Macro overview

In 2023, the Micro Opportunities Strategy ended up trailing its benchmark primarily due to a substantial rally in micro cap stocks during the fourth quarter. This rally was led predominantly by stocks that were highly shorted and unprofitable. Notably, the micro cap index, with a healthcare allocation exceeding 20% —largely in the biotech sector—saw remarkable performance. Our focus on investing in higher quality companies poses a challenge in matching the index's performance during such periods of significant gains.

Below is a visual of the best performing absolute and relative factors in the fourth quarter:

	Absolute Return (%)					Relative Return (%)				
Russell 2000	**1Q23**	**2Q23**	**3Q23**	**4Q23**	**2023**	**1Q23**	**2Q23**	**3Q23**	**4Q23**	**2023**
Extremely Shorted	8.7	5.2	(10.7)	24.4	27.1	6.0	0.0	(5.6)	10.4	10.1
Negative Earnings	2.6	7.9	(13.0)	18.9	14.6	(0.2)	2.7	(7.8)	4.9	(2.3)
Dividend Shrinkers	3.0	4.0	(2.4)	18.3	23.7	0.3	(1.2)	2.8	4.3	6.8
High Volatility	(1.0)	7.6	(8.0)	17.3	15.1	(3.7)	2.4	(2.8)	3.3	(1.8)
Low ROE	(0.2)	3.5	(7.7)	17.3	11.9	(2.9)	(1.7)	(2.5)	3.3	(5.1)
Single-digit Share Price	2.2	6.8	(10.4)	17.2	14.6	(0.6)	1.6	(5.3)	3.2	(2.4)
Stock Issuers	2.1	7.9	(11.4)	16.8	14.1	(0.6)	2.7	(6.3)	2.8	(2.9)
Negative Cash Flow	1.9	7.6	(12.6)	16.3	11.5	(0.8)	2.4	(7.4)	2.3	(5.4)
Low ROIC	(0.7)	6.0	(9.3)	16.2	10.9	(3.4)	0.8	(4.2)	2.2	(6.0)

