Q2 2022 ESG SMID VALUE STRATEGY UPDATE

By Adam Peck

Small cap equities continued their decline in the second quarter of 2022, knocking the Russell 2000 Index off 30% from its peak last November. Small caps typically underperform large caps in bear markets. While this time is no different, we think small caps are setting up for a future period of outperformance based on their valuations relative to large caps. The last time and only time since 1985 small caps were this cheap vs. large caps was in late 1999 and early 2000.

The SMID strategy slightly outperformed our benchmark, the Russell 2500 Value Index, which declined 15.4%.

We continue to look for undervalued companies with strong businesses and management teams. With so many companies selling off in the last few months, we are seeing many attractive opportunities, but also think our own portfolio is uber attractive right now. The hard part in this phase of the downturn is figuring out if forward earnings expectations are achievable.

Today, one third of the SMID portfolio trades for less than 10x earnings and four companies trade for less than 5x. The market is clearly saying that it thinks earnings will drop a precipitous amount as the economy declines in the face of persistent inflation, continued supply chain disruptions and the twin headwinds of declining fiscal and monetary stimulus. We are also cognizant that consumer sentiment is at 70-year lows.

We can't predict where exactly the economy will go nor how long the headwinds will last. We do know that as long as the businesses we own are fundamentally sound and management teams execute, they will eventually be rewarded with higher valuations.

Top Detractors

The worst performers in the quarter were CNX Resources (CNX) and Virtu Financial (VIRT). CNX was the top performer last quarter, having doubled from its lows last fall up until early June. The selloff late last month was a bit surprising to us. The company hedges the vast majority of its natural gas production. Spot natural gas prices spiked to over $9/mcf in May and have since declined to just under $6/mcf. Because the company hedges its production, it has essentially locked in over $650mm of free cash flow production this year, regardless of the price of natural gas. That gives the company a 21% free cash flow yield. We think natural gas prices will be higher going forward compared to average prices over the last few years and therefore believe the high free cash flow yield is sustainable.

Virtu Financial (VIRT) was another large detractor, driven by investors' fear that retail trading flows would slow from the highs experienced during the 2021 meme stock bubble. While it is unlikely that volumes will eclipse last year's level, VIRT will still report solid earnings as volatility persists in the market. Also, there is some risk to revenues as the SEC is looking into the practice known as payment for order flow. Eliminating payment for order flow would hurt VIRT in the short-run. Until the SEC makes a final decision on order flow the uncertainty will likely continue for the stock. However, we think it is now fully priced in as Virtu trades at roughly 6x earnings vs. its average of 14x over the last ten years.

Top Contributors

StoneEx (SNEX) is another brokerage and financial company, but it actually ended up being one of our top performers. SNEX was able to outperform this quarter by taking advantage of current volatile market conditions. It has more of an institutional customer base and is not impacted by retail flows or headline risk about market structure reforms. Also, SNEX holds customer cash balances which will benefit from a rising rate environment.

The top performer for the quarter was Renewable Energy Group (REGI). As discussed last quarter REGI received a take-out offer from Chevron and therefore traded flat at the takeout price this quarter, making it a top performer, as nearly every other stock in the portfolio declined.

Sales

We sold three positions during the quarter: Spirit Aerosystems, Cambium Networks, and Osisko Gold Royalties. All were sold due to changes in fundamentals. We felt the outlooks and recent execution were not meeting our expectations and recycled the proceeds into two new names as well as adding to companies we had more confidence in like Iridium Communications and the aforementioned Virtu.

Additions

The first new addition was Talos Energy, Inc. (TALO). Talos is a Gulf of Mexico (GOM) oil and gas exploration and production company that is also developing one of the largest carbon capture storage systems (CCS) in the world. On an ESG basis we like that the GOM actually has the lowest carbon footprint per barrel in all of North and South America. TALO is working to lower its own carbon emissions intensity and has been successful with a 25% reduction since 2018 and is well on its way to achieving its 30% reduction goal by 2025.

TALO's valuation is low, which is to be expected as it's a commodity driven business; however, it is less levered than its peers and trades at a 25% discount with a PE of 2.9x, making it extremely undervalued, in our opinion. We think the Russian invasion of Ukraine has fundamentally changed the supply/demand dynamic for oil and gas and should place a floor on oil in the $70-$80 area. We think TALO's 29% FCF yield is sustainable and at $80 price of oil per barrel, the stock trades at more than a 50% discount on a PV-10 basis, which is a calculation of its net asset value.

Over 20% of the world's 2000 largest companies have committed to net zero carbon emissions by 2050. There is and will be an ever-increasing drive to lower carbon emissions, which is in constant conflict with the world's ever-increasing demand for energy. One way to solve this conundrum is to reinject carbon back into the earth where it came from. Talos is a leader in CCS and has partnered with very large companies like Chevron to make carbon capture happen. We believe the market opportunity is 16x larger than where it is today and that this opportunity is not currently reflected in the stock's valuation.

The other new addition to the portfolio was Veeco Instruments (VECO). Veeco is an innovative manufacturer of semiconductor process equipment which solves an array of challenging materials engineering problems. Its comprehensive collection of ion beam, laser annealing, lithography, and single wafer wet etch and clean technologies plays an integral role in the fabrication of key devices that are enabling the 4th industrial revolution of all things connected.

VECO traditionally served the hard disk drive market, which tends to be volatile given its commodity nature. With the acquisition of Ultratech in 2017, VECO has won business at leading edge semiconductor foundries with its laser annealing and EUV mask blanks offerings.

The transformation of VECO under the leadership of Bill Miller to a diversified supplier of leading-edge semiconductor manufacturing capabilities has led to a higher expected long-term growth rate, increased profitability, and a higher valuation. VECO's sustainability efforts are also best-in-class.

The stock trades 11x this year's earnings which is a 50% discount to its average 5-year valuation multiple.

(Disclosures and chart showing ESG SMID Value Strategy Largest Contributors and Detractors on next page).

ESG SMID Value Strategy
Largest Contributors and Detractors – Q2 2022

5 Best - Absolute Contribution			
Ticker	**Company**	**Average Weight**	**Contribution**
SNEX	StoneX Group Inc.	3.50%	14 bps
INFU	InfuSystem Holdings, Inc.	2.68%	1 bps
REGI	Renewable Energy Grp, Inc	.25%	0 bps
DGX	Quest Diagnostics Inc.	1.90%	-02 bps
ICFI	ICF International, Inc.	4.09%	-04 bps
	5 Best Total	**12.43%**	**.08** bps

5 Worst - Absolute Contribution			
Ticker	**Company**	**Average Weight**	**Contribution**
ATKR	Atkore, Inc	4.83	-90 bps
JLL	Jones Lang Lasalle, Inc.	3.50	-93 bps
CIEN	Ciena Corp.	3.99	-102 bps
VIRT	Virtu Financial, Inc. Class A	2.64	-108 bps
CNX	CNX Resources	5.47	-137 bps
	5 Worst Total	**20.43**	**-530** bps

Disclosures:
Reader should not assume that investments in the securities identified were or will be profitable. Timing differences of purchases and sales may have a modest impact on the actual contribution numbers presented. The holdings identified do not represent all of the securities purchased, sold, or recommended. The calculation's methodology along with details on all holding's contribution to the overall account's performance during the measurement period are available upon request. Past performance does not guarantee future results.