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Small Company Returns

The drivers of—and prospects for—Small Company strategy performance

EXECUTIVE SUMMARY

The Brown Capital Small Company strategy boasts one of the best long-term performance track records in its category since its inception in 1992. However, its performance has struggled mightily since the end of 2020. Investors are wondering what has triggered the worst stretch of performance in the strategy's history.

In this article, Brown Capital Chief Investment Officer **Damien Davis** explores five reasons Small Company strategy has underperformed in the last four years—and why it may be ready to bounce back.

By Damien Davis, chief investment officer and sr. portfolio manager on the Small Company Team

The five drivers of our underperformance since the end of 2020 are:

1. **Market sentiment** shifted away from the high-quality growth companies we favor.
2. One highly focused area, life sciences, experienced **end-market weakness** due to concerns about high inflation and interest rates, among others.
3. Companies' focus on revenue growth as opposed to **profitability** altered the universe in which we search to find Exceptional Growth Companies.
4. As a **benchmark-agnostic manager,** we had less exposure to some sectors that performed well, such as Industrials.
5. Some portfolio holdings saw their fundamentals deteriorate and were outright **mistakes.**

November 2024

No two ways about it, the performance of the Small Company strategy has been abysmal of late. In fact, after decades of outperforming, we are currently enduring the worst stretch of relative performance in the 30-year-plus history of the strategy. Unsurprisingly, our underperformance has been a main topic of discussion in many client meetings. We have also addressed the issue in our quarterly commentaries, webinars and white papers, including "The Case for Going Small," published in March 2023. And yet our underperformance has persisted. To help investors understand what's going on, we thought we would share a comprehensive review of the drivers of our poor performance and the prospects for a rebound.

Performance review

Let's start with the numbers. Chart 1 shows the trailing returns of the Small Company Fund (Investor shares) through Sept. 30, 2024. As you can see, our 1-year, 3-year and 5-year returns now all lag the Russell 2000® Growth index significantly, by a disappointing 16.96%, 8.48% and 7.01% a year, respectively. For the first time in our strategy's history, even our 10-year returns have fallen below the benchmark.

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Chart 1: Small Company Fund (Investor shares) Trailing Returns (as of 9/30/2024)

	Annualized								
	Since Inception*	20 Years	15 Years	10 Years	5 Years	3 Years	1 Year	YTD	3 Months
Small Company Fund	10.73%	10.49%	10.93%	8.32%	1.81%	-8.83%	10.70%	1.80%	8.48%
Russell 2000® Growth Index	7.75%	8.99%	11.09%	8.95%	8.82%	-0.35%	27.66%	13.22%	8.41%
Morningstar Category: US Fund Small Growth	N/A	N/A	N/A	9.94%	10.04%	-1.41%	25.69%	12.69%	7.44%
Excess Return Over Benchmark	**2.98%**	**1.50%**	**-0.16%**	**-0.63%**	**-7.01%**	**-8.48%**	**-16.96%**	**-11.42%**	**0.07%**

Chart 2: Small Company Fund (Investor shares) Calendar Year Returns (as of 9/30/2024)

	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023
Small Company Fund	2.19%	8.75%	8.34%	28.90%	-0.67%	29.22%	45.26%	-4.17%	-37.98%	19.12%
Russell 2000® Growth Index	5.60%	-1.38%	11.32%	22.17%	-9.31%	28.48%	34.63%	2.83%	-26.36%	18.66%
Morningstar Category: US Fund Small Growth	2.44%	-2.41%	11.26%	22.30%	-5.63%	28.64%	40.43%	10.41%	-27.81%	16.68%
Excess Return Over Benchmark	**-3.41%**	**10.13%**	**-2.98%**	**6.73%**	**8.64%**	**0.74%**	**10.63%**	**-7.00%**	**-11.62%**	**0.46%**

Excess Return Over Benchmark is the difference between the return of the Fund and the Index.

Source: CFS. *Inception date for the Investor Share Class is 07/23/1992. Inception date for the Institutional Share Class is 12/15/2011. Performance of the Institutional Share Class prior to 12/15/2011 is based on the performance of the Investor Share Class. Performance of the Investor Share Class started on 12/31/1992. The Fund's Total Operating Expense Ratio: Investor Class 1.28% and Institutional Class 1.08%.

