

Capstone High Quality Small Cap

There are three main building blocks of our investment process, small cap, high quality, and attractive valuation. We like to own companies that are growing faster than the market while trading at a significant discount. When we started our firm, we chose a portfolio of 45 companies that met all of these criteria and have steadily managed our holdings for 25 months. Over that time frame, our turnover has been approximately 40%. Although we did not outperform during the quarter, we remain ahead of the benchmark since inception. Our annualized since inception return, after all, fees and expenses, is 14.8%, compared to the benchmark's annualized return over the same period of 14.3%. Below is a table that corresponds to the characteristics of the portfolio at year-end 2015, year-end 2016, and year-end 2017. The shaded lines show the ratio of the metric in relation to our benchmark, the Russell 2000.

	12/31/2015	12/31/2016	12/29/2017
FY1 P/E	12.1	13.7	13.7
Benchmark relative	0.7x	0.7x	0.7x
ROE	19.5	18	19.7
Benchmark relative	3x	3x	3.4x
Earnings Growth*	29.5	39.2	23.5
Benchmark relative	2.43x	3.46x	2.1x
Debt. to Cap.	36.2	30.5	24.8
Benchmark relative	1.03x	0.83x	0.71x
*Historical 3 Year			
Source: Factset			

We have maintained our valuation bias against the benchmark with the PE of our portfolio being just 70% that of the Russell 2000. The ROE of the portfolio is three times that of the benchmark, and the earnings growth of our portfolio is almost twice that of the benchmark. Our portfolio's earnings growth has remained better than the benchmark during the period, as has our Net Debt to Market Capitalization ratio. Our disciplined process has enabled us to continue to upgrade our holdings while maintaining an attractive portfolio of stocks. We currently have a portfolio that, when compared to its benchmark, is three times as profitable, has EPS growth two times as high, and is trading at a thirty percent discount. For the quarter we were down 1.24% after fees, underperforming the benchmark return of 3.33%.

Capstone Global Investments High Quality Small Cap Strategy

As of December 29, 2017 (net of fees)				
	4Q 2017	2017	2016	Since Inception*
Capstone HQ Small Cap	-1.24%	6.91%	27.79%	14.76%
Russell 2000	3.33%	14.63%	20.73%	14.29%
*Annualized with Inception Date 12/01/2015				

29-SEP-2017 to 29-DEC-2017

Ticker		Contribution To Return
	Total	-1.15
	5 Highest	2.09
FII	Federated Investors, Inc. Class B	0.65
LAZ	Lazard Ltd Class A	0.50
KLIC	Kulicke & Soffa Industries, Inc.	0.39
MAN	ManpowerGroup Inc.	0.28
TSE	Trinseo SA	0.27
	5 Lowest	-3.10
RTEC	Rudolph Technologies, Inc.	-0.32
HOFT	Hooker Furniture Corporation	-0.36
OCLR	Oclaro, Inc.	-0.54
AEIS	Advanced Energy Industries, Inc.	-0.59
AAOI	Applied Optoelectronics, Inc.	-1.29

Quarterly Attribution:

The quarter, much like the entire year, was a story of large cap growth stock leadership. Small cap stocks and specifically, small cap value stocks, did not perform nearly as well as the rest of the market. Within the Russell 2000, small cap stocks trading at less than 15x FY1 EPS returned on average 2.8% vs a 3.7% return for stocks trading at a multiple of over 28x. Our technology companies performed poorly during the quarter. We believe there is significant opportunity in the optical networking ecosystem and are closely monitoring the trends in the cloud and with large tech firms that operate cloud services.

Academic literature

A new study published in the Financial Analysts Journal (Volume 73, number 4) named “Optimal Tilts: Combing persistent characteristic portfolios” offers continued support to our High Quality Small Cap investment thesis.

Portfolio Review

During the quarter, we sold six positions. Two of the companies generated long-term gains for the portfolio, and the appreciation resulted in stretched valuations in our assessment. Four of the positions sold had deteriorating earnings, and generated losses in the portfolio.

We bought six stocks during the quarter:

UltraClean Holdings (UCTT) – a semiconductor capital equipment supplier with a 9x FY2 PE, mid-20s ROE and strong EPS growth. It had sold off because of lack of margin growth. We think stable margins with strong EPS growth makes it attractive.

CAI International (CAI) – a container shipping lease and management company with a 8x FY2 PE, double-digit EPS growth, and improving margins. There was a shakeout in the container business with the 2016 bankruptcy of Hanjin. The market has right-sized itself, with strong global trade lease rates are improving.

