philosophy. Currencies and countries add extra dimensions for risk management easing the task of focusing performance on individual stocks. Such global scope prevents one trend from seizing the market and

[1] Please see our commentary for the 1st quarter of 2021 where we discuss the volatility/liquidity cycle and its effect on our (and many other strategies) performance: [VCM 2020-1st-Quarter_commentary]

[2] Investors picked up some new habits along the way, like bidding up short-squeezed video game stores and movie theatres

[3] Biotechnology firms will always be some of the largest contributors and detractors in a small cap strategy. We risk-weight our positions to prevent the portfolio from resembling a public venture capital fund.

pushing a whole category of stocks one direction or the other.

For example, a big issue that faced international markets this past quarter was China. Intervention of the Chinese government in the economy roiled Hong Kong and mainland Chinese markets. First, they targeted the big technology companies. Then they targeted the for-profit education firms. Finally, the government enacted the 'three red lines' regulations to reign in over-levered firms. This action pushed debt-laden real estate firm Evergrande to the brink of collapse.

Our strategy had a slight overweight in Hong Kong, and held one of the for-profit education firms, but the team rapidly closed the overweight once the intent of the Chinese government was made clear. Political risk is rarely rewarded in the markets.

All in, the overweight in Hong Kong cost the strategy 0.2% in performance, a total that could have been higher had we not missed the subsequent weakness in the second half of the quarter.

Significant contributors to the international portfolio included Mitsui O.S.K lines (9104-JP), Benefit One (2412-JP), Azimut Holdings (AZM-IT). Signify (LIGHT-NV) was the biggest detractor

Mitsui O.S.K. Lines and other Japanese shipping companies experienced steady increases in charter rates as the global supply chain crisis unfolded. The firms have come under pressure lately as governments begin to take steps to ease the bottlenecks.

Azimut Holdings is an Italian asset management firm that has continued to report steady asset under management growth over the past several months.

Benefit One is a healthcare and benefit service provider in Japan. They experienced steady business trends from their core business in 2020, and strong growth in their COViD related services segment.

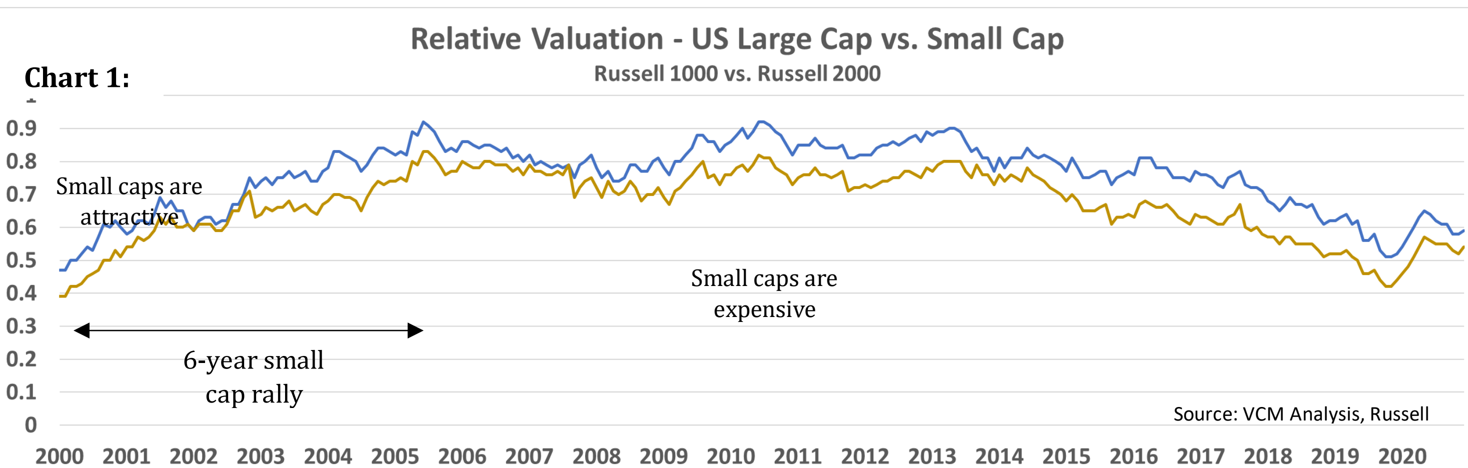
Signify NV (the former light bulb business of Philips Electronics) a long beneficiary of the COViD induced home improvement boom, struggled to source supply for their growth and gave back some of the gains from the past year.