The performance data quoted represent past performance. Past performance is no guarantee of future results and investment return and principal value of an investment will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost. Current performance may be lower or higher than the performance data quoted. Performance current to the most recent month-end may be found at www.browncapital.com or by calling 1-877-892-4226. Please see disclosures.

Chart 2 provides a bit more insight by showing calendar-year returns. In seven of the 12 periods shown, we outperformed. However, the magnitude of our underperformance in 2021, 2022 and year-to-date 2024 is what has tanked our trailing returns.

We think our performance roller coaster over the last 10 years is best illustrated in Chart 3, which shows the Fund's cumulative excess returns over the Russell 2000® Growth index back to Sept. 30, 2014. As you can see, there are two distinct periods. To the left of the purple vertical line—through 2020—we generally outperformed (positive slope). Our peak cumulative outperformance topped out at a staggering 88 percentage points in 2020, with the Fund returning a cumulative 160% and the index just 72%. After 2020, it's the opposite story, with our cumulative outperformance rapidly eroding away (negative slope).

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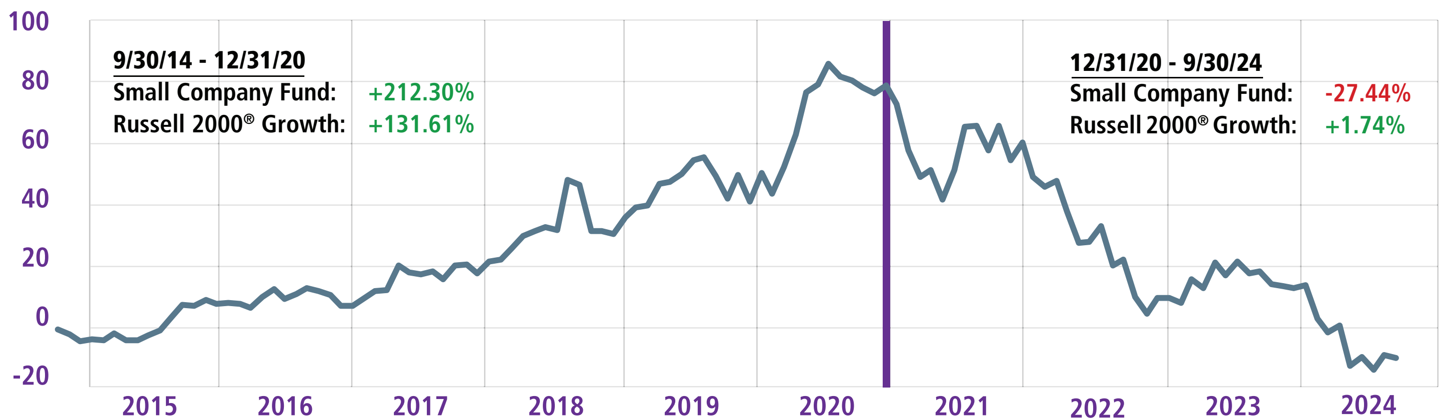
Chart 3: Small Company Fund (Investor Shares) 10-Year Cumulative Excess Return (in %, 9/30/14 - 9/30/24)



Sources: CFS and Brown Capital

The five drivers of our underperformance since the end of 2020 are:

1. **Market sentiment** shifted away from the high-quality growth companies we favor.
2. One highly focused area, life sciences, experienced **end-market weakness** due to concerns about high inflation and interest rates, among others.
3. Companies' focus on revenue growth as opposed to **profitability** altered the universe in which we search to find Exceptional Growth Companies.
4. As a **benchmark-agnostic manager,** we had less exposure to some sectors that performed well, such as Industrials.
5. Some portfolio holdings saw their fundamentals deteriorate and were outright **mistakes.**

To appreciate these drivers fully, a quick reminder of how we invest. We identify and invest in what we call Exceptional Growth Companies (EGCs). We believe EGCs offer products and services their customers cannot live without, saving time, lives, money and headaches, or providing exceptional value to consumers. We think EGCs enjoy business models that other companies do not want to compete against, with financial strength and sustainable competitive advantages. Finally, we believe that EGCs possess investment attributes that allow us to hold them for years and even decades, including durability of revenue growth, defensibility of market presence, deliverability of growth plan and profitability to fuel earnings growth. Our strategy allows us to identify these companies early in their growth cycles and hold them as they compound their growth.

Now let's explore each of the five drivers in detail.

