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The Case for Going Small

The Brown Capital Small Company strategy is in its second period of protracted underperformance in its 30-year history. Here's why we think things are looking up.

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One of the most difficult things to do for anyone in a performance-driven occupation—athletes, business professionals, and even musicians—is to have a clear-eyed view of just what to do when performance suffers. Are recent setbacks just a temporary slump that should be powered through, or are they a sign that something fundamental has changed and a major overhaul is needed? With the performance of our Small Company strategy struggling recently, the question has arisen in the minds of some clients.

Fortunately, the slump-vs.-overhaul question is not one that I and the rest of the Small Company Team have had to wrestle with all that often. The Small Company Fund (Investor shares) has a history dating back 30-plus years, and since inception to Dec. 31, 2022, we have generated average annual returns of 10.68%, with an excess return of 3.52% a year over the Russell 2000® Growth index's 7.16% return. In those three decades, we have had only had two periods of protracted underperformance: 2002-2004, and the current stretch, which dates back to June 2020.

During our last bad patch 20 years ago, I was fairly new to the Small Company Team, and at the time I drew great inspiration from the strategy's co-founders, Keith Lee and Bob Hall. After a decade of success leading up to the 2002-2004 period, Keith and Bob led the team through a no-holds-barred review of why we were underperforming, and they continually stressed the importance of consistency in managing the investment program. Our review revealed that a small number of portfolio companies that had performed horribly had torpedoed returns, including one holding that detracted more than 500 basis points (bps) from performance in a single year. However, our review 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. To lessen the impact from individual portfolio holdings, in 2005 we tweaked our investment strategy to include an additional risk-control measure that limited the maximum weighting of a portfolio holding to 6% of the portfolio's market value. That measure is still in place today.

Over the last few months, the Small Company Team has followed suit and taken an in-depth look at what has led to our terrible performance in the recent period and what we should expect going forward. The bottom line: While some significant detractors have hurt our returns, by and large our companies are doing what we expect them to do operationally and fundamentally. Similar to last time, we believe that the disconnect between stock prices and fundamentals cannot persist for long, making us particularly optimistic now regarding the prospects of our portfolio of small Exceptional Growth Companies (EGCs).

Drivers of Recent Underperformance

We have discussed the recent underperformance of the Small Company strategy in recent commentaries and webinars, but here is a quick summary. During the two-and-a-half years to Dec. 31, 2022, the Small Company Fund lost 24.85% annualized, 29.54 percentage points behind the Russell 2000® Growth's gain of 4.69%. Within that 30-month timeframe, however, there were two distinct economic and market environments in which our performance suffered—one raging bull market from the economic reopening, and one bear market amid historic interest-rate hikes. For Small Company Fund returns, this was a one-two punch.

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The first environment was September 2020 to March 2021, when the U.S. and other economies reopened following the COVID-19 shutdowns. After fearing a prolonged recession and widespread company bankruptcies, investors flocked to equities, particularly those low-quality companies that they had shunned in the first half of 2020. The Russell 2000® Growth index soared 36.20% in those six months. The Small Company Fund appreciated as well, but returned just 12.93%, 23.27 percentage points behind the index. Simply put, our high-quality growth strategy did not participate in the so-called junk rally. This period more than reversed the 18.43% outperformance that the Fund had achieved during the flight to quality in the first six months of 2020, at the beginning of the pandemic.

The second environment was the high-inflation/rising-interest-rate conditions that characterized the year 2022. The Federal Reserve raised interest rates seven times during 2022, for a total increase of 4.25%. This was the fastest rate of interest rate hikes since the 1980s. As the Federal Reserve and other central banks tightened monetary policy, equities and other long-duration assets such as Treasury long bonds tanked. Within equities, though, the "growthier" the company, the more the stock price fell. Higher inflation caused investors to more heavily discount the value of future cash flows. For a portfolio like ours, in which we hold companies with revenue and earnings growth projected years into the future, the damage was particularly acute. All told, in 2022, the Russell 2000® Growth index was down a 26.79%, with the Small Company Fund down a whopping 37.03%, or 10.24 percentage points more than the benchmark.

What's common in both of these environments is that our underperformance was spread pretty evenly across the sectors of our portfolio. It was more of a shift in market sentiment than widespread blow-ups of the companies we hold. Of course, it is natural and expected that our process should go out of favor at some point—but a one-two punch in rapid succession is rare for us indeed. The fact is, since mid-2020, most of our companies have improved operationally and fundamentally as we have expected, but their share prices have suffered nonetheless, as shown in the table below. The disconnect mentioned above is back.

Small Company Fund Top Ten Holdings By Weighting as of Dec. 31, 2022

During the recent two-and-a-half year stretch of underperformance, most of our top 10 holdings had strong revenue growth and solid margins but still lagged the Russell 2000® Growth's return of 4.69%.