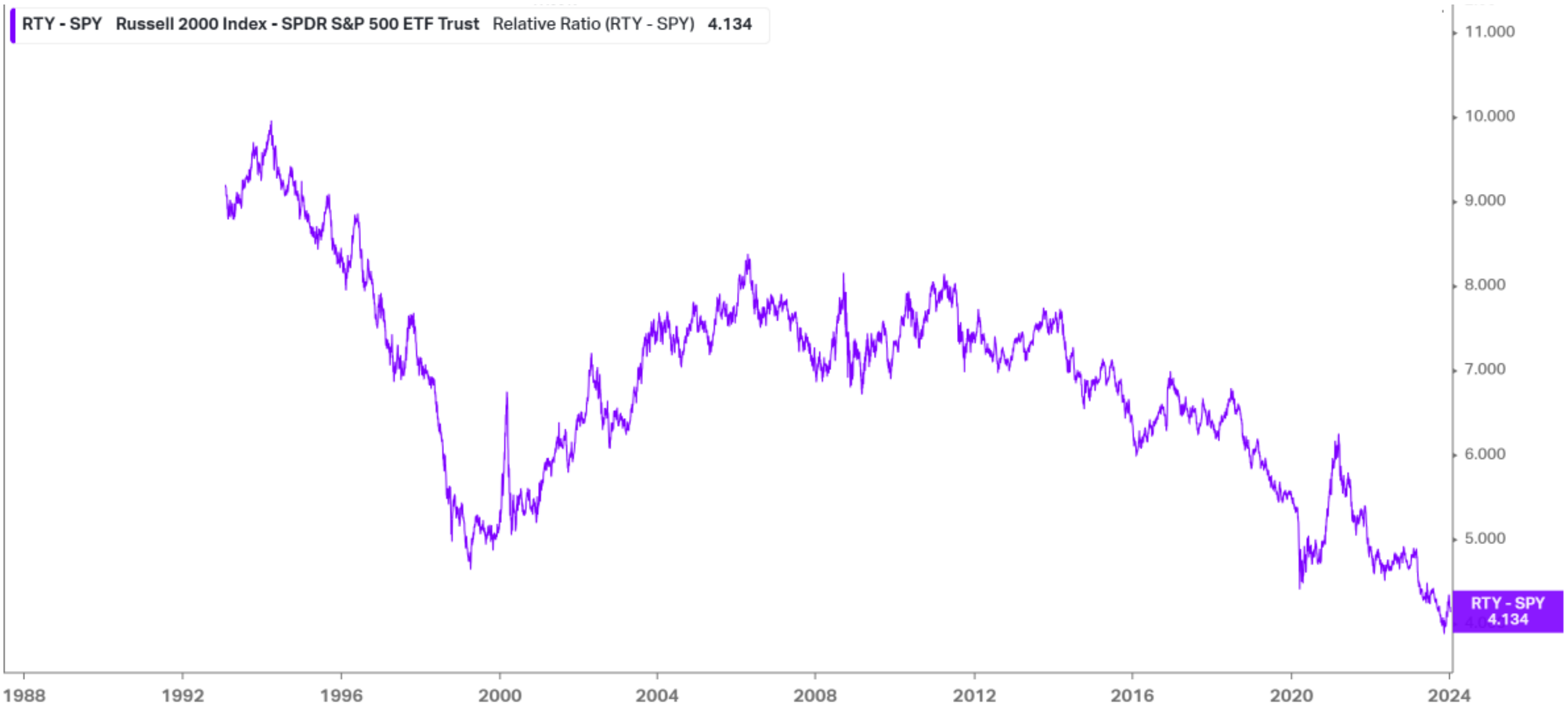
Source: Furey Research

As you read through strategist's outlooks or watch CNBC/Bloomberg, you probably see many predictions on what the market will do in 2024. Some pundits even provide an exact prediction on where the S&P 500 will finish 2024. This always seems like a waste of time because of the uncertainty and new information received every single year. Looking back at 2023, there were multiple instances when the market dynamics changed. We had a banking crisis with two of the largest failures in history and a Federal Reserve pivot at year's end sparking a massive rally in stocks. We try to take a Bayesian approach to the market, which simplistically means we change our mind when more data or evidence becomes available.

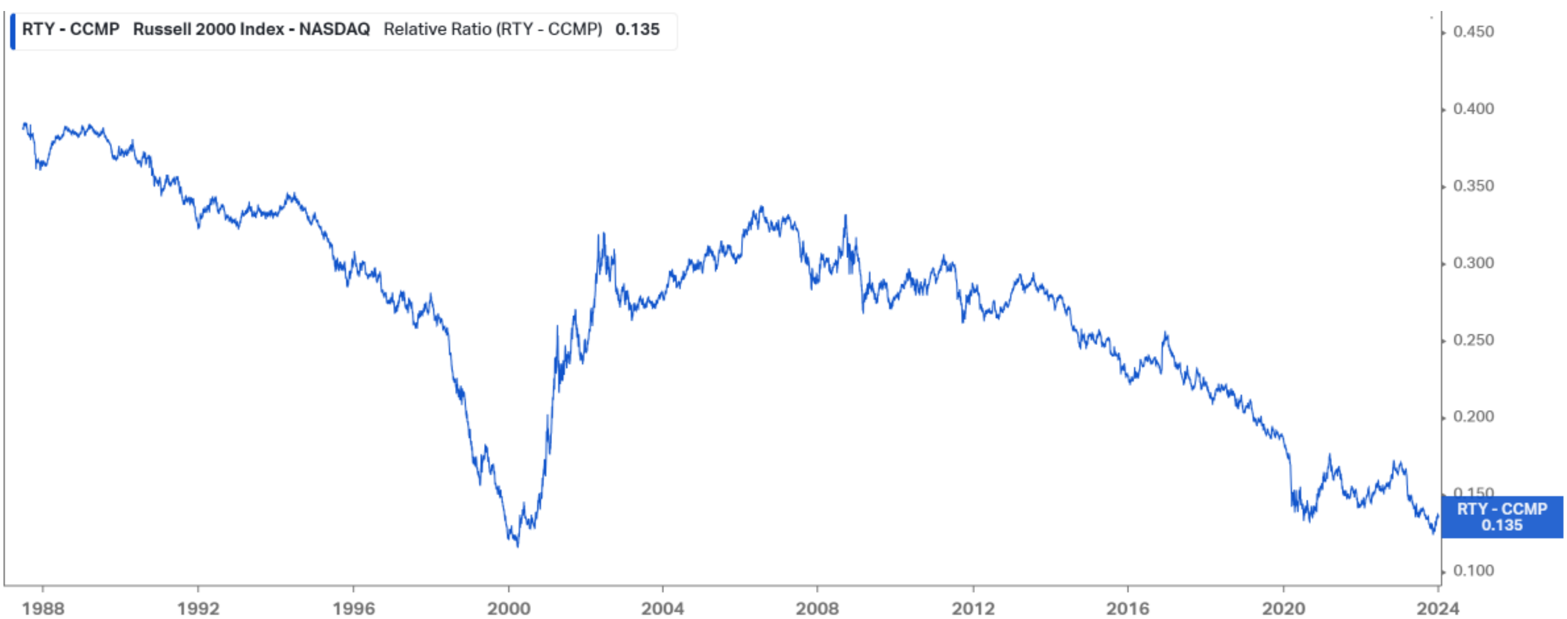
Turning our gaze to 2024, the prevailing conditions seem to favor micro caps, both on standalone terms and in comparison to asset classes. The easing inflation, stable unemployment claims, and recent improvements in housing starts create a challenging backdrop for an imminent recession. While bearish data points are always present, our stance remains bullish until these key economic indicators shift. Notably, small caps are up 60.7% on average one year after bottoming, beating large caps by an average of 21%.

