Q3 2022 ESG MICRO Cap Opportunities Strategy Update

By Nathan Fredrick, CFA

Micro - Still Looking for a Bottom

Upside and downside volatility continued again in the third quarter, with a bear market rally mid-quarter followed by a continued selloff to previous year-to-date lows. Our views have not changed since the last quarterly letter, and we still believe the Federal Reserve is tightening into a slowing economy. It appears that the Fed will not relent until inflation is tamed or at least beginning to recede. With headline inflation still around 8% and many of the sticky subcomponents rising, it is unlikely that we see a pivot anytime soon.

The market seems to be bullish on the idea that the Federal Reserve will pivot because they are “breaking things” and we have seen signs of this around the world in the FX markets collapsing against the US dollar and more recently with the precipitous rise in UK Gilts market followed by Bank of England intervention. The Fed is running into a problem known as Triffin’s Dilemma which in simplistic terms is the conflict of economic interests between the domestic interests of the reserve currency (USA) and the international interests of the rest of the world. The rest of the world needs US dollars to settle many cross-border transactions (think energy) and the United States supplies dollars by running deficits and easy monetary policy. However, the Federal Reserve has a dual mandate of stable prices (inflation) and maximum employment.

The Fed is myopically focused on bringing down inflation through financial tightening. This has resulted in the rise of the US dollar and interest rate yields around the world to levels that make it difficult for the rest of the world to operate. For example, countries need to settle almost all oil transactions in US dollars, and it is more expensive if the US dollar is rising significantly against your own currency. US dollar policy is the purview of the US Treasury, and they also seem to be fine with the rising dollar. If rates and the US dollar continue to rise like they have to combat inflation, it will put continued pressure on inflation throughout the rest of the world. As of now the Federal Reserve is focused on US inflation despite its significant impact on the rest of the world. It will be interesting to see how these two opposing forces play out in the coming quarter. Like we said in the last letter a market bottom is often more of a process and not a point in time. Leading indicators have not yet bottomed; there is no pivot from the Federal Reserve, there is no new stimulus program from the government, and the markets are retesting new lows. However, sentiment is fully bearish based on fund flows, the AAII survey, technical analysis indicators, and media attention. So, we would not be surprised to see additional bear market rallies as Q4 2022 unfolds.

The strategy underperformed its benchmark for the quarter. The underperformance came during the bear market rally through the middle of the quarter and almost all the underperformance was recouped as the market slid back in the second half. Several of our companies received takeout offers and we still hold a couple as we search for replacements. This brings our total take outs in the last four quarters to four companies. It is encouraging that other companies are also seeing value in the names we own. We are looking to deploy the cash in the fourth quarter but as there could be more pain in store for stocks broadly, we will be vigilant in adding new names. Second quarter earnings reports were not very good, and we expect continued volatility coming into this earnings season. We will be listening to see how the second half of the year is playing out and possibly glean some insight into what companies think about their prospects for 2023.

In a more difficult macro environment, we are looking for companies with pricing power, recurring revenue, and dominant market share. There should be a lot of good opportunities in the market as some investors indiscriminately sell micro stocks. Specific industries that we are most focused on today are Healthcare, Energy, and Consumer Staples. We are also looking for high-quality names that have seen irrational selling. Microcap investing can be difficult because of the large drawdowns, but if we can take advantage of capitulation, we should be able to find a few mutli-baggers in the rubble of the bear market.

Top Contributors

The micro strategy underperformed the Russell 2000 Index for the quarter with the top positive contributors being ChannelAdvisor Corporation (ECOM) and Tecnoglass (TGLS). ECOM is a leading e-commerce cloud platform software-as-a-service (SaaS) company whose mission is to connect and optimize the world's commerce through marketplaces, digital marketing, shoppable media, and brand analytics. We purchased ECOM in the second quarter of this year and they received a takeout offer from CommerceHub for $23.10, which was a 57% premium to the closing price on September 2, 2022.

The other top contributor, Tecnoglass (TGLS), is a building materials company that specializes in glass windows for commercial and residential properties. TGLS stock has been punished by the market because of its association with the housing market. While mortgage rates have increased and single-family housing starts have slowed, Tecnoglass's business has proven more resilient because of its commercial glass business, which is still seeing growth, and its single-family business, which focuses more on the south, specifically Florida, which has been a strong market. The business model proved itself in the last quarter by not only beating Wall Street consensus numbers, but also raising guidance for the remainder of the year.

Largest Detractors

The top detractors for the quarter were Unitil Corporation (UTL) and InfuSystem Holdings (INFU). The top detractor, Unitil Corporation, is a public utility holding company that engages in the distribution of electricity and natural gas. It operates through three segments: Utility Electric Operations, Utility Gas Operations, and Non-Regulated. Utilities are a defensive sector in the stock market and have held up nicely in sell offs. However, with interest rates rising rapidly it has put pressure on the utility sector because now there is competition for the yield they provide. We still like the defensive qualities UTL provides to the portfolio, but it does look like the sector could be under pressure if rates continue to grind higher.

The second largest detractor, InfuSystem Holdings, provides infusion pumps and related products and services in the United States and Canada. The company operates in two segments, Integrated Therapy Services (ITS) and Durable Medical Equipment Services (DME Services). INFU had a tough quarterly earnings report with a guidance cut due to delays in business initiatives with new partnerships signed with GE Medical this year. We still like the name, but the company is now a show me story and will likely need some good quarterly earnings reports to start outperforming again.

Additions

During the quarter, we purchased Zevia (ZVIA), a plant-based beverage company offering a zero-sugar soda solution. In addition to sodas, ZVIA offers teas, children’s beverages and energy drinks. ZVIA has been around for almost ten years and during this time has established a strong distribution channel and key relationships with retailers such as Costco and Target. ZVIA's management team has been undergoing a succession plan and currently has a new CEO, CFO and Chief Commercial Officer. During this management transition, ZVIA is currently undergoing a product rebranding which should draw more attention to the brand and appeal to a broader audience. Additionally, on a valuation basis, the company is trading well below its peer group offering a similar or greater growth profile. We think Zevia is at an inflection point on multiple fronts and are excited for what the future brings to the table.

Sales

We sold USA Truck in the quarter after it received a takeout deal that closed last quarter. As mentioned in our last letter we did sell Gold Royalty Corp. early in the quarter.

(Disclosures and chart showing ESG MICRO Opportunities Strategy Largest Contributors and Detractors on next page).

ESG MICRO Opportunities Strategy

Largest Contributors and Detractors – Q3 2022

5 Best - Absolute Contribution				
Ticker	**Company**	**Average Weight**	**Contribution**	
ECOM	ChannelAdvisor	3.53	158	bps
TGLS	Tecnoglass Inc.	3.36	55	bps
LMAT	LeMaitre Vascular, Inc.	3.48	31	bps
ANIK	Anika Therapeutics, Inc.	2.95	18	bps
PERI	Perion Network	4.83	16	bps
	5 Best Total	**18.15**	**278**	**bps**

5 Worst - Absolute Contribution				
Ticker	**Company**	**Average Weight**	**Contribution**	
UTL	Unitil Corporation	4.39	-111	bps
INFU	InfuSystem Holdings	3.68	-108	bps
HBIO	Harvard Bioscience, Inc.	3.14	-102	bps
GOOD	Gladstone Commercial	3.97	-63	bps
AKTS	Akoustis Technologies	2.88	-63	bps
	5 Worst Total	**18.06**	**-447**	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.