Company	Ticker	Portfolio Weighting (12/31/22)	Revenue Growth TTM (6/30/20- 12/31/22)	Operating Margin TTM (12/31/22)	Total Return (6/30/20-12/31/22)
AppFolio	APPF	5.4%	63%	-15%	-35%
Paycom Software	PAYC	5.3%	74%	28%	0%
Manhattan Associates	MANH	5.1%	27%	20%	29%
Cognex	CGNX	5.0%	46%	27%	-18%
Tyler Technologies	TYL	5.0%	66%	12%	-7%
Bio-Techne	TECH	4.9%	52%	22%	27%
Alarm.Com	ALRM	4.7%	50%	6%	-24%
Veeva Systems	VEEV	4.6%	68%	21%	-31%
Datadog	DDOG	4.5%	248%	-4%	-15%
Ansys	ANSS	4.3%	36%	29%	-17%

Note: Due to Veeva's Jan. 31 fiscal year end, revenue growth shown is for 7/31/20-1/31/23, and operating margin is as of 1/31/23.

That's not to say that there haven't been any disappointments in our portfolio. As is the case when we outperform, some companies don't perform as we expect. The three largest detractors during this period were Q2 Holdings (QTWO), Neogen (NEOG) and Alteryx (AYX), which detracted 254 bps, 241 bps and 187 bps, respectively, from performance. Q2 Holdings, a provider of software solutions to the banking industry, experienced a stock price decline as a result of a slowdown in customer and revenue growth following the pandemic. Neogen, which provides products for food-safety testing, saw its stock price negatively impacted following its announcement of a large acquisition. Alteryx, which develops software tools for data analytics, experienced negative stock price movement due to concerns about increasing competition in its markets.

The Small Company Fund is concentrated, with just 42 holdings as of Dec. 31, 2022, so one company can have a significant impact on performance (even with the 6% cap), with one or two contributors often boosting returns in up periods and one or two detractors really hurting in down periods. Interestingly, in the recent two-and-a-half-year period of underperformance we have been discussing, that has not been the case. The three top detractors mentioned above comprised just 6.82 percentage points of the overall 29.54% performance shortfall. That's further evidence that our investment approach has simply fallen out of favor, as opposed to our portfolio being riddled with blow ups.

The Case for Investing in Small Growth Companies

At Brown Capital, we are growth-equity portfolio managers, not asset allocators. In fact, since the vast majority of our assets under management come from our Institutional and Financial Advisor channels, it is instead our clients who know the most about asset allocation. Some of them have been adding to their Small Company positions, seeking to benefit from the disconnect mentioned above. Others have published research papers advocating overweighting U.S. small cap growth in general, citing a variety of reasons: small caps' low absolute and relative valuations compared to large caps, the resilience of small caps during periods of rising rates, and the history of small caps' strong performance coming out of recessionary periods.

We will leave such analysis to the asset allocators, but it is worth noting that we are seeing other signals through our research that could augur better times ahead for Small Company investors. In general, the EGCs we hold have strong balance sheets with little or no debt, which will help them sustain and grow their businesses when economic conditions are uncertain. Our companies report that supply-chain constraints are easing and the costs of goods and shipping have been moderating in recent quarters. This shows signs of a more rational pricing environment, which better positions companies for potential profitability improvements going forward. Combined with the fact that many of our portfolio companies have been able to implement price increases for their products or services over the past year, this suggests that perhaps the worst pain for many of these companies is already behind us.

Additionally, the recent strong IPO market has expanded the overall pool of small, high-quality growth companies, and these companies are now more attractively priced. The years 2020 and 2021 featured robust IPO issuance in the U.S., with 2020 the strongest year in two decades. Recent additions to our Small Company portfolio reflect this. Of the 11 new additions to the strategy in 2021 and 2022, seven of them went public in 2020 or 2021. In addition, we are seeing increased focus on the part of company managements on profitability, as opposed to revenue growth at all costs. This philosophical shift is reflected in our conversations with management teams. All of this should further increase the size of the pool of small, high-quality, earnings-focused growth companies.

Why Choose the Brown Capital Small Company Strategy

In light of the factors making investing in small growth companies more attractive, and given the drivers of our recent underperformance, why do we think the Small Company strategy's prospects in particular are looking up? First, the disconnect cannot last forever; if our companies' fundamentals continue to improve, that should eventually be reflected in higher stock prices. Second, our track record shows our ability to bounce back following periods of significant underperformance. After the 2002-2004 period, the Small Company Fund significantly outperformed for years, eventually earning us Morningstar Manager of the Year in 2015. In fact, from the end of 2004 through June 2020 (when the current stretch of underperformance began), the Small Company Fund generated annualized returns of 13.89%, 5.59 percentage points ahead of the benchmark return of 8.30%.

