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Neuberger Berman Small Cap Intrinsic Value

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Performance Highlights

The Small Cap Intrinsic Value strategy posted a gain in 3Q 2024 but underperformed the Russell 2000 Value Index (the "Index"). For the year-to-date, the strategy remains in positive territory but lags the Index.

Without mincing words, we had a disappointing quarter. When the market rally finally started to include smaller and value companies our performance lagged in a meaningful way. The speed at which sentiment reversed around our sector positioning and some of our companies was dramatic. Adding to the sting was the poor performance of our technology investments.

Market Context

Economic news events from June thru early July, could explain why our sector positioning quickly fell out of favor. They were – the prospects of a Trump victory, the dampening of inflation and the likelihood of more protectionism, regardless of who were to win the election.

Taking the playbook from the market's performance in 2016, pattern-based traders quickly went to work buying smaller, domestically focused value stocks. Many momentum strategies were long large cap tech stocks and short small cap value ETF's. The ensuing collision or trend reversal resulted in profitable trades losing up to 1000 basis points of returns in 20 days.

As long-term investors, the issue for us is whether the broadening of the market rally requires a rethink or adjustment to our sector weightings and factor exposures. The conventional asset allocation strategy is to underweight small caps and value factors late in an economic cycle then aggressively increase these factors early in an economic recovery or early in an interest rate easing cycle (as many did in July when lower inflation led many to believe an easing cycle would begin).

We looked back over thirty years at prior small cap and value cycles to see if any observations would be helpful in charting a course correction. We note from the data is that there are three primary contributors to a small cap outperformance cycle – a recession or significant economic slowdown that results in a valuation compression of small stocks, an interest rate easing cycle and then an economic expansion which drives a cyclical recovery of earnings. The data from the four prior periods of small cap outperformance that we observed leads us to the same place when discussing the likelihood of a small cap out performance cycle. The strongest arguments are relative value and a Trump Presidency. In our view, compressed valuation and a significant drop in rates are more powerful drivers of future small cap returns and candidly not as obvious.

Portfolio Review

The speed at which sentiment reversed around our sector positioning and some of our companies was dramatic. In less than three weeks from July 10 to July 26 we experienced significant relative underperformance. The first and perhaps most important question is whether the fundamental outlook for our portfolio worsened relative to the small cap universe. With virtually all our companies having reported their financial results we can say very little has changed for our portfolio on a relative basis. June earnings were in line and slightly better than the results reported from the index as a whole and guidance for the next quarter was also in line with the small cap benchmark (R2V).

In our view a powerful rotation towards laggard sectors and factors compounded the challenges presented by price reversals in individual stocks during the quarter. The swing in our quarterly attribution analysis was oversized and highlights both stocks and sectors going into reverse. During the first and second quarter our stock selection and sector weightings were both positive contributors to returns while in the third quarter the same stocks and sector weightings were decidedly negative.

Often the bigger challenge for our strategy is misjudging the downside risks and the ensuing performance drags with value based special situation turnarounds – the value traps! Before the mea culpa, note there have been several outstanding performers this year which we'll discuss later. But as far as 2024 is concerned our investments in ViaSat (VSAT, a provider of satellite services) and Wolfspeed (WOLF, a manufacturer of silicon carbide semiconductors) contributed much of our underperformance in the year and during the quarter.

Both ViaSat (VSAT) and Wolfspeed (WOLF) were one time investor darlings with rich valuations. WOLF which currently trades at $9.35

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compared to our cost of $19 traded at $122 three years ago and VSAT currently $11.25 versus our cost of $22 traded at $87 in 2018. So, what has gone wrong and why are we still invested? Well in short, we believe both stocks can triple and still sell at a discount to our intrinsic value. Nevertheless, both management teams need to regain the confidence of their investors. WOLF's first order of business is proving it has the financing to complete the build out its world class silicon carbide semiconductor manufacturing facilities which require another $1.8 billion dollars. It also needs to refinance convertible debt coming due in 2026. A favorable decision on a pending application for a CHIPS Act grant (slightly less than $1 billion) will shore up confidence. Also contributing to the negative investor sentiment is the slowdown in EV adoption and aggressive Chinese competitors in the silicon carbide wafer business. One step at a time and let's see if they get the CHIPS Act money.

