2nd Quarter 2021 Small Cap Strategy Commentary

The “Big” picture:

We dedicated considerable ink on the inflation topic in our last correspondence with you. Those concerns then are facts now. From this week’s Wall Street Journal, “the Labor Department said last month’s CPI increased 5.4% from a year ago, the largest one month change in 13 years. The June headline CPI was up 0.9% month over month, well above May's 0.6% monthly pace and consensus for 0.5%. It is the fourth consecutive monthly beat for headline CPI and fastest monthly rise since 2008”. Being up 5.4% year-over-year, higher than consensus for 4.9% and May's 5.0% rate, the big impacts were from used car/truck prices with largest monthly increase on record and travel/transportation costs. Core CPI, that is, excluding food and energy prices, was up 0.9% over May, hotter than from April’s 0.7% pace and above consensus for 0.4%. At +4.5% year-over-year, it was the largest annual gain for core prices since November 1991. Some focus was on the 0.5% overall rise for shelter prices, with rent and owners' equivalent rent both matching May's pace (+0.2% and +0.3% m/m, respectively). The debate remains over what proportion of these price hikes is transitory, with analysts noting June's increases were spread across a range of categories. The report may not have much impact on the Fed’s tapering timing (currently buying fixed income securities at $120 billion per month) but it could factor into fiscal stimulus discussions.

This is scarcely a victory lap as we also conveyed that attendant to inflation would be higher interest rates and a weaker U. S. Dollar; in fact, the two have gone the other direction. The dollar is stronger and interest rates are lower than our last writing. The interest rate action is most puzzling. The moves mentioned here may sound penny ante, but as the most liquid market in the world, the 10-year U. S. Treasury has made some wild moves. Three months ago it was at 1.65%, it drifted down into the 1.5’s percent. After the Fed’s June meeting where they stated they were “thinking about thinking about” starting to tighten, it fell immediately and down to 1.25% within days. It was a real head scratcher. The only good news to us was that even the most knowledgeable 10-year Treasury observers could not land on a reason or rationale; was it concern for the spread of the new COVID Delta variant? a massive short squeeze? a response the Fed’s to repo market activities? the market sensing that the economic growth for the second half of 2021 was going to be far weaker than anticipated? Just weird. It seems that the dollar’s strength is directly corelated to a drop in interest rates.

While in this week’s testimony the Fed is holding fast to the notion that the current blossoming inflation is transitory and that they have the tools to ensure that it will be, we believe inflation will be far stickier, that the 10-year Treasury has put in its lowest yield for the year and, if that is the case, the dollar may reverse and weaken.

More quietly however has been the reduction in the growth of the money supply (M2). As ardent monetarists we place great store in this statistic. Growth was collapsed from 26% growth in February to 9% in May. This is a de facto tightening that may create some pressures upon the equity markets in the months ahead.

The “Small” picture:

On to your portfolio specifics. At the center of our disciplined approach is valuation. The normalized price-to-earnings ratio is 21.2x for your portfolio. That is at a discount to the Russell 2000 which is at 23.9x, but with other statistics much better - over twice higher return on equity, or profitability, accomplished with very low levels of debts. The portfolio turnover of its positions is quite low by industry standards while supporting our average holding period of about three years for a security. This is especially important to our tax paying clients. In short, the portfolio is far more profitable (ROE) than the Index, accomplished with very low levels of debt, and acquired at a discount price (P-E) to the Index. This has been the classic trademark of Radnor Small Cap portfolios.

The portfolio had the following characteristics on June 30, 2021:

	RCM Portfolio	Russell 2000*
Normalized Price to Earnings	21.2x	24.0x
Price to Book Value	3.6x	2.6x
Return on Equity	10.2%	5.0%
Net debt/book capital**	6.2%	4.0%
Market Cap***	$4,455M	$1,241M
Number of issues	40	~2000
Portfolio turnover***	38%	NA

* Russell 2000 iShares is used as proxy for the index (actual index info unavailable under our FactSet subscription). ** Net debt means difference of total debt minus cash & short-term investments on balance sheet. *** This is an annualized statistic, measured in number of issues in and out of the portfolio. The Russell 2000 Index rebalances its positions annually at 6/30, RCM does not.

