

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 31 months. Our annualized since inception return, after all fees and expenses, is 11%, compared to the Russell 2000 annualized return over the same period of 14.6%. Below is a table that corresponds to the characteristics of the portfolio at year-end 2015, year-end 2016, year-end 2017, and quarter end. The shaded lines show the ratio of the metric in relation to our main benchmark, the Russell 2000.

	12/31/2015	12/31/2016	12/29/2017	6/30/2018
FY1 P/E	12.1	13.7	13.7	11.5
Benchmark relative	0.7x	0.7x	0.7x	0.6x
ROE	19.5	18	19.7	20
Benchmark relative	3x	3x	3.4x	3.4x
Earnings Growth*	29.5	39.2	23.5	27.1
Benchmark relative	2.43x	3.46x	2.1x	2.2x
Debt. to Cap.	36.2	30.5	24.8	29.5
Benchmark relative	1.03x	0.83x	0.71x	0.89x
*Historical 3 Year				
Source: Factset				

We have maintained our valuation bias against the benchmark, and the PE of our portfolio is 60% of the Russell 2000. The ROE of the portfolio is three times that of the benchmark, and the earnings growth of our portfolio is 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. For the quarter we were up 0.3% after fees, underperforming the Russell 2000 return of 7.75%.

Quarterly Attribution:

Investors hopped on the small-cap bandwagon in the quarter as ETF flows were \$9.5 billion on the perception that small-cap stocks are immune to a trade war. Valuation did not matter, and momentum was key until June. Lower quality stocks driven by biotech were up significantly. From a factor viewpoint, using forward PE, the lowest quintile (stocks trading below 11.6x) returned 2.7% versus the highest quintile (stocks trading above 27x), which returned 12.8%. Using ROE to look at the Russell 2000, the highest quintile (13.8 and above) returned 4.8% while the lowest quintile (all negative) returned 11.7%. From a size perspective, the lowest and highest quintiles (below \$300 M and above \$1.1 B) both returned around 7% while the smaller quintiles between these

Quarterly Attribution Continued:

market caps returned 11%. If you look at the portfolio attribution for the