The good news for ViaSat is that it doesn't need any money since it recently completed a $1.9 billion refinancing. But what VSAT needs to do is halt a recent string of competitive losses to Starlink, AKA Elon Musk, in their In-Flight Connectivity business. United Airline and Emirates just awarded Starlink contracts and now investors are panicked that Musk and Company are on a tear at VSAT's expense (United is a VSAT customer). Prior to these most recent awards VSAT was on its own winning streak with an 80% market share of the IFC contracts put up for bid. But a resurgent Musk has discouraged many investors. Not every part of VSAT competes with Musk. Out of VSAT's $1.6 billion in EBITDA there is $150-$250 million of highly valued earnings coming from its Advanced Technology and Defense segment. Analysts have pegged its valuation at north of $3.5 billion. If correct, you're buying the rest of the company at two times the $1.3 billion of cash flow it generates. With Starlink on a roll we believe that it will take a bit more time for investors to regain some confidence in the long-term value that we believe exists in the shares.

It's human nature to focus more on failures and mistakes than success but I will highlight a utility stock that has outperformed Nvidia this year. Vistra Corp (VST) our electric IPP (Independent Power Producer) is up 260% this year, rallying from $38 to $138 on the outlook for higher electricity prices driven by demand from data centers running AI applications. We have taken some profits, selling approximately one half of our position in the runup. I think it's important for clients to know that we first started buying VST 11 years ago at $19 and over the ensuing four years bought more between $6.50 and $32. With an average cost of $18 we then watched it trade between $17 and $32 for another six years between 2017 and 2023. This seven-bagger took over 11 years and a 70% drawdown before it paid off. Value investing – not for the faint of heart or the impatient.

During the quarter, we trimmed or eliminated some of our winners. Proceeds were redeployed into attractively valued new ideas and existing names. We remain hesitant to buy regional banks and conservative with our introduction of new investments.

BEST AND WORST PERFORMERS FOR 2Q 2024[1]

Best Performers	Worst Performers
Vistra Corp.	ViaSat, Inc.
Criteo SA Sponsored ADR	Cleveland-Cliffs Inc
Ciena Corporation	Rambus Inc.
AerCap Holdings NV	Wolfspeed Inc
Coherent Corp.	Stratasys Ltd.

1. Reflects the best and worst portfolio performers for the year, in descending order, based on individual security performance and portfolio weighting. Positions may include securities that are not held in the portfolio as of 9/30/2024. Information is based upon a composite account and additional information regarding the performance contribution calculation methodology is available upon request. Specific securities identified and described do not represent all of the securities purchased, sold or recommended for advisory clients. It should not be assumed that any investments in securities identified and described were or will be profitable.

Outlook

It's hard to say what kind of risk and/or opportunity lies ahead in the fourth quarter. We have a tightly contested Presidential election with diametrically opposed economic and regulatory agendas together with wars in Europe and the Middle East. Our seat belts are fastened yet we continue to look for compelling out-of-favor companies with the potential to generate exciting long-term returns.

As always, we are indebted to you for your patience and inspired to generate the long-term performance that brought you to us in the first place.

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Intrinsic value reflects the team's analysis and estimates. There is no guarantee that any intrinsic values will be realized; security prices may decrease regardless of intrinsic values.

The **Russell 2000 Value® Index** measures the performance of those Russell 2000 Index companies with lower price-to-book ratios and lower forecasted growth values. The index is market cap-weighted and includes only common stocks incorporated in the United States and its territories. (Russell 2000® Index: measures the performance of the 2,000 smallest companies in the Russell 3000® Index, which represents approximately 10% of the total market capitalization of the Russell 3000® Index. The index is market cap-weighted and includes only common stocks incorporated in the United States and its territories.)

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