Driver #1: Market sentiment

As bottom-up investors, we think that company fundamentals drive share prices—most of the time. However, in the three decades that we have managed the Small Company strategy, we have seen a handful of disruptive times when exogenous forces caused a wide disconnect between our companies' fundamental performance and their share-price total returns. In such times, when market sentiment swings violently away from the kinds of high-quality growth companies we seek to invest in, it seems like fundamentals go out the window.

In the last decade, this occurred most acutely in the year 2022, when the Small Company Fund was down 37.98%, 11.62 percentage points worse than the Russell 2000® Growth index's return of -26.36%. Of course, 2022 was a highly unusual year, marked by supply-chain pressures following COVID-19, an inflation shock, and the fastest-rising interest rates in 40 years. For that calendar year, many of our companies generated impressive revenue growth and profitability, but suffered jaw-dropping share-price declines, as shown in Chart 4. All of our top 10 holdings as of Dec. 31, 2022, generated double-digit revenue growth, seven out of 10 posted double-digit EBIT margins, but 9 out of 10 saw their share prices get hammered. (Abiomed, the exception, was acquired.)

This year, 2024, has been somewhat of a repeat of 2022, with macroeconomic concerns again dominating the market. Hopefully, the Fed's much-anticipated decision in September 2024 to finally cut interest rates marks the return to more normal market conditions where fundamentals are driving stock prices once again. That is when our time-tested process shines.

> Market sentiment shifted away from the high-quality growth companies we favor.

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Chart 4: Top 10 Small Company Fund Holdings (as of 12/31/22)

TICKER	COMPANY NAME	1-YR REVENUE GROWTH	GAAP EBIT MARGINS	2022 TOTAL RETURN
ABMD	ABIOMED, Inc.	22%	14%	6%
APPF	AppFolio Inc Class A	16%	-3%	-13%
MANH	Manhattan Associates, Inc.	13%	20%	-22%
PAYC	Paycom Software, Inc.	25%	24%	-25%
TECH	Bio-Techne Corporation	19%	27%	-36%
VEEV	Veeva Systems Inc. Class A	26%	27%	-37%
CGNX	Cognex Corporation	28%	30%	-39%
TYL	Tyler Technologies, Inc.	43%	11%	-40%
ALRM	Alarm.com Holdings, Inc.	21%	8%	-42%
DDOG	Datadog Inc Class A	70%	-2%	-59%

Source: FactSet

Driver #2: End-Market Weakness

That said, parts of our portfolio have disappointed fundamentally since the end of 2020. In particular, our holdings that are exposed to the life-sciences area—which comprise about 16% of the portfolio as of Sept. 30, 2024—experienced significant and unexpected end-market weakness, particularly over the last 18 months. We invest in many "picks and shovels" types of life-sciences companies that help other drug and medical-device companies with research and development (R&D), product discovery, manufacturing, marketing and commercialization. Over the last year and a half, these companies cited several reasons for a slowdown in demand. First, there is the withdrawal of government stimulus spending related to COVID-19 that had propped up life sciences spending in 2020 and 2021. Second, because of the supply-chain issues circa 2021 and 2022, many drug and device companies had built large stockpiles of supplies that they have been working off in the last couple years, crimping recent demand. Third, high interest rates in the last two years created a weak funding environment for biotechs, limiting R&D. Finally, weak macroeconomic conditions in China depressed biotech spending in that country. We saw these factors affect our companies firsthand. For example, both **Repligen** (RGEN) and **Bio-Techne** (TECH) cited these factors throughout 2023 and the first half of 2024. Despite enjoying a bump from COVID-19 stockpiling early on, both companies ended up being overall detractors to Small Company Fund performance in the period since Dec. 31, 2020.

One highly focused area, life sciences, experienced end-market weakness due to concerns about high inflation and interest rates, among others.

Encouragingly, there are signs that demand is picking up again for life-sciences companies. Biotech funding levels in 2024 are comfortably on track to clear the mid-$50 billion average observed during the three years leading up to the pandemic, according to William Blair's research. In addition, the late-stage clinical-trial pipeline has seemingly normalized over the last 18 months. Biopharma R&D spending as of the second quarter of 2024 was up 7% year over year, which is back to the mid- to high-single-digit growth of the last decade. Our holdings are now echoing this optimism. In the third quarter of 2024, Repligen's management said that most of the destocking is behind us, and that revenue from China should rebound either this year or next. For its part, Bio-Techne said its markets have been stabilizing the past two or three quarters, with funding levels up 19% and China stimulus in the works.