Are micro caps and small caps nearing their bottom, particularly when compared to the Nasdaq and S&P 500? Past communications have touched on this, and while we might have been slightly early in our assessment, as Large Cap Growth stretched further, we are now convinced that micro cap and small cap sectors are poised to be the superior investment choices for the coming years. The theme of this letter, "A ship in harbor is safe, but that is not what ships are built for," underscores the necessity of venturing beyond the comfort zone in investing. It's easy to play it safe with the market's top performers, like the "Magnificent Seven," which, as reported by Yahoo Finance, yielded a 107% return in 2023. However, considering these giants' market size, we question the wisdom of expecting a repeat performance and suggest exploring underperforming sectors with promising macroeconomic setups.

As seen in the two charts on the next page showing the Russell 2000 relative to the S&P 500 and Nasdaq indices, small caps have not only been underperforming for the last year, but they have also been perpetual laggards for the last decade. The underperformance is comparable to what we saw during the '99 tech bubble and we would expect a similar rebound.



Source: Koyfin



Source: Koyfin

In line with our last quarterly letter, our favored sectors remain healthcare, industrials, and energy. Additionally, we're growing increasingly bullish on financials, partly due to declining interest rates and a more accommodating Federal Reserve. However, it's important to note that our concentrated portfolio approach may lead to an overweight in specific sectors due to our preference for certain stocks, rather than a broad sectoral outlook. Beyond sectoral analysis, we're scouring opportunities among neglected stocks, including failed IPOs and defunct SPACs with potential residual value. We're also keen on companies that have underperformed since the pandemic or those whose earnings have temporarily plummeted but show signs of reacceleration. There's a wealth of opportunity amidst the debris of the post-pandemic bubble.

While our bullish outlook persists, and we view market dips as buying opportunities, it's crucial to acknowledge that small cap indices could still experience sell-offs. The significant upswing at the end of 2023 has led to overstretched technicals, and some rebalancing at the start of the year wouldn't be surprising. However, such movements should be seen as opportunities rather than indications of fundamental weakness.

Company Deep Dive: Hudson Technologies (HDSN)

Hudson Technologies (HDSN) is an interesting case for investment in 2024, having caught our attention for its remarkable Returns on Invested Capital amidst a pool of undervalued companies. Initially, HDSN appeared to be just another overperformer during the pandemic, but a deeper dive into their operations revealed a more compelling narrative.

HDSN is, in their words, "a refrigerant services company providing innovative solutions to recurring problems within the refrigeration industry. Hudson has proven, reliable programs that meet customer refrigerant needs by providing environmentally sustainable solutions from initial sale of refrigerant gas through recovery, reclamation and reuse, to final refrigerant disposal and carbon credit trading."

In simple terms HDSN provides refrigerant products and services to HVAC systems, both commercial and residential. These refrigerants are highly regulated by governments and are very bad for the environment if they leak out. There are a few different types of refrigerants that are used, and the chemistry has changed over the years, but the bulk of refrigerants currently used in HVACs is called hydrofluorocarbon (HFC). There are greater than 125 million refrigeration and cooling systems in the U.S. today that employ HFC refrigerants.

