Small Cap Strategy - 1st Quarter 2022 Commentary

The Big Picture:

In our quarterly letter reviewing December 31, 2021, we expressed a little amusement with security analysts and investment strategists making their forecasts for the then year ahead, 2022. We intend no disrespect to those that do this and we are fairly certain it is an exercise performed by popular demand. It is an expected tradition. Still, here we are just a scant 90 days into the new year and kerflooey!

Let's start with the bond market and the Federal Reserve's better late than never addressing the rapidly accelerating inflation problem. Of course, our focus is on small cap equites, however stocks do not reside in a different universe from bonds. It is often a heart/lung relationship.

From Morningstar:

"In just the last week, the yield on the U.S. Treasury 10-year note has jumped to 2.32% from 2.19% and is up from 1.63% at the start of January. At the same time, the yield on the U.S. Treasury 2-year note has risen to 2.11% from 1.97% a week earlier, and 0.79% on Jan. 3. This is translating into pain for bond investors in their portfolios. The $16.5 billion iShares US Treasury Bond ETF is down 5.90% year to date, falling more than 3% in the past month and more than 1% in the past week. A broader tracker of the bond market, the $305 billion Vanguard Total Bond fund, is down 6.4% this year, with a 2.7% decline in the past month. For comparison, the worst year in history for Vanguard Bond Fund was a 2.66% decline in 1994. "Volatility in the bond market is very high," says Eddy Vataru, lead portfolio manager of the Osterweis Total Return Fund. These declines are some of the worst that the bond market has seen in many years. For example, the Morningstar US 5-10 Year Treasury Bond index is down 5.7% so far in 2022 and has lost some 9.6% since its last peak in August 2020, the largest drawdown in its history".

With 10-year Treasury yields rising from 1.51% to 2.34% over the quarter, and aggregated Treasury market returns also suffering their largest drawdown (–10.3%) since the bond series began in 1976. For what's it is worth, Radnor Capital has maintained a very defensive posture toward bonds for a considerable time, sparing our balanced large cap and straight fixed income accounts the wreckage mentioned above.

Then on February 24th the Russian invasion of Ukraine, starting the first major conflict in Europe since April 1945. Frankly, I do not even know how begin to address this war and the accompanying humanitarian crisis; I'll leave that to government spokespeople and the media. However, the implementation of severe sanctions against Russia and Belarus has, and will, effect specific securities in your portfolio, and of course, the market's behavior in general. We'll be more specific in the portfolio review section of the letter. In recent letters we have sought to express some of our portfolio management operating "rules". One aspect in particular has been to reference that our portfolios usually remaining statistically fully invested, carrying only frictional levels if cash. That can be a scary statement in times of turmoil – like now. The first quarter's return is an example of why we do not attempt market timing strategies; only a cash position of close to a 100% would have achieved similar "flattish" performance for the quarter. I am reminded of a song's lyrics "I foresee terrible trouble, but I remain here just the same" (Fagan/Becker).

The Small Picture:

On to portfolio specifics, let's first look at valuation. At the center of our disciplined approach is valuation. The normalized price-to-earnings ratio is 16.6x for your portfolio is at a discount to the Russell 2000 at 20.3x, but with better other statistics; over 390 basis point higher return on equity, or profitability (many of our portfolio companies, especially in energy and materials, have experienced 5 years of losses and no ROE; accounting for that, the underlying portfolio ROE is 11.3% vs. 4.7% for the Index), accomplished with Index levels of low debt. 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 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 March 31, 2022:

	RCM Portfolio	Russell 2000*
Normalized Price to Earnings	16.6x	20.3x
Price to Book Value	3.6	2.1
Return on Equity	8.6%	4.7%
Net debt/book capital**	12.9%	4.9%
Market Cap***	$4.6 billion	$1.03 billion
Number of issues	38	~2, 000
Five Year Portfolio turnover***	33.8%	-

* 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.

As mentioned, we like to review operational points before we go deeper into the portfolio specifics. Our process 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 than the Russell 2000 Index, and we do that with a compact portfolio, just 38 positions currently. A compact portfolio as ours will experience more volatility relative to the Russell 2000 as the differing movements of 2,000 stocks can dilute the result versus a mere handful of 38 or so. We eschew companies with heavy debt levels. Our shopping universe is defined as being within the market cap ranges of the Russell 2000. As indicated in the nearby statistical panel your portfolio market cap is $4.6 billion however, we do not rebalance annually as the Index does. We do not time the market– we are usually statistically fully invested.

Viewing the quarter by weighted contribution to return, the top five contributors were all long-term holdings and each one influenced to some degree by the war in the Ukraine and/or energy policies: fertilizer producer Intrepid Potash, up 92.3% contributed 2.7% to return as Russian, Belarus, and Ukraine potash supplies are not in the market; AeroVironment, very much in the news as its Switchblade drone and backpack size missiles are in great demand in Ukraine, being perfectly suited for that type of

warfare up 51.7% contributing 1.4.86% to results; then the rest are all energy related: land based driller, SM Energy, up 18.7% contributing .4% to results, APA Corp. (formerly Apache Energy) up 54.3% contributing 1.4%, and natural gas driller EQT, up 58.7% adding 1.2% to results.

Of the bottom five detractors were mostly in the Consumer Discretionary category with housing related and retail issues leading. They were: Montrose Environmental -1.11%; manufacturer of artificial sweetener additives Whole Earth Brands, -.86%, RV manufacturer Thor Industries, -.61%; Meritage Homes -.73%; eponymous Installed Building Products, -.1.3%.

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. Overweighted Energy added .49% to return followed by the Materials which added 231 basis points to return (a basis point, or bp, is 1/100th of 1.0%) and the Industrial Sector added 223 basis points to return as the more value-oriented positions provided performance leadership. The Consumer Discretionary sector was overweighted too, but "cost" 2.3% to overall performance. One of the underweighted sectors but with better stock selection was a contributing group, Information Technology added +150 bp. The underweighted sector of Financials subtracted 2 bp from results.

In portfolio activity the market has presented us with the opportunity to harvest and cultivate; that is trimming successful positions and initiating new positions that have been previously sharply depressed in price. Given very strong performance contribution from Energy and Materials, we used that strength to reduce positions in driller Helmerich & Payne, APA (formerly Apache Energy) and fertilizer producer Intrepid Potash. We are scouting about in some last year's IPO's that by their subsequent performance were clearly brought to market prematurely, (although propitious to the seller IPO firm!). Here they are with their percentage levels of price declines from their IPO highs: Allbirds (78.5)%, Figs (43.5)%, Weber (52.0)%, Sweetgreen (65.8)%, Dutch Bros (79.1)%. Weber makes outdoor grilling equipment, Figs is introducing an element of style to surgical scrubs, Sweetgreen operates restaurants devoted to salads and healthy food, Allbirds makes sporty shoes from recycled materials, and Dutch Bros operates coffee shops, mostly in West Coast locations.

Sincerely,

Doug