Driver #3: Profitability

We search for EGCs that have less than $500 million in revenue at the time of initial purchase. We generally look for companies that are profitable, but given our long-term perspective, we sometimes invest in unprofitable companies that we believe to be on the path to profitability. The fact is, there have been fewer profitable companies in our universe in recent years. In 2018, 36% of companies in the Russell 2000® Growth index were GAAP unprofitable; by 2023 that had grown to 46%. That rise reflects a shift in the priorities of company management teams from profitability to revenue growth, probably reflecting the desires of public and private equity investors at the time. Moreover, our bottom-up search for EGCs tends to lead us to

sectors like technology and health care, which have even fewer profitable companies. At the end of 2023, 78% of health care companies in the index were GAAP unprofitable as were 55% of technology companies.

The bottom line is that in recent years we have owned more unprofitable companies than we typically have in the past. Some of those companies actually helped our performance in the years leading up to 2022, but during that year, the sudden inflation shock hurt valuations of growth companies generally, and unprofitable growth companies in particular. Looking ahead, we are optimistic on the profitability front. Several of the companies we purchased in the last few years are achieving profitability, albeit later than we expected. Two examples include **Datadog** (DDOG, first purchased in 2020) and **AppFolio** (APPF, first purchased in 2019), which both finally turned profitable in fiscal year 2023, later than we expected. Those holdings that have not reached profitability but remain in the portfolio are making progress toward that goal. We believe we will ultimately be rewarded for holding these investments. Also encouraging is the fact that more companies in our research pipeline are emphasizing profitability, expanding our candidate pool. Since the end of 2022, six out of the 10 companies we have added to the portfolio across sectors were GAAP profitable at the time of purchase.

Companies' focus on revenue growth as opposed to profitability altered the universe in which we search to find Exceptional Growth Companies.

Driver #4: Benchmark-Agnostic

One of the key tenets of our EGC investment philosophy is our commitment to being benchmark-agnostic. We do not structure our portfolio to match up to benchmark sectors, so there are almost always sectors in which our portfolio is more concentrated and other areas in which we have fewer (if any) holdings. Throughout our history, our divergence from the benchmark has helped our performance at times, but since the end of 2020 it has hurt us. For example, 30% of our portfolio is in what we call Medical/Health Care companies, as of Sept. 30, 2024. However, the Health Care sector was the worst performing sector in the Russell 2000® Growth index from Dec. 31, 2020, to Sept. 30, 2024, returning a cumulative -29.92%, vs. the overall index's return of 1.77%. All told, the Medical/Health Care area accounted for about half of our underperformance since the end of 2020.

The best performing sector in the index since Dec. 31, 2020, was Industrials. Driven by heavy demand from the CHIPS Act and the Infrastructure Investment and Jobs Act, as well as demand for new construction including technology infrastructure (data warehouses, manufacturing facilities and e-commerce centers), the industrial sector has performed well. Industrials accounted for 18% of the benchmark weight and had a cumulative return of 37.73% from the end of 2020 to Sept. 30, 2024, vs. the index's overall return of 1.77%. Industries like Construction & Engineering, Building Products and Trading Companies & Distributors, where we have no exposure, more than doubled in share price. In the Small Company Fund, our custom Industrial Products & Systems sector comprises just 11% of the portfolio and averaged a horrific cumulative return of -58.06%. Notable Industrials laggards include **Proto Labs** (PRLB), **Cognex** (CGNX) and **Xometry** (XMTR). About one-third of our total relative underperformance during this period is due to the Industrials sector alone.

As a benchmark-agnostic manager, we had less exposure to some sectors that performed well, such as Industrials.

In a first for us, this year our relative performance was also meaningfully hurt by a single company in the index that we did not own, and indeed could not have owned—Super Micro Computer (SMCI). Supermicro, as it's known, makes servers that house Nvidia's (NVDA) graphics processing units. The company generated nearly $15 billion in revenue in its last fiscal year, far above our current maximum revenue threshold of $500 million. In fact, when the company went public in March 2007, it was already too large for our portfolio. At the start of 2023, Supermicro traded at roughly $8 a share. As the potential of AI has caught on since then, investors bid up shares of the company and turned Supermicro into an AI-related "meme stock" like Nvidia. The share price topped $123 a share in March 2024. In fact, Supermicro single-handedly comprised nearly half of the Russell 2000® Growth index's 4.45% return in the first half of 2024. Supermicro graduated out of the Russell 2000® Growth index on June 28, 2024. Its stock price was promptly cut roughly in half during the third quarter, but the damage was done. Our relative "losses" were essentially locked in. That is particularly frustrating, and a reminder why an index is not always an accurate gauge of our short-term performance. The bottom line is that not owning Super Micro accounted for one-fifth of our underperformance year to date through Sept. 30, 2024.