Meta Financial Group (CASH) – a financial conglomerate that trades at 10x FY2 PE, has EPS growth of 30-40% a year, and has double-digit profitability. Meta has a strong tax refund loan business driving its growth.

First Foundation (FFWM) – a financial conglomerate with robust loan growth in multifamily housing and strong net interest income trades at 14x FY2 PE, has EPS growth of >30% a year, and has double-digit profitability.

KEMET Corporation (KEM) – manufactures capacitors and is supply constrained. It is trading at 10.5x FY2 PE, has a low 20's ROE, and solid EPS growth. Planned CapEx to expand capacity should increase earnings.

Preferred Bank (PFBC) – a commercial bank with strong ties to the ethnic Chinese community in California and other high net worth markets in Northern California and New York. It has a 14.6x FY2 PE, mid-teens profitability metrics, and EPS growth of 20-30%.

Closing Comments

Although 2017 was disappointing from a relative benchmark view, we generated positive returns and maintain an advantage over our benchmark since our inception. Over short periods of time we will lag the benchmark, but we believe that the fundamental building blocks of our investment process, small cap, high quality and attractive valuation, will generate a well-constructed portfolio, potentially outpacing the market. During periods of underperformance many managers are tempted to directionally bend their strategy, however we choose to maintain our discipline as shown by our portfolio characteristics. We look forward to keeping you up to date on our portfolio's progression through 2018.

Sincerely,

Chad Deakins, CFA

Portfolio Manager, CIO

Capstone Global Investments Performance Results:

High Quality Small Cap Equity - December 1, 2015 through December 29, 2017

Year	Gross of Fee Return (%)	Net of Fee Return (%)	Benchmark Return (%)	Number of Portfolios	Composite Dispersion (%)	Total Composite Assets at End of Period	Total Strategy Assets at End of Period	Total Firm AUM	Total Firm AUA
12/1/2015 to 12/31/2015	-4.81	-4.89	-5.02	1	0	<1	<1	<1	<1
2016	32.3	31.02	21.32	3	0.01	2	2	3.5	3.5
2017	7.98	6.91	14.63	5	0.02	2.5	5.8	6.3	9.6

GIPS Disclosures:

Capstone Global Investments claims compliance with the Global Investment Performance Standards (GIPS®) and has prepared and presented this report in compliance with the GIPS standards for the period December 1, 2015 through December 29, 2017. Capstone has not been independently verified for GIPS compliance.

1. Capstone Global Investments is an independent investment adviser registered with the State of Georgia. Capstone was founded in December of 2015 and manages small-cap equity strategies. For composite reporting purposes, the Firm is defined as all equity portfolios managed by Capstone.
2. Beginning December 2015, the composite includes only (SMA) portfolios benchmarked to the Russell 2000 Small Cap Index.
3. The Capstone High Quality Small Cap Equity SMA Composite is composed of portfolios invested in US equities which have a market capitalization greater than \$50 million and less than \$10 billion. The investment goal is to find high quality investment opportunities that are trading at a discount to the market and have a catalyst to help propel their relative valuation up to fair value. A complete description of the composite is available on request.
4. The composite was created in January 2016. A complete list and description of firm composites and performance results are available upon request.
5. All returns are expressed in US dollars. Policies for valuing portfolios, calculating performance, and preparing compliant presentations are available upon request.
6. The primary benchmark for the Capstone High Quality Small Cap Equity composite is the Russell 2000 Small Cap Index (Net). The Russell 2000 Small Cap Index returns are provided to represent the investment environment existing during the time periods shown. For comparison purposes, the index is fully invested and includes the reinvestment of income. The returns for the index do not include any trading costs, management fees, or other costs. Index returns have been taken from published sources.
7. Gross returns presented above as supplemental information. The SMA fee includes all charges for trading costs, portfolio management, custody, and other administrative fees. Net returns are calculated by subtracting the highest applicable SMA fee (1.00% on an annual basis, or 0.083% monthly) on a monthly basis from the gross composite monthly return. The standard fee schedule in effect is as follows: 1.00% on total assets.
8. The minimum portfolio size for the U.S. High Quality Small Cap Equity composite is seventy-five thousand dollars.
9. Past performance is not indicative of future results and no investment is guaranteed for the return of principal and/or return on investments. All information provided and used in calculations is believed to be correct, but accuracy cannot be guaranteed. Please consult with a financial professional before investing.
10. Composite dispersion is measured as the average of monthly standard deviations for the periods shown.