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September 8, 2020

Kippington Capital September Insights

Portfolio Insights

Kippington Capital's focus of investing in high-quality businesses continues to be rewarded as the competitive advantages these companies possess helped position them to perform admirably through these challenging times. Strong operational performance has translated to share prices and has led us to position trimming in some instances as a result of both substantial appreciation and optimistic valuations.

On the other side of the coin, the process of building our 9th long position continues. After beginning to enter the position several weeks ago, shares quickly reached a level that did not support continued accumulation. However, they subsequently retreated to the low end of fair value range, which offered the opportunity to resume building the position. Achievement of a full-sized position will be completed in the short-term, and additional information on this position will be provided in the Q3 partner letter.

Market Insight

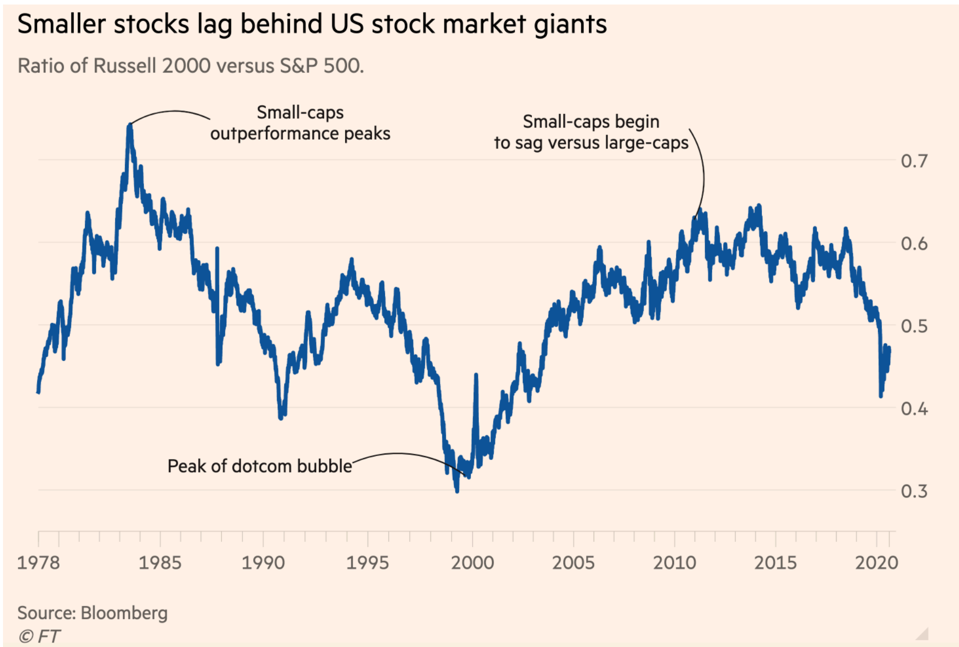
The Russell 2000 gained 5.6% in August trimming its total YTD loss to just -5.5%. The US economy continued to reopen and recover with unemployment dropping to 10.2% as of the July report, down from 11.1% in June and 14.7% in April when most of the country was closed for business. Initial unemployment claims continue to hover around 1 million per week, but signs of consumer confidence (or possible stir-craziness) continue to show through. Restaurants are seeing increased activity, and moviegoers are starting to return to the cinema with 70% of AMC's theaters open for Labor Day weekend. What's more, the Bureau of Labor Statistics' jobs reports show that the US has created about 10.5 million jobs since the low in the April report leaving us about halfway back to the pre-shutdown high in total jobs.

It's also important to note that at month's end, Chairman Powell announced at the Federal Reserve's annual Jackson Hole Symposium (done remotely), a highly-anticipated and meaningful change to policy framework. Going forward, the Fed will use an average inflation target instead of an absolute one. Translated for investors: since we have been running under the Fed's inflation target of 2% over the past 10 years, easier monetary policy can be expected to continue even if inflation begins to hum over 2% in order to compensate for the last decade.

Forward Insight

Small caps' outperformance is cyclical, and has lagged large caps over the past decade (Chart 1).

Chart 1: Russell 2000 vs S&P 500 Performance



However, in reality, even large caps have lagged large caps as five digitally dominant stocks represent the bulk of the performance of the S&P 500. The five largest companies in the S&P 500 are all technology companies and account for nearly 20% of the market value of the entire index. Apple (AAPL), Microsoft (MSFT), Amazon (AMZN), Google owner Alphabet (GOOGL), and Facebook (FB) are collectively worth $4.85 trillion, greater than the market cap of <u>every</u> company in the Russell 2000 ($4.5 trillion). An analysis of the performance of the popular bell weather index, the S&P 500, shows that without the contribution of those 5 tech companies, the index would firmly in negative territory for the year.

The cause of this year's small cap underperformance can be attributed primarily to the economic impact of Covid-19, which has harmed smaller, more domestically-oriented companies more than large multinationals. Financial, industrial, consumer discretionary, and real estate stocks make up 16%, 15%, 13%, and 6% respectively of the Russell 2000. That makes the index more dependent on a US economic upswing than the global and tech-dominated S&P 500.

Interestingly enough, the muted performance of smaller stocks is primarily a US phenomenon, as Japanese, European, UK and Australian small-caps have all performed better than the respective countries' blue-chip equity indices over the past decade. In China small caps have narrowly underperformed.

The small cap sector due to its size has structural issues that impact performance. Small caps are often thinly covered by professional analysts. Consequently, they are less efficient and less liquid leading to very lumpy periods of returns. Regardless of short-term volatility, the historical "excess returns" small caps have demonstrated cannot be ignored. In the first decade of the 21st century, the Russell 2000 returned nearly 24 per cent, while the S&P 500 fell by more than 24 per cent. The Nasdaq 100, meanwhile, lost almost half its value over the 10 years after the dotcom bubble burst.

So while smaller US companies have underperformed as of late, they may be nearing a breakout. The COVID-19 governor on small cap performance may soon be removed as development and deployment of an effective vaccine could enable the US to achieve a sustained return to semi-normal business and economic activity. That reinvigorated domestic economy could unleash small cap performance. The capricious and uncoordinated opening and closing of the economy, businesses, and schools has promoted anxiety and uncertainty. This has severely limited consumer/commercial confidence as illustrated by limited capital investment and economic/social activity, all of which has disproportionately affected domestic small caps.

The reduction in CapEx related to COVID-19 is expected to be bigger than the 11.3% decline that occurred in 2009 in the wake of the global financial crisis according to Refinitiv, a global provider of financial market data. By sector, energy, consumer discretionary and real estate were seen taking the biggest axes to capital expenditure with cuts of 25%, 23% and 20% forecasted respectively.

At Kippington our process instills the patience to maintain a long-term view and select high-quality businesses that compound over long timeframes. It's these businesses that are likely to best capitalize on the various factors driving toward small-cap leadership.

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,

Conor Mahlmann
Kippington Capital Management