

**BirdRock Asset Management  
Q2 2018 Update  
Small Cap Value & Market Outlook**

**Small Cap Value Performance Summary**

**Strategy Highlights**

**Market Review & Commentary**

It was a solid second quarter for small caps as growth, value and core did well across the board. Can the small rally continue for the remainder of the year and defy the critics while leaving the large caps in the dust?

It's possible as revenue revisions have been very good and estimated growth has picked up to 8% from 6%. Valuations are not what they were in February as the market bottomed out but still in the 50th percentile historically. The question now is whether earnings in 2019 will be as robust as they've been as the comparisons get more difficult. Earnings for small caps are expected to grow 18.1% in 2019 and this would justify the continued rally with Materials leading the way with expected 26.2% growth. The market has also digested the seventh Federal Reserve rate hike and performance, historically, has been mixed after this much tightening.

BirdRock's small cap value composite gained 9.91% during the second quarter and outpaced its representative benchmark which moved ahead 8.30%. For the year-to-date period, the BirdRock Small Cap Value is up 8.45% vs 6.35% for the Russell 2000 Value. Trailing one year returns saw the BirdRock Small Cap Value up 20.88% vs 12.57% for the Small Value index.

Small Value was the winner during the second quarter with a gain of 8.30% and outpaced Small Growth which returned 7.23% and Small Core which returned 7.75%.

For the year, Small Growth is still leading the pack with a gain of 9.70% while Small Core is up 7.66% and Small Value is trailing with a gain of 5.44%.

Contributors to our out-performance during the quarter were our Health Care positions which gained, overall, 19.33% in Q2 and lead by Diplomat Pharmacy which gained 26.85%. Halyard Health also had a nice second quarter with a gain of 24.24%. Year-to-date, the HealthCare sector is also the leading driver of performance in the Russell 2000 Value with a gain of 17.49%. No other sector has double-digit gains year-to-date.

Consumer Staples is gained 5.88% for the benchmark in Q2 and we were able to exceed that with a gain of 11.14% as Performance Food Group gained 22.95% and contributed to performance. We were also slightly overweight the second for the period.

We were overweight the Industrials sector in the second quarter as well as year-to-date. This has been a contributor to performance as our selections gained 14.12% through June while the benchmark gained 5.58%. ArcBest Corporation contributed to performance with a gain of 42.87% while Insperity Inc gained 37.25%. For the year, our Industrials selections have added 17.16% to performance while the benchmark is up 3.89%.

Detracting from performance in Q2 was our slight overweighting in the Materials sector while also slightly underperforming for the quarter. The Materials sector gained 6.54% in Q2 while the Small Cap Value Composite gained 5.11%. Lagging during the quarter was Myers Industries, Inc which fell -8.64% after reporting better than expected earnings of 0.24 vs the estimate of 0.19 but guidance fell short of market expectations.

Our biggest performance detractor, Federated Investors, fell -29.50% during the second quarter and lagged the benchmark by a wide margin as earnings fell short of the Street's expectations. Lower revenues and reduced equity assets affected the company's Q2 results. Management noted lower expenses and improved AUM (Assets Under Management) on the conference call. Because of the recent disappointing guidance, we are assessing our thesis for this specific portfolio holding.

For the year-to-date period, HealthCare and Industrials continue to act as contributors to overall portfolio performance with solid earnings and top-line growth. Insperity is our leading performer year-to-date in the Industrials sector with a gain of 66.91% while Diplomat Pharmacy is the leading gainer for the Healthcare sector for the Small Cap Value portfolio with a gain of 27.35%.

## **Outlook and Positioning**

We believe stock selection is becoming even more important as money flows have been robust in the Small Cap asset class, but, what can move in quickly, can also move out quickly.

In addition, Volatility has been uncharacteristically quiet since the market bottomed in February and this has helped lower quality, "smaller" small caps and those with challenging balance sheets to outperform.

Given that, we believe the reversal into higher quality companies and those with more durable balance sheets will outperform during the remainder of 2018. We aim to

participate in the equity gains as these more turbulent times have historically benefitted our investment strategy.

Our investment approach stems from looking at both, downside risk as well as upside potential. Our investment process reflects this notion. Recouping significant losses in an investment portfolio is very hard; better to defend your capital instead by vigilance on the front-end.

Despite the recent small caps performance, we believe there's still some wind at the backs of small caps. Relative and absolute valuations are around the 50<sup>th</sup> percentile historically.

Forward-looking estimates continue to be positive. Assuming continued >3% GDP growth in the latter two quarters of 2018, which we expect, would typically benefit small caps. Merger and Acquisition activity is still staying quite strong and housing looks healthy. This trend historically favors small rather than large.

Thank you for your confidence and trust.

BirdRock Asset Management

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