William Schaff
Chief Executive Officer,
Portfolio Manager

Steve Block
Portfolio Manager

SECOND QUARTER 2021

Small Cap Value Commentary

Market Summary

The Russell 2000® Value Index (the "Benchmark" or the "Index") added 4.6% in the second quarter for a year-to-date gain of 26.7%. This quarter the strongest performance came from Communication Services (+53%) led by AMC's 455% gain. Energy jumped 20% reflecting higher oil prices as travel ramps up and industrial companies run at full capacity. Real Estate gained 8% led by strong performance from the retail, industrial, and residential groups. Consumer Discretionary rose 6% on attractive returns from the retail group, while Technology grew 5% on good results from the software and services group. Materials also saw a 5% rise led by aluminum, construction materials, and paper and forest products. Health Care gained a modest 4% as the equipment and services group's 9% gain outpaced the flat performance from the pharmaceutical group. Financials were flat for the Benchmark as lower treasury yields caused a 2% banking decline, while diversified financials gained 9%. Investors sought out consumer finance, investment banking, and mortgage REITs.

Performance Summary - Quarter

For the quarter, our small cap value strategy (the "Strategy" or "Portfolio") outperformed the Benchmark. The Portfolio was fully able to offset not owning AMC, the largest detracting factor for the quarter. The only sector negatively impacting relative performance was Real Estate due to weak performance from retail property owner American Finance which gave back some of its strong gains from last quarter.

Energy was the strongest sector in the second quarter thanks to big gains from exploration and production companies Range Resources, Magnolia Oil & Gas, PDC Energy, and ChampionX. The common theme was higher oil and gas prices to which these companies are leveraged.

Consumer Discretionary was driven by strong performance from Scientific Games which offers technology that goes into slot machines, lotteries, and now also sustains sports betting and online gaming. Retailers Boot Barn and American Eagle were also good performers offsetting weaker results from Asbury Automotive.

Financials were led by banks Bancorp and Meta Financial, both of which offer debit cards and other non-traditional products and services. These banks are experiencing stronger growth than traditional banks who are struggling with historically low net interest margins resulting from low interest rates. We also owned New York based Sterling Financial whose stock rose after receiving an acquisition offer.

Industrials outperformed the Benchmark thanks to big gains from commercial construction distributor Wesco and from Cornerstone Building Products which provides windows and sidings to commercial builders. MYR Group, an Engineering and construction contractor, saw its stock ramp higher as its utilities customers need to build more green power and upgrade their existing transmission and distribution infrastructure.

Materials beat the Benchmark as Arconic's stock shot higher. Arconic provides aluminum to vehicles and planes, and is also used in packaging, construction, and industrial products. Specialty chemicals provider Ferro saw its stock jump after receiving an acquisition offer.

In Utilities, South Jersey's stock gained double digits, and we avoided a decline of similar magnitude from Brookfield Renewable.

Other Contributors for the Quarter

With the expected opening of schools in the fall, Scholastic, a provider of supplemental reading and education material, should perform well later this year. 30% of their revenues come from books which we expect to be back in earnest this fall.

Through their 1,400 stores, Aaron's provides rent-to-own household goods such as furniture, appliances, and electronics. Demand is as strong as residential housing and Aaron's same store sales were up almost 15% in the first quarter, the company's first double digit result since 2009.

Other Detractors for the Quarter

Heritage Insurance provides homeowner insurance mostly along the east coast, and 30% of their insured value is in Florida where weather related losses have outpaced strong price hikes recently. They continue to raise prices by double digits, and we expect that it should be enough to generate a return on equity of 8%-12% in the next couple of years. If so, this stock that now trades significantly below book value could see much brighter days ahead.

Skywest fell in line with the airline group this quarter after strong gains earlier. Consumer travel is coming back quickly, but business travel probably won't return meaningfully until sometime next year.

Performance – Year-to-Date

The Strategy has outperformed the Index year-to-date. We have been able to offset the fact that we did not own either AMC or Gamestop, the two most famous (infamous?) meme stocks in the Benchmark which have been large contributors to the Benchmark's return in the first half of the year.

Financials has been the strongest performing sector for the Strategy. Most of the alpha has come from the banks group partly due to Triumph Bank, Bancorp, and Meta Financial, each of which have sizable non-traditional banking operations that are driving profits unrelated to traditional borrowing and lending. Pinnacle Bank (Tennessee), Sterling Bank (New York), and Great Western Bank (Midwest) were also exceptional performers in the first half of the year.