We have recently experienced a number of new clients, so, even as refresher, a couple of operational points are important to emphasize before we go deeper into the portfolio specifics. We often stress at the beginning of these letters "big picture" discussions and analysis: "top-down" observations. Our process, by contrast, is "bottom-up". We make individual valuation-based stock assessments through a repeatable process. We don't attempt to mimic an index; in fact, we strive to look very different that the Russell Index, and we do that with a compact portfolio, just 40 positions currently. A compact portfolio will experience more volatility relative to the Russell 2000 as the differing movements of 2,000 stocks can mute the result versus the easily observable impact of a mere 40 stocks. We eschew companies with heavy debt levels. Our shopping universe is defined as being within the market cap ranges of the Russell 2000, the highest of which is now $12.4 billion (as indicated in the nearby statistical panel your portfolio market cap is $4.4 billion). We do not time the market– we are always statistically fully invested. Stocks that underperform the Index by 20% from their cost are reviewed for potential elimination. We have been managing this asset class under these principles and disciplines for over 25 years.

As for your account, viewing the quarter by weighted contribution to return, the top five contributors were all long-term holdings: retailer of modern high-end furniture, RH, up 13.3% contributing .87% to results; manufacturer and retailer of durable, high-end coolers and cups, YETI, up 27.2% or a .74% addition to returns; land based oil and gas driller, Helmerich & Payne, up 21.0% for a .60% contribution; on-line creator of customized and delivered individualized fashion packages, Stitch Fix up 28%, contributing .47% (we sold this position for $87.00 in February and repurchased it last quarter at $49.00); and Jefferies Financial, up 17.9% adding .38%. It was just announced that Japan's Mitsui Financial Group will purchase up to a 4.9% stake in Jefferies.

Of the bottom five detractors it was a bit more difficult to categorize other than to some extent they were mean-reverting moves. Three of them were the previous quarter's top contributors: Sonos, the manufacturer/retailer of high quality, remote, sound speakers, "costing" 40 basis points (a basis point, or bp, is 1/100th of 1.0%), very long-term holding RV manufacturer Thor Industries -47 bp, and AeroVironment, a leader in unmanned aerial vehicles, primarily for military applications, -41 bp.; manufacturer of semi-conductors to enable touch screen panels, Synaptics, -26 bp; and Dycom Industries, and infrastructure leader in telecommunication/internet systems deployments, -.44%.

Moving from contribution to sectoral attribution, the higher weighting of larger positions in a concentrated portfolio will heavily influence those sector results. We define an over/under weight as +/- 1% to the Index's weighting. We were about market weighted in Information Technology, but that sector was our biggest "cost" at 1.85% to results and overweighted Consumer Discretionary subtracted 42 bp basis points to return. Overweighted Industrials subtracted 81 bp after the sector had been running hot for the past several quarters. For the most part being underweighted, or under exposed, in specific sectors also helped return. Being underweighted in Financials was actually contributory by 10 bp; that is, better stock selection overcame an 11% relative underweight. Finally, zero exposures in Real Estate, Telecommunications and Utilities combined to cost 30 bp. With limited "seating" in a concentrated portfolio we rarely see compelling investments within these fairly small sector weights.

In portfolio activity we were a bit more active than usual. The markets and most portfolios have performed reasonably well over the past 18 months. We moved to accomplish two objectives; reduce positions that have performed exceedingly well and to capture, to book, some of those gains while introducing a bit more defensive tenor to the portfolio. We should not be surprised to see the markets experience a breather in the near term. To that end we reduced Synaptics, Yeti, Sonos, and Littelfuse. We added or increased positions in J&J Snack Foods, dental supply company Henry Schein, and a new position in Jazz Pharmaceutical which specializes in sleep disorders. In the nearby contributors paragraph, we mentioned the reestablishment of a position in Stitch Fix.

Sincerely,

Doug Pyle