Driver #5: Mistakes

We have also made some flat-out mistakes in our investment research. Chart 5 summarizes four mistakes that we have sold from the Small Company portfolio since 2023. A recurring theme

for a couple of these examples is the impact of large acquisitions. Our portfolio companies frequently make acquisitions and often they are beneficial in terms of increasing product offerings, integrating new technologies or expanding into new markets. However, we have learned the hard way that when our companies make particularly large and impactful acquisitions, we need to act quickly if we determine that the acquisition could negatively impact our investment thesis and future outlook for the company. For example, **Neogen** (NEOG) provides diagnostic testing for food safety. In December of 2021 , the company undertook a large acquisition which curtailed its growth prospects. **QuidelOrtho** (QDEL) provides medical diagnostic tests for flu, strep throat, COVID-19 and other viruses. In 2021, Quidel acquired a larger company, Ortho Diagnostics, which crimped its growth profile. In retrospect we held on to these companies for too long after their acquisitions began to impact their fundamentals.

Rounding out the mistakes, **Alteryx** provides comprehensive self-service data-analytics software to data scientists and business analysts. We failed to appreciate the speed with which Alteryx's competition was eroding its differentiation. Fortunately, Alteryx was acquired, partially ameliorating that mistake. Finally, we underestimated how much Proto Labs's failure to effectively integrate a series of small acquisitions over time had disrupted its operations and watered down its competitive advantage, hurting its revenue growth and profitability profile.

Chart 5: Mistakes Sold Out of the Small Company Fund Since 2023

COMPANY	COMMENT
Neogen	Large acquisition negatively impacted the company's growth prospects
QuidelOrtho	Previous top performer, held too long after poor acquisition
Alteryx	Increasing competition made their products less differentiated
Proto Labs	Failure to execute in terms of revenue and profitability growth

On the bright side, our investable universe is robust. In the past two years, we have added what we consider to be 13 new EGCs to the Small Company portfolio, across nearly all of our custom sectors and with the majority being profitable.

Looking ahead

We hope this analysis provides investors insight into our disappointing performance over the last four highly unusual years. As a benchmark-agnostic manager, we are used to looking and performing differently from the index, but we are not accustomed to disappointing investors for such a protracted period.

Five years ago, all Brown Capital employees gathered at our holiday party to celebrate the end of a great decade. A speech about our bright future was interrupted by our founder Eddie Brown, who was quick to remind everyone that good times don't always last. Eddie recalled previous periods when we have been out of favor, underperforming and disappointing clients. He reminded us to stay focused and stay humble.

For half of the members of our Small Company Team, this recent period has been their first time going through such a performance struggle. In the 30-year-plus history of the Small Company strategy, we have only had one other stretch of poor performance that approaches the current one—2002 to 2004. At that time and following a decade of success leading up to that period, Small Company strategy co-founders **Keith Lee** and **Bob Hall** led the team through a no-holds-barred review of why we were underperforming. Our review revealed that a small number of portfolio companies that had performed horribly had torpedoed returns. However, our post-mortem also highlighted that the vast majority of our holdings remained fundamentally strong and were doing what we expected them to do; the strength of their fundamentals was just not being reflected in their stock prices. We believed that this disconnect between fundamentals and stock prices would not last forever, and that eventually the merits of our companies would be recognized, resulting in higher stock prices. This belief proved to be true, as a number of our poorly performing holdings during that period ended up being among our top contributors to performance in subsequent years. Overall, we performed quite strongly for the ensuing decade, culminating with our receiving the prestigious Morningstar Manager of the Year award in 2015. In hindsight, this bounce back in performance was only possible because we maintained consistency in how we managed the investment program.

Today, we are quite hopeful about the prospects for the Small Company portfolio making a similar comeback. We are as excited about the companies in the portfolio as we ever have been. We are also seeing signs that the market is finally moving back to an environment where company fundamentals—as opposed to macroeconomic data, or market sentiment, or benchmark anomalies—drive stock performance. That is when our time-tested process shines, as history shows. ■

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