



THERE IS LUCK.

AND THERE IS SCIENCE.

Investing is a science.

It requires a plan and

discipline to follow the plan.

Anything short thereof is blind exploration.

Fall 2019—Market Dislocation Presents Small Cap Opportunity

Dear Valued Clients and Friends,

MARKET PERSPECTIVE: After trading in a wide range for most of Q3, the small cap segment of the market sold off sharply late in the third quarter due largely to the very real possibility that the trade conflict between the US and China would not only continue but perhaps intensify. As a result of this uncertainty, the S&P 500 was +1.70%, the Nasdaq Composite +0.18% and our benchmark, the Morningstar US Small Growth Index, finished -4.45%. The Rocket Capital Small Cap Growth Composite finished -6.46%. On a YTD basis the S&P was up 20.55%, the Morningstar US Small Growth Index up 16.93% and the Rocket Capital Small Cap Growth Composite up 13.69%. While we are not pleased by our relative performance recently, one quarter does not a trend make.

The quarter was very challenging to say the least as it appeared that for whatever the reason, assets flowed dramatically from the growth to value segment of the market. I believe this phenomenon will be short lived as we move into the Q3 earnings season with expectations set very low and announced earnings thus far having been better than expected. I also think our portfolio companies will hold up well as they have very little exposure to effects of the ongoing trade conflict with China.

Furthermore, US stocks in general should benefit from a lower interest rate environment, extremely low inflation and a stable US economy. Also, when you compare this to the overall health of other global economies, the US stacks up very well. One of the other concerns which have recently created uncertainty for the market was the inversion of the yield curve. While this has in some cases, but not always, been a precursor to a recession, it typically leads a recession by 18-24 months. In addition, historically the stock market has done quite well in the interim.

TECHNICAL PERSPECTIVE: The recent action in the stock market is inconclusive with the three major indices holding up much better than many of the stocks that make them up. While the DJIA, S&P 500 and NASDAQ Composite remain above their 50- and 200-day moving averages, the Russell 2000 Growth Index is currently trading just below its 50- & 200-day moving averages which isn't a great surprise when considering investors' current appetite for risk. The good news is that a couple days of solid outperformance in small caps would turn the index and moving averages up which would add to my bullish enthusiasm. My weekly study of over 1,000 charts is also neutral with the majority of stocks in holding patterns. Despite the lack of clear trends, I have still been able to find quite a few companies with good charts and fundamentals to add to the portfolio.

Regarding market sentiment, according to the American Association of Individual Investors Survey, optimism about the short-term direction of the market fell to its lowest levels in several years with just 20% of investors bullish. This adds to my bullish enthusiasm. On the negative side, on the supply and demand front there has been a significant number of IPOs and secondary offerings which is flooding the market with new supply in a declining demand environment. The result of this has been very poor stock performance after the offerings and, more recently, postponed or canceled offerings.

SECTOR COMMENT: Sector leadership recently has been a hodgepodge of sectors which is unusual as we normally have a sector or two which demonstrate clear leadership. Without the presence of a clear leader, the groups that appear to have the most momentum in Technology Hardware are the Semiconductor Equipment & Mfgs and the Internet-Network Solutions segment. In Technology Software, only the Enterprise Software group stands out. In Healthcare, they are the Medical-Systems/Equipment and Medical Products sectors. Notably absent from the leader board are Medical Biomed-Biotech in healthcare and most subsectors in software.

PORTFOLIO ADJUSTMENTS: In the third quarter we added three new positions including The Rubicon Project (RUBI*8.71), Funko (FNKO*20.58), and Luna Innovations (LUNA*5.79), all having excellent charts and fundamentals. We sold five positions entirely including CyberOptics (CYBE *14.29), Vocera Communications (VCRA*24.65), Alarm.Com (ALRM*46.64), Parateum (TEUM*1.29), and Planet Fitness (PLNT*57.87), because they broke down technically.

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COMPANY HIGHLIGHT: Luna Innovations is a provider of fiber optic testing and sensing products to the telecom, aerospace, auto, and infrastructure industries. Customers use Luna's products to monitor and improve production processes by receiving highly detailed stress, strain, and temperature measurements.



Luna recently reshuffled its business by divesting assets and acquiring two new companies. In so doing, it has focused on its core strengths which has resulted in accelerated organic revenue growth, improved margins, and a deleveraged balance sheet.

Given its small market cap and minimal analyst coverage, we believe the strong execution has gone largely unnoticed by the market which allowed us to purchase shares at what we viewed as an attractive price.

Technically the stock is quietly consolidating recent gains after breaking out of a staircase pattern which is very bullish.

In conclusion, I still contend that if there is a major near term move in the stock market it will be higher, and I believe the small cap sector has the greatest potential when considering both the technical and fundamental characteristics. If I am wrong, we have a meaningful cash position which will help minimize the damage in a decline and, more importantly, enable us to take advantage of the weakness to add to both existing and new positions. Please let us know if you would like to discuss this further.

Sincerely,

A handwritten signature in blue ink, appearing to read "J.D. Hurd".

J.D. Hurd
President / Senior Portfolio Manager

A handwritten signature in blue ink, appearing to read "Grant Larson".

Grant Larson, CFA
Research Analyst / Operations

A handwritten signature in blue ink, appearing to read "Ben J. Scheibe".

Ben J. Scheibe
Sr. Vice President

The Morningstar US Small Growth as an index more comparable to the portfolio make up of the Rocket Capital Small Cap composite. All indexes and our composite are reflective of dividend reinvestment. Our composite does not represent all accounts of Rocket Capital Management, just those invested in that strategy. Past performance is not an indication of future returns. Individual investment returns may be different than the composite returns presented.

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