



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.

## Winter 2020—Market Dislocation Presents Small Cap Opportunity

Dear Valued Clients and Friends,

**MARKET PERSPECTIVE:** Our Fall Newsletter suggested that we were anticipating a change from stock market leadership to the small cap segment of the market as opposed to what we have experienced over the last several years, domination by the mega cap stocks. What transpired was the opposite with most of the major indexes making meaningful gains with powered by a handful of Mega Cap Tech stocks. Case in point the NASDAQ Composite continued dominance in the 4<sup>th</sup> quarter with a 12.17% return and finished the year with a whopping 34.80% gain. Compare this with our benchmark, the Morningstar US Small Growth Index up 8.89% for the 4<sup>th</sup> quarter and 27.33% for the year and the Rocket Small Cap Growth index up 6.82% and 21.45% respectively. While our assumption was proven wrong, we still feel very strongly that it is not a matter of if, but when the small caps begin to reemerge as the leaders.

The driving force behind this large cap outperformance appears to be that after a relatively lackluster third quarter the underinvested large institutional investors began pouring capital into a very short list of high profile companies such as AAPL, MSFT, TSLA, INTC, and NVDA to mention a few. This phenomena was also prevalent in our portfolios as well with our top performers also featuring those with the largest market caps.

Looking at the macro picture many of the things that were in place in the third quarter are still in place, interest rates and inflation remain at historically low levels and don't appear to be moving higher any time soon. Also, Revenue and Earnings Per Share reports have been better than expectations thus far with decent guidance looking forward. Also, the US economy remains one of the most stable in the world and continues to grow, albeit at a modest pace. There are always things to be concerned with and most importantly is that stocks are certainly no longer inexpensive as they were 90 or 120 days ago. The fear of the trade conflict between the US and China slowing down the economy has now been replaced with the fear of the Corona Virus spreading and causing a major global slowdown and cannot be taken lightly. At least for now the stock market has taking it in stride. Please keep in mind that most of the companies in our portfolios and their suppliers are not greatly exposed to an ongoing disruption in China if there is one.

**TECHNICAL PERSPECTIVE:** Currently the technical outlook for the stock market is mixed. Many stocks are extremely over-extended, over bought with some nearing a blow off top phase. This often occurs at the end of a short-term nearly vertical run leading to a sudden, sharp correction which seemingly comes out of nowhere. This is a clear sign over speculation and often ends badly. Having said that, there are a number of technical indicators that are still very positive, for example, the Advance-Decline on the NASDAQ Composite is still trending nicely higher, most of the major indexes have held at or near their 50 moving averages and most important to me, individual charts are in solid uptrends or consolidating after large moves. The trend is still up until proven otherwise. Market sentiment indicators, as you would expect, show that both professional and individual investors are bullish in their outlook for stocks but not extremely so likely because of the uncertainty surrounding the Corona Virus.

All things considered the trend is certainly up for now, but investors should be prepared for a sharp, nasty correction at any time. Our strategy will be to sell over extended stocks into this strength and avoid the temptation to chase stocks that have already had significant short-term price runs.

**SECTOR COMMENT:** The Computer Software Group has reemerged with the Enterprise & Security sub sectors leading the charge follow with most all the other software sectors participating. The information technology hardware sector of the market has also been strong recently lead by, Semiconductor Equipment Manufacturers and the Semiconductor Manufacturers themselves. In Healthcare, the Medical-Biomed-Biotech have also improved and have the most good charts followed by the Medical-Systems/ Equipment group. We look to add to our positions here on weakness.

**PORTFOLIO ADJUSTMENTS:** In the 4<sup>th</sup> quarter we added four new buys, Digital Turbine (APPS\*6.65), Inspire Medical Systems (INSP \*80.57), Veracyte (VCTY\*26.31), and Five9 (FIVN\*76.84). We trimmed 1 position Ring Central (RNG\*245.73) and sold outright Profire Energy (PFIE\*1.30), HyreCar (HYRE 3.85), and Funko Inc. (FNKO\*9.24) because they had sagging fundamentals and had broken down technically.

*Continued On Back*



**COMPANY HIGHLIGHT:** Luna Innovations, (LUNA\* 8.91). Rarely have we highlighted the same company in back to back newsletters but in the case of Luna we felt compelled to do so as the company has seen an acceleration in all key measures. 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 a breakout to new highs.

In summary, while our thesis on a reemergence in the small cap performance vs their larger peers has not yet take place, we are more confident than ever that it will play out. This belief is fortified by our outstanding performance thus far in 2020. As always, please reach out to us if you would like to discuss this in greater detail.

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 "Jim Nelson".

**Jim Nelson**  
*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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