VILLERE & C°
SELECTIVE INVESTING SINCE 1911

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Will the Small-Cap Rally Continue?

A perspective on active management, concentrated portfolios, and small-cap investing

“We believe that every investment should be weighed on its own merits and fundamental value.”

Q. Small-cap stocks have significantly outperformed large-cap stocks so far this year. Why did we see a shift in the market leadership?

Every segment of the market has a rotational quality. In 2017, large-cap stocks, as measured by the S&P 500 Index, dramatically outperformed small-caps stocks, as measured by the Russell 2000 Index.[1] This occurred although large caps are usually less volatile and generally pay a higher dividend. Small-cap stocks are inherently riskier and should command a higher return over time.

The reversal of the market leadership that has occurred in 2018 was aided by a number of factors, including attractive valuations in small-cap stocks, the relative strength of the U.S. economy, tax cuts that have benefited domestic small-cap companies as they pay much higher taxes than their comparable large-cap companies, and trade tensions favoring smaller U.S. companies as they have less overseas exposure than larger companies.

Q. Why does active management matter when investing in small-cap stocks?

Despite the large inflows into passive investments in recent years, we believe the case for active management of long-term, equity investment portfolios remains strong. The small-cap universe is particularly compelling given its size and the limited availability of research.

When investors buy a passively-managed index fund or ETF, regardless of market-cap or style focus, they are blindly buying the whole index and are not discriminating among stocks. We believe that every investment should be weighed on its own merits and fundamental value.

Small-cap indexes are often skewed as heavy cash flows have forced the larger, more liquid member stocks to be artificially valued. This creates inefficiencies for active managers to exploit through fundamental analysis and stock selection. As an active manager, we are not limited to just the stocks in the indexes but have a broader set of companies to invest it, and are also able to add value by being more selective in our investment choices.

After a prolonged period of low volatility in the markets, the return of higher volatility has presented an opportunity for active managers to take advantage of mispricing in the market for certain sectors and companies.

Q. By design, concentrated portfolios facilitate investing in the highest conviction ideas and therefore limit overlap with an index. Can you elaborate on this and why you use a concentrated portfolio approach?

Our approach is to invest selectively and taking a long-term perspective. We often say that we invest in companies, not stocks. Our active, concentrated portfolio strategy of 20-30 stocks allows us to pursue our most compelling investment ideas.

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If you have 100-130 stocks in your portfolio, it is difficult to know all the companies well. One of the benefits of having a concentrated portfolio is that we believe we know the companies in our portfolios better. If you have a large number of holdings you also run the potential risk of becoming a "closet-indexer" and mirroring the benchmark index too closely.

We believe in bottom-up investing where you buy investments that should do well in any market or economic cycle. We think that this lends itself to long-term investing, which reduces turnover and is less vulnerable to capital gain taxes and any investing fads.

Q. What are a couple of examples of stocks you hold in the portfolio that represent your investment approach? Why do you like them?

As I mentioned, we look for companies that we can hold long-term, typically more than five years. We seek to identify unique opportunities, businesses that dominate their space, mispriced securities, and companies that may be out of favor, overlooked, or relatively unknown.

POOL Corp. is a long-term holding at Villere which we believe should flourish in any cycle as they provide products—swimming pool supplies—that are in demand constantly. It is hard to see why the demand would slow, or how POOL, as the dominant player, would see sales and income slow.

Financial Engines is a pioneer in the high-growth financial technology sector, and a provider of technology-enabled portfolio management services and investment advice to participants in employer-sponsored retirement plans. Financial Engines recently agreed to be acquired, which also reflects the opportunity for investors when investing in quality small- and mid-cap companies.

Q. What is your outlook and what may drive the small-and mid-cap markets in the second half of 2018?

Our outlook for small- and mid-cap stocks remain moderately constructive. Although the stock market is always dependent on the economy, all signs point to continued U.S. economic growth as we have low inflation, low interest rates, low unemployment, higher savings rates, and optimistic consumers who are spending money on homes and cars.

The stock market returns have always been lumpy. They include periods when stocks have gone nowhere, they include losses and large gains. We believe that high market volatility will likely continue, and it may be a bumpier ride for investors going forward.

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Q. Villere's investment philosophy is built on the core belief that growth should be achieved at a reasonable price. Where do you find good values and stocks that are attractive given that we are in the later stages of the economic cycle and have had a long market rally?

There are attractive stocks out there, but they are getting harder to find and risks are elevated in the later stage of a bull market. However, while the market does seem to be pricey, there are always hiccups in company valuations as a result of a corporate earnings miss, management dislocation, unique events, etc.

Our job is to discern whether these are temporary, which may allow us to take advantage of the market's valuation, or if the problems are inherent and indicative of a long-term, insurmountable problem. Given the prospects of more uncertainty and volatility, we will continue to run our selective, disciplined investment process that has served us well in the past.

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[1] The S&P 500 gained 21.83% in 2017 and is up 2.02% year-to-date as of May 31, 2018. The returns of the Russell 2000 Index were 14.65% and 6.90%, respectively, for the same periods. Past performance does not guarantee future results.

Opinions expressed are subject to change, are not intended to be a forecast of future events, a guarantee of future results, nor investment advice.

RISK CONSIDERATIONS

A mutual fund's investment objectives, risks, charges and expenses must be considered carefully before investing. The statutory and summary prospectuses contain this and other important information about the investment company and may be obtained by calling 866.209.1129 or visiting villere.com. Read carefully before investing.

Mutual fund investing involves risk; loss of principal is possible. Investments in smaller and medium sized companies involve additional risks such as limited liquidity and greater volatility than large cap companies. The Villere Balanced Fund will invest in debt securities. Investments in debt securities typically decrease in value when interest rates rise. This risk is usually greater for longer-term debt securities. Investments in lower rated and nonrated securities present a great risk of loss to principal and interest than higher rated securities. The Villere Equity Fund may invest in foreign securities. Foreign investments involve additional risks, including currency fluctuation, political and economic instability, lack of liquidity and differing legal and accounting standards. These risks are magnified in emerging markets. The Equity Fund's ability to invest in initial public offerings (IPOs) involves a higher degree of risk than more seasoned companies.
Past performance does not guarantee future results.

It is not possible to invest directly in an index.

Cash Flow measures the cash generating capability of a company by adding non-cash charges (e.g. depreciation) and interest expense to pretax income.

Russell 2000 Index consists of the smallest 2,000 companies in a group of 3,000 U.S. companies in the Russell 3000 Index, as ranked by market capitalization and serves as a benchmark for small-cap stocks in the United States.

S&P 500 is an unmanaged index which is widely regarded as the standard for measuring large-cap U.S. stock market performance.

As of June 17, 2018, Villere Balanced Fund held 366,805 shares of Pool Corp. and 87,697 shares of Financial Engines. Villere Equity Fund held 57,050 shares of Pool Corp. and 15,550 shares of Financial Engines.

Fund holdings and/or sector allocations are subject to change at any time and are not recommendations to buy or sell any security.

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