SMALL CAP CORE

INVESTMENT COMMENTARY & REVIEW

by Quinn Stills

First Quarter 2023

In 2022 we averred that there would not be a genuine recession. We came to this conclusion because an economic slowdown was not evident in the collective balance sheets of the companies we reviewed. In 2022, our somewhat contrarian opinion was rooted in our decades of experience examining thousands of balance sheets through many economic cycles. Prior to a recession, we normally see a broad-based swelling in the accounts receivables, inventories and pre-paid expenses accompanied by sharply negative earnings revisions across many industries.

Dear friends, as of this writing, things appear to have changed. Indeed, companies have been reporting their 4th quarter 2022 earnings and filing their 4Q2022 financial statements throughout late March and early April. Now for the first time in many years, we are seeing signs of an economic downturn manifest in the financial statements of many companies across several economic sectors. As a result of our observations, we believe the risk of a recession is higher than at any time since the pandemic of 2020. In the section below, we explain the steps we have taken to seek to mitigate recession risk effects on the portfolio.

For the quarter, the top performing sectors included information technology, utilities and real estate. The weakest sectors included financials, health care and consumer discretionary. On the individual stock level, the top performing stocks included Indie Semiconductor, Axcelis Technologies, and Perion Network. The weakest performing individual stocks included Customers Bancorp, Washington Trust Bancorp, and Independent Bank Corp.

In light of our increasingly cloudy backdrop, we have taken three important steps. First, we have positioned the portfolio in companies we identify as having fortress like balance sheets. We believe this should help safeguard the portfolio from the most serious impacts of any economic downturn. Second, we have reduced the portfolio's exposure to financial services, which are leveraged by their very nature, and we have cut back our exposure to commercial real estate, which is similarly debt-leveraged. For perspective, 54% of the portfolio's holdings as of 3/31/23 have no net debt! Third, and finally, we have increased the portfolio's emphasis on companies that uniquely differentiate themselves through advanced technological innovations that should allow them to grow independent of cyclical economic activity. We believe the combination of these three actions should help the portfolio mitigate the deleterious effects of an economic downturn.

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