The real opportunity for HDSN lies in the legislative landscape. The American Innovation and Manufacturing Act (AIM Act) of December 2020 mandates a phasedown in the production of virgin HFCs, significantly enhancing the market for reclaimed HFCs. With the EPA ruling a 40% reduction in virgin HFC production by 2024 and the current reclaimed HFC market at a meager 2%, HDSN, holding a dominant 35% market share in U.S. reclaimed refrigerants, is poised for substantial growth. They currently have the largest percentage of market share in the United States (35%) for reclaimed refrigerants. Reclaimed gas also has a larger gross margin for HDSN of ~50% compared to ~20% for virgin gas.

HDSN's valuation is equally enticing. Despite an extraordinary earnings per share (EPS) of over $2 in 2022, driven by price increases and low-cost inventory, we remained cautious until the company navigated these high comparisons. Management has given 2025 guidance of >$400 million in sales and a 35% gross margin. We believe these estimates are conservative, with the 35% acting as a floor in gross margin and anticipate higher earnings if pricing really takes off. HDSN had +50% gross margins in 2022 and today they are still around 40%. Some quick math on management's numbers suggests a floor of around $1.50 in EPS, potentially exceeding $2, if pricing remains favorable.

Determining an appropriate earnings multiple is challenging due to the uniqueness of HDSN's business model and lack of public pure play competitors. However, comparing them to waste management/recycling or chemical companies suggests a potential stock price range of $20 - $40 in the coming years, notably higher than the current $13 share price and less than 9x our conservative earnings estimate.

Establishing a precise price target is somewhat of a waste of time with HDSN. Market dynamics, particularly the supply-demand imbalance and potential price surges in HFCs, will significantly influence their profitability.. Past instances in similar market conditions have seen prices skyrocket, sometimes by 30 times. There are parallels to past phasedowns of other refrigerant gasses that saw prices go up as much as 30x, to just recently in 2022 moving from low single digits per pound to $10/lb.

HDSN's environmental impact cannot be overstated. As global cooling needs rise – with an expected increase from two billion AC units today to five billion by 2050 – HDSN's role in reducing emissions becomes increasingly crucial. Since 2000, HDSN has reclaimed more than 72 million pounds of refrigerant or 84 million tons of CO2 equivalent GHG emissions. While it is not likely or possible for industries or people to give up cooling, we appreciate that HDSN will be a part of the solution preventing these gasses from entering the atmosphere.

HDSN is exactly what we look for in micro cap investing: a market leader in a niche industry, with multiple growth catalysts, trading at a low valuation. With the potential for HFC pricing to make headline news in 2024, HDSN stands out as a compelling investment opportunity in the micro cap space.

Top Detractors

The top detractor in the fourth quarter was Talos Energy (TALO), with its performance largely affected by the declining oil prices rather than any fundamental issues within the company. Nevertheless, there is room for improvement in management's capital allocation and the efficiency of drilling programs. These are considered short-term concerns and given TALO's attractive valuation at a lower multiple compared to its peers, the stock is well-positioned for potential outperformance should oil prices rebound. Additionally, we are closely monitoring the prospects of Carbon Capture and Storage (CCS) development in 2024, which could further enhance TALO's performance relative to its industry counterparts.

First Internet Bancorp (INBK) was the largest detractor for the year, driven, in large part, by the bank failures early in the year. All our banks were unable to avoid residential. These refrigerants are highly regulated by governments and are very bad for the environment if they leak out. There are a few different types of the stock downdraft in the industry, but we were able to sell INBK and buy Coastal Financial Corporation (CCB), a higher quality bank which we think has more catalysts and upside potential in 2024.

Top Contributors

The top contributor for the fourth quarter was Tecnoglass (TGLS). Coming into the quarter TGLS had a couple of difficult earnings reports driven, primarily due to fluctuations in the Colombian peso against the US dollar rather than core business issues. A strengthening peso adversely impacted their gross margin, creating a perception of contraction. However, this is seen as a transient issue expected to normalize in the upcoming quarters. Furthermore, TGLS's stock price has shown a high correlation with interest rates. With the ten-year treasury yield dropping from around 5% to 4% swiftly in the fourth quarter, TGLS and other rate-sensitive stocks experienced a significant rally. Coupled with TGLS's low valuation, there is a potential for further multiple expansion in 2024, even if interest rates stabilize. Additionally, a key competitor of TGLS recently received multiple acquisition offers at a valuation double that of TGLS, highlighting its undervaluation.