Industrials outpaced the Benchmark. The strongest gainer was Atkore which surprised investors with strong demand for cabling and assorted electrical products from data centers, warehouses, and airports. Other strategy winners in the commercial building theme were Wesco and Cornerstone Building Products. Gibraltar's stock gains came from strong housing and solar panel products. MYR Group's performance was additive as well.

Energy was fueled by the same factors as in the second quarter with strong oil and gas prices driving many of our stocks higher including ChampionX, Magnolia Oil & Gas, PDC Energy, Parsley Energy, and Range Resources.

In Consumer Discretionary we slightly outperformed the Index despite not owning Gamestop. Strong performance from Scientific Games offset much of the shortfall from not owning Gamestop. We also sold Penn National Gaming, a large weight in the Index, before its double digit decline this quarter.

Health Care underperformed in the pharmaceutical/biotechnology group. Our strategy in this group is to own companies with revenue, cash flow, and multiple products. These factors, however, have been out of favor this year. Investors have bid up single pipeline drugs companies with no revenues and certainly no cash flow.

Communications Services lagged because we did not own AMC. Strong performance from Nexstar offset some of this shortfall. In Materials our holdings could not keep up with the Benchmark's large weight in the volatile steel and aluminum industries. We typically own companies that have less exposure to raw materials prices and tend to have more stable businesses. Cash was a detractor as well.

Quarterly Purchase and Sales Summary

Much of this quarter's activity centered around positioning the Strategy to remain within our allowed deviation of the Russell 2000 Value's new sector weights. A higher Health Care weight had us purchasing Bridgebio Pharma (drugs that target niche, unmet medical needs), Myriad Genetics (testing for hereditary cancer), Invitae (genetic testing), Varex (x-ray tube provider undergoing a company-wide transformation), and Orthofix (bone growth therapies under a new CEO from Biomet).

In Financials, we sold Pinnacle Financial as it has become too expensive, and we placed the proceeds into Dime Community (New York) and Texas Capital. Dime is merging with Bridge which will create a much more diversified and more profitable bank. Texas Capital's new CEO comes from JP Morgan and is charged with turning this formerly sleepy bank into one with impressive growth and profits. We also reduced our positions in Sterling Bancorp, OneMain, Stifel, and Primerica, stocks that are nearing mid-cap valuations.

Due to valuations and to a higher index weight we added to many of our existing REITs as well as initiating a position in Ryman Hospitality, owner of 5 resort hotels under the Gaylord brand. We expect growth here to be remarkable post-Covid.

Industrials now contains Deluxe, a provider of products and services to small businesses. They have a new CEO intent on growing the business and profitability. In order to begin doing that, Deluxe recently bought a payment processing company which many of Deluxe's four million customers can use.

In Consumer Discretionary we took profits in Ruth's Chris and Kohl's and reduced American Eagle, Scientific Games, Boot Barn, and Asbury Automotive. Designer Brands, a leading shoe retailer is new to the strategy – we think as American return to work, school, and get back to their everyday lives, shoe demand should pick up markedly.

Portfolio Positioning

Two-thirds of the Portfolio is positioned in categories that we believe will be winners through 2022. We expect somewhat higher inflation in quarters ahead which would mean steeper interest rate curves where banks (19% of the strategy) should thrive. Housing is certainly out of equilibrium where supply cannot catch up to demand – we have 7% weight here as we forecast favorable business in housing for quite some time. Vehicles (6% weight) are also in short supply, and we expect strong demand here for the next couple of years. Real Estate (8% weight) is making a comeback with a stronger economy and the values here are among the best of all the sectors. Energy has a 7% weight because we believe strong energy prices coupled with free cash flow generation by exploration and production companies will bring investors back into these stocks. Travel is 5% of the strategy – there should be tailwinds here for quite some time as consumers catch up on vacations and businesses start sending their people on the road once again. Other themes include construction/infrastructure and semiconductors, both of which should continue to see strong demand as well.

PHOCAS Financial

WWW.PHOCASFINANCIAL.COM
1080 Marina Village Parkway, Suite 520, Alameda, CA 94501
510-523-5800 | info@phocasfinancial.com