US Small Cap Outlook

The outlook for small cap stocks remains strong. After a rapid run-up in late 2020 into early 2021, small caps have remained flat since February, allowing large cap stocks to catch up. After a 6-year run of outperformance by large cap stocks from 2014 to mid-2020, small cap stocks were as inexpensive relative to large cap stocks as they had been since the growth and technology boom of the late 90s. Recent performance has not changed that fact. (See Chart 1)

Comparisons to the technology boom of the 90s are worth considering. During those years, large growth companies led the market, almost to the same degree as our current market. Once those trends reversed, they led to a 6-year run of small cap outperformance

Chart 1:



that did not tire until the end of the Great Financial Crisis.[4]

What could trigger this reversal in market sentiment? There are many potential catalysts: inflation, economic growth, interest rates. Central to all of them sits the Federal Reserve. With their balance sheet topping 8 trillion dollars and the Fed Funds rate at zero, the Fed could find itself in a conundrum. If inflation continues to rise, and recent supply chain and employment issues evolve into slower growth, what does the Fed do? Raising rates risks throwing the economy into recession, while another round of balance sheet expansion will fuel inflationary fires.

For small caps it does not matter - either option is beneficial. A reversal in the low rates that have propelled large growth stocks to such high valuations would support smaller, less expensive stocks instead. While the small cap universe has its share of expensive growth stocks, they represent a much smaller portion of the universe than large caps.

If inflation is allowed to rise, price increases will play into the hands of the large number of small-cap cyclical stocks as they realize the pricing power they have waited years for. It was this factor that drove the outperformance in the latter parts of 2020, and there is much more room to run. Additionally, the market will realize that as soon as economic growth resumes, they should expect rates to rise.

International Small Cap Outlook

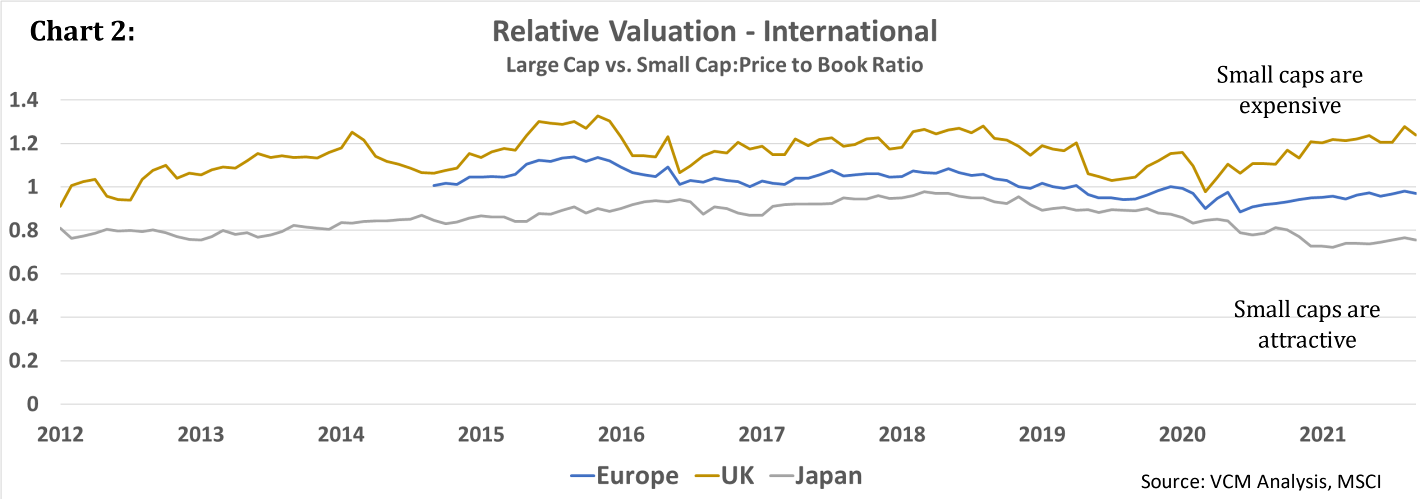
While not as extreme as the US, small caps overseas also have valuation support for their cause. Different accounting rules and practices make it difficult to compare across national borders, but do not prevent comparison within countries or regions. (See Chart 2)

The biggest disparity exists in Japan, where small caps are yet to fully recover from the selloff in the spring of 2020. This may reflect the struggle that Japan has experienced in re-opening their economy, placing undue pressure on firms with less capital strength to weather the downturn.

In line with this perspective, we see less valuation support in the UK where the recovery has been stronger. Europe falls somewhere in the middle.

The COViD pandemic remains an ongoing theme. Different degrees of containment exist across the developed world ranging from mixed results in the US, some instances re-opening in Europe, confusion in Japan, and full lockdown in much of Australia. Market reactions can go either way and risk management remains critical.

Chart 2:



[4] Certainly, that time was one of great turmoil as the technology bull market unwound. When small caps are this inexpensive, they can serve as a refuge. From the end of 1999 until the end of 2005, the Russell 2000 index returned 44% (about 6.3% annually) and returned another 18.4% in 2006. The S&P 500 lost 6.6% through 2005 and returned 15.8% in 2006. Mark Twain once said while history never repeats, it often rhymes. (Sources: Russell, S&P, FactSet)