



# Small/Mid Cap with Managed Accounts

## Quarterly Review

- The first quarter of 2025 showed broadly negative returns for the US equity markets as core large cap indices outperformed small cap indices. The economy is showing resilience with employment reports somewhat stable and inflation over the past few reports appears to be on a better path at two plus percent. Yet the market has been unsettled with major policy uncertainty around tariffs, fears of stagflation and disruption in artificial intelligence with the “DeepSeek” announcement. Risk off has been the dominant market theme with few areas of the equity market escaping a negative return during the quarter. Previous market expectations for a strong rebound in small cap relative revenue and earnings growth in 2025 is now in question.
- The Small/Mid Cap strategy outperformed the Russell 2500™ Index during the first quarter. Our portfolio return topped the benchmark which as our quality fundamental theme proved more resilient in an otherwise difficult market. Widespread market weakness occurred after a mid-February peak, as enthusiasm regarding a healthy economy as well as potential long-term upside from productivity enhancing Artificial Intelligence (AI) applications gave way to policy uncertainty around tariffs, fears of stagflation, and AI disruption after the DeepSeek news event. Risk off became the dominant equity market theme for the second half of the quarter, with not many places to hide. Portfolio performance was led by favorable stock selection in health care, communication services, information technology and industrials with a modest offset from a portfolio underweight to interest rate sensitive sectors (such as real estate) helped by a decline in rates.
- Strong stock selection within the health care, industrials, communication services and information technology sectors provided positive relative performance in addition to an overweight to utilities which was the top performing index sector. During the quarter, positions in Option Care Health, Beacon Roofing Supply and Chemed Corporation added the most to performance.
- Option Care Health is a provider of infusion services both in the home and facility setting for various chronic and acute therapies. Outside of favorable demographics and site of care trends, the company benefits from being the consolidating player in a fragmented industry. The stock was a notable detractor during the fourth quarter, driven by an unexpected strategic decision by a pharmaceutical supplier to significantly reduce the price and the discount available to Option Care on a meaningful product. We stayed the course with our position and were rewarded with a significant rebound in the stock price once the company formally quantified the marginal impact of this event while reiterating their commitment to deliver on long-term annual growth rates.
- Beacon Roofing Supply is a leading distributor of roofing materials and complimentary building products. The industry and Beacon both have several attractive characteristics such as: 1) steady growth potential, with 80% of revenue from repair & remodel into an aging housing stock; 2) a fragmented market, with opportunity for organic growth via share gain and greenfield expansion, as well as inorganic growth potential; 3) a large market size opportunity, not just in roofing supplies, but also in adding adjacent exterior building product distribution capability; 4) scale economy advantages such as the ability to serve national accounts, greater product depth and product availability, and digital order intake and inventory management capability; 5) Strong free cash flow, allowing for Beacon to repurchase stock and pay down debt. These attractive characteristics have garnered the attention of others, and during the quarter an overture to acquire the company was made public. After initial resistance from Beacon management, the parties came to an agreement in late January for a cash acquisition of the company
- Chemed Corporation is a holding company with two subsidiaries: VITAS, which provides hospice care and palliative care services, and Roto Rooter which provides plumbing, drain cleaning, and water restoration services.



The VITAS segment has experienced strong demand coming out of COVID-19, lower variable labor expenses and has consistently received favorable reimbursement from various healthcare payors. The company has also been active in acquisitions, which has strengthened their position in states that disproportionately have more demand for their services and has used their scale to leverage fixed costs. The company believes they can benefit from heightened industry growth which is expected to be consistent over the next decade. The improvement in the VITAS segment has offset a weaker Roto Rooter business that is experiencing softness in demand due to a pullback in consumer spending as well as navigating a more difficult environment to market their services with search engines.

- Detracting from relative return was an underweight to financials and real estate and an overweight to the industrials sector in addition to lagging stock selection in the utilities sector. During the quarter, positions in Five9, Inc, Boot Barn Holdings and Arcosa, Inc. detracted the most to performance.
- Five9 is a leading provider of cloud-based customer contact center software serving businesses worldwide. The company has had steady operating performance but very volatile stock performance as the market digests the impact of generative AI on the software industry, as well as the customer contact center industry. Despite positive earnings revisions and healthy organic revenue growth, the stock has experienced earnings multiple compression which negatively impacted the share price. We continue to see a distinct franchise selling at a discounted valuation and maintain an investment.
- Boot Barn is the leading retailer of Western/Country apparel and cowboy boots in the US. The company operates 400 stores as of December 2024 but plans to more than double its store count to 900 over time. The fast pace of new store openings is supported by strong demand and very attractive new store economics. The company's most recent earnings report in January this year was strong but earnings guidance for the next quarter did not meet lofty investor expectations following the stock price rally in the three months prior to the report. Also, the company disclosed that it sources roughly 30% of its goods from China and 25% from Mexico. As a result, Boot Barn is expected to be negatively impacted by the implementation of tariffs. The stock was also negatively impacted by the sharp decline in consumer sentiment in February and March. We added to our position in February on price weakness because we believe Boot Barn will be able to mitigate the impact of tariffs better than most retailers given their market leadership/scale will give them pricing power and leverage over suppliers. Valuation is also cheap compared to other retailers growing store count at a similar pace.
- Arcosa has been strategically simplifying its business to focus on construction materials. In August 2024, it announced the acquisition of a US based materials company which increased its construction materials segment to nearly two-thirds of total earnings while increasing margins. The share price rallied on the news during the fourth quarter, but during the first quarter of 2025, the share price declined due to concerns about weaker construction spending and the impact on construction aggregates demand. In addition, investors have become cautious regarding its wind power business which could be negatively impacted by policy changes under the new administration. We maintain a positive pricing outlook for the aggregates business, even with a more modest construction outlook and believe Arcosa will continue reshaping its business into a more durable and better valued enterprise.

## Outlook

- We remain committed to identify inefficiencies in the small/mid cap market resulting in stock prices and valuations not accurately reflecting our assessment of the underlying value of the corporate enterprise. This approach is applied consistently over time, regardless of the current market environment.
- While many forms of inefficiency may exist, we focus on companies that are misunderstood, underfollowed or in the midst of a “special situation” where we believe we can use our strengths in the form of our time horizon, resource deployment or a willingness to solve complex situations. We require fundamentally sound business models, capable management teams and financial stability. Fundamental to our process are distinct, company specific catalysts on the horizon to help sustain, enhance, or highlight the fundamental outlook.
- These principles are applied consistently over time, regardless of the current market environment. With a “margin of safety” and a proper time horizon, our goal is to achieve an attractive total return for our investors, while managing to an appropriate level of risk.



## Important Disclosure

**Key Risks:** *Equity Risk, Market Risk, Non-US Securities Risk, Liquidity Risk. Investing involves risk including possible loss of principal.*

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