The largest contributor for the year was Limoneira (LMNR). During 2023, LMNR implemented a strategy to realize the value of their underlying assets, which management and Riverwater believed were significantly undervalued. The company successfully sold some assets during the year, using the proceeds to substantially reduce its debt. The announcement in the fourth quarter regarding the potential sale of the entire company triggered a surge in its stock price. Despite the impressive performance in 2023, we assess LMNR as still being undervalued and anticipate it will continue to create substantial value in 2024.

Additions

Tactile Systems Technology (TCMD) develops advanced home therapy devices to improve health and quality of life for patients with chronic conditions. Areas of therapeutic focus are (1) vascular disease, with a goal of advancing the standard of care in treating lymphedema (2) oncology, where lymphedema is a common consequence among cancer survivors and (3) providing airway clearance therapy for those suffering from chronic respiratory conditions, including bronchiectasis. It's noteworthy that Riverwater divested from Electromed (ELMD), a competitor in the airway clearance sector, in favor of investing in TCMD, which presents opportunities in both bronchiectasis and lymphedema markets.

The markets for lymphedema and bronchiectasis are large, each exceeding $5 billion. In the U.S. alone, it's estimated that over 20 million people with lymphedema remain undiagnosed, compared to 1.4 million diagnosed cases, and 4.4 million potential bronchiectasis cases are undiagnosed against 0.5 million diagnosed. TCMD has leading solutions for both markets, and most of its competitors are small private companies or are embedded within larger medical device companies which do not prioritize these markets.

TCMD aims to achieve $350 million revenue, $50 million adjusted EBITDA, and $75 million free cash flow by 2025. This implies revenue growth of 13% and EBITDA growth of 14%, which are reasonable targets given their historical growth rates since 2015, including the pandemic period. TCMD sold off in 2023 because of lower-than-expected sales by a channel partner for AffloVest, and due to investor concerns that GLP-1 drugs, like Ozempic, would result in lower lymphedema over time. This is expected to be resolved by 2Q 2024. Sadly, for those affected, lymphedema is an irreversible condition, making TCMD's products a vital and lifelong treatment. The recent stock selloff created an attractive entry point from a valuation perspective, and we believe TCMD offers significant return potential over the next several years.

The other addition was Hudson Technologies (HDSN), which we discussed in the deep dive section.

Sales

We sold Electromed, Inc. (ELMD) as we discussed above. While ELMD remains a favorable company in its sector, we identified greater upside potential in TCMD, which also offers better liquidity. The decision was further influenced by the CEO transition that occurred at ELMD in 2023. We also sold The Real Good Food Company, Inc. (RGF) during the quarter. A recent addition, RGF unfortunately experienced operational issues that caused them to miss sales estimates and led to a capital raise. Combined with their large debt load, these factors prompted us to exit the position.

Thank you for your trust and confidence and please reach out with any questions.

Nathan Fredrick
Portfolio Manager

(Disclosures and chart showing strategy largest contributors and detractors on next page).

Micro Opportunities Strategy
Largest Contributors and Detractors – Q4 2023

5 Best - Absolute Contribution			
Ticker	Company	Average Weight	Contribution
TGLS	Tecnoglass Inc.	5.85%	217 bps
LMNR	Limoneira Company	5.50%	190 bps
FBIZ	First Business Financial Services, Inc.	4.36%	146 bps
MEC	Mayville Engineering Company, Inc.	4.61%	136 bps
UTL	Unitil Corporation	3.97%	94 bps
	5 Best Total	**24.29%**	**783 bps**

5 Worst - Absolute Contribution			
Ticker	Company	Average Weight	Contribution
TALO	Talos Energy, Inc.	3.73%	-70 bps
ASLE	AerSale Corporation	3.84%	-57 bps
LEU	Centrus Energy Corp. Class A	6.26%	-39 bps
RGF	Real Good Food Co., Inc. Class A	0.10%	-32 bps
MCS	Marcus Corporation	3.21%	-22 bps
	5 Worst Total	**17.14%**	**-220 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 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.