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Kippington Capital Management August Insights

Portfolio Insight

Kippington Capital implements a disciplined strategy in selecting high-quality businesses, and that has given us a significant advantage through the past several months of severe uncertainty. The impact of COVID-19 has been pervasive, and as such no company has escaped unscathed. In fact, some firms, particularly the "digitally dominant", have even thrived. To that end, the companies selected within the Kippington portfolio have competitive advantages and outstanding management which have kept their businesses performing at the highest level. There's no question that the companies in which we own shares will be much more valuable in 5 years, regardless of virus or vaccine.

I began building a new position at the end of July, which brings our total number of long positions to nine. We began buying shares at the higher end of our fair value range, and, should shares continue to increase in value, a fully sized position may not be achievable. I'm comfortable with the advantages and management of this business and believe the prospects for both the near-term and long-term future are outstanding. I will have more information on this business towards the end of the year.

Market Insight

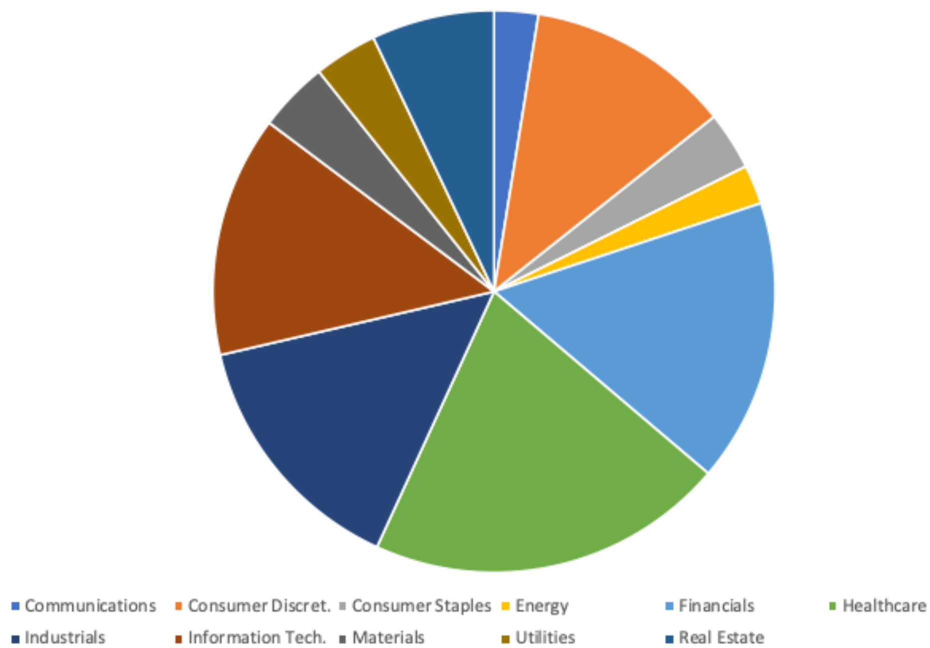
The Russell 2000 continued to climb out from the hole it dug earlier this year with a 2.77% return in the month of July. This leaves the index down 10.6% YTD. Similar to the major equity indices, the US economy forged ahead in its attempted recovery, but damage from the coronavirus continued to show through. Initial unemployment claims remained enormous at just under 1.5 million per week through the end of July. The country's Q2 GDP fell 9.5% both year-on-year and sequentially, the largest quarterly decrease since the 1940s. On the positive side, the unemployment rate has fallen to 11.1%, a high number on an absolute basis but much lower than the peak of 14.7% set in the April report. It's apparent now that whichever "letter" recovery investors may have been expecting – u, v, w, etc. – the best we can expect at this point is what some are comparing to a Nike swoosh. That is to say, it's a long road ahead.

Forward Insight

In order to understand the future of the US small-cap market, it's most important to know what that market is actually comprised of. Index composition is becoming an increasingly prescient topic in the large-cap world. The S&P 500, long thought to be the diversified bellwether of the US stock market's largest companies, is now dominated by five technology businesses: Facebook, Apple, Amazon, Microsoft, and Google (referred to as FAAMG). In fact, the five FAAMG firms account for fully 22% of the index's composition. The shares of these companies have increased in value an average of 36% this year, however the S&P 500 is flat YTD. If you examine the entire index instead, you'll find the median company's shares are down 11%.

There isn't near as much concentration in the Russell 2000 given there are many more companies and the dispersion of market cap is much smaller. Nonetheless it's important to understand the composition of the market as this will drive index, and thus passive investing, returns. The four most prominent sectors in US small-caps are healthcare, financials, industrials, and technology, and they account for over 65% of the market (Chart 1).