As the table below shows, we have a long history of generating excess returns over longer time periods, despite some occasionally ugly short-term relative numbers. That said, you should be aware that some of our trailing numbers could remain in the red or even worsen over the next year or so as significantly positive quarters in past periods roll off. Note that this may occur even if we outperform going forward. This same phenomenon occurred after our underperformance in 2002-2004. We have seen this before.

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Small Company Fund Rolling Returns, Back to Inception Q1 1993

As long-term and benchmark-agnostic managers, we know that our short-term returns sometimes lag the benchmark. In fact, in the 119 quarterly periods dating back to our inception, we have outperformed the Russell 2000® Growth index just 56% of the time. The longer the time period, the more often we have outperformed.

	Quarter	1-Year	3-Year	5-Year	10-Year
% Periods Outperformed	56%	66%	81%	90%	100%
Number of Periods	119	116	108	100	80

Source: CFS.
*Inception date for the Investor Share Class is 07/23/1992. Performance of the Investor Share Class started on 12/31/1992. Excess Return Over Benchmark is the difference between the return of the Fund and that of the Russell 2000® Growth index. The Gross Expense Ratio for the Fund (Investor shares) is 1.28%.
Past performance does not guarantee future results. Returns are presented net of fees. 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.

Third, in 2021 we increased our portfolio guidelines to allow us to invest in companies with up to $500 million revenue at the time of initial investment. Previously, the revenue cap was $250 million, which had been established at the strategy's inception nearly 30 years earlier. Given the effects of inflation alone, the $250 million cap had the effect of incrementally shrinking the pool for us to search in for EGCs, especially given the recent trend of companies going public later and at larger sizes. Adjusting the revenue cap for inflation has further expanded our pool of investable candidate companies. Recent additions show how we have taken advantage of that. Three of the six new additions to the portfolio during 2022 have revenue in this expanded range between $250 and $500 million.

We have often said that small EGCs don't grow in a straight line, and that there are inevitably some scrapes and stumbles along the way. When a company falters, we focus on determining whether it is just a short-term bump in the road for the company, or whether it reflects diminished fundamentals, such as a detrimental change in the company's strategy, the loss of key personnel, or a more difficult competitive landscape. Most times we find that the company is still on the right track, and our investment thesis on the company remains intact. In these situations, we continue to hold the investment, and often add to our position.

So as we turn that same light inward on our recent portfolio returns, we return to the same question—is our poor performance recently just a stumble or is something fundamentally broken? We think the former. The current stretch of underperformance has many similarities to the 2002-2004 period described above. The exact macro factors that are influencing markets are different this time around (i.e., COVID-19, inflation, interest-rate hikes, supply-chain challenges, etc.), yet our process remains the same. We understand that our long-term track record of outperformance includes short-term periods of underperformance. Our 30-year history shows that we have the discipline to stick to our process despite periods of poor performance. For clients, there is nothing worse than managers who mistake slumps for secular changes, and unnecessarily overhaul their process or philosophy. We know we can't predict the future of the economy or the markets, but we can maintain our discipline. That has been the key to our success for the past 30 years, and we expect that it will remain so in the coming years.

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Small Company Fund Quarter End Returns, As of December 31, 2022

The Small Company Fund seeks long-term capital appreciation. Current income is a secondary consideration in selecting portfolio investments.

	Annualized							
	Since Inception*	20 Years*	15 Years*	10 Years*	5 Years	3 Years	1 Year	3 Months
Small Company Fund	10.76%	10.96%	9.38%	10.08%	2.26%	-4.62%	-37.90%	-2.96%
Russell 2000® Growth Index	7.16%	9.50%	7.26%	9.20%	3.51%	0.65%	-26.36%	4.13%
Morningstar Category: US Fund Small Growth	N/A	N/A	N/A	10.18%	6.61%	4.01%	-27.81%	4.19%
Excess Return Over Benchmark	**3.60%**	**1.46%**	**2.12%**	**0.88%**	**-1.25%**	**-5.27%**	**-11.54%**	**-7.09%**

Source: CFS.
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. Excess Return Over Benchmark is the difference between the return of the Fund and the Russell 2000 Growth Index.
Past performance does not guarantee future results. Returns are presented net of fees. 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.

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The Russell 2000® Growth Index measures the performance of the smallcap growth segment of the US equity universe. It includes those Russell 2000® companies with higher price-to-value ratios and higher forecasted growth values. The Russell 2000® Growth Index is constructed to provide a comprehensive and unbiased barometer for the small-cap growth segment. The index is completely reconstituted annually to ensure larger stocks do not distort the performance and characteristics of the true smallcap opportunity set and that the represented companies continue to reflect growth characteristics.

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More information about these risks and other risks can be found in the Fund's prospectus.