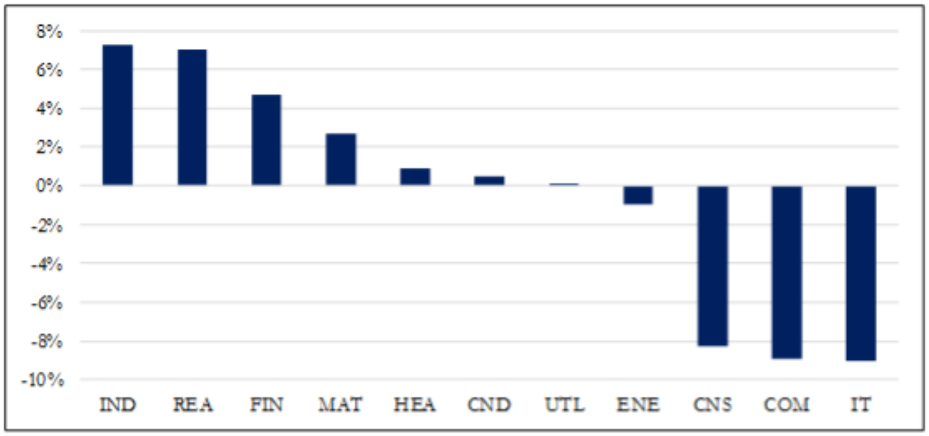
Chart 1: Composition of the US Small-Cap Market



Source: FTSE Russell

Going a level deeper, there's more clarity in the future performance of the small-cap market if you compare the difference in sector weights to the large-cap indices. This shows that small-caps have a much heavier weighting of industrials, real estate, and financials (Chart 2). What's more, large-caps have a heavier weighting in technology, communications, and consumer staples.

Chart 2: US Small-Cap vs Large-Cap Sector Weights

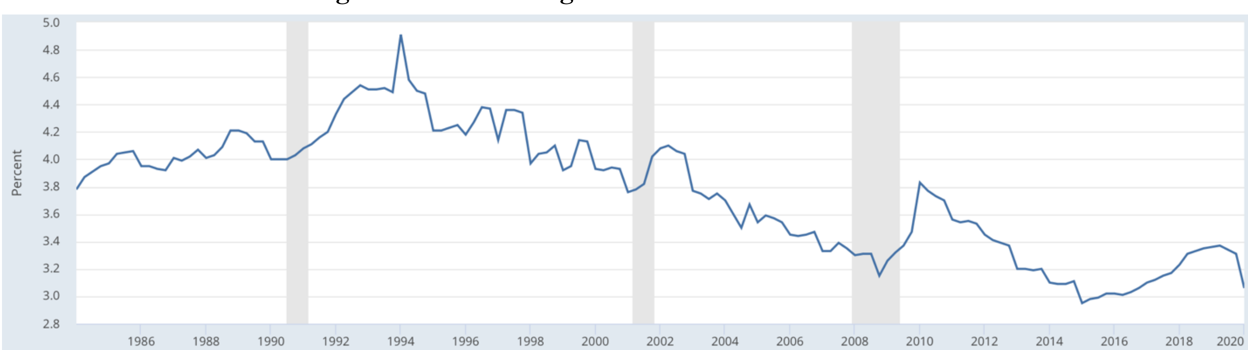


Abbreviations: CND=Consumer Discretionary, CNS=Consumer Staples, COM=Communications, ENE=Energy, FIN=Financials, HEA=Healthcare, IND=Industrials, IT=Information Technology, MAT=Materials, REA=Real Estate, UTL=Utilities

Source: MSCI, Refinitiv, THR

With that data, it becomes clear that, relative to their large-cap equivalents, broad small-cap indices are likely to be the poorer performers in the short-term. Industrials will face challenges from disrupted supply chains, real estate (a large portion being commercial) will contend with brick and mortar bankruptcies, and financials will continue to battle historically compressed net interest margins (Chart 3).

Chart 3: US Banks' Average Net Interest Margin



Source: St. Louis Federal Reserve FRED

Small-cap indices are heavy in all three of these sectors, whereas large-caps will benefit from the tailwinds helping their proportionately bigger allocation to consumer staples as well as, and perhaps especially, communications and technology.

This doesn't mean that small-cap investors are doomed to relative performance that is lesser than other equity asset classes. In fact, it's quite the opposite. The small-cap universe is in transition from an environment in which the rising tide lifts all ships towards a stock-picker's market. Passive investing in small-cap indices will likely prove a less productive use of capital going forward. However, those looking for businesses with promising futures that are perhaps unaffected by the changes brought about by COVID-19 are likely to drive excess total return.

As always, I welcome the opportunity to address any topics discussed herein as well as specific issues or portfolio objectives you may have. You can reach me directly at (847) 648 - 2667 or by email at conor@kippingtoncapital.com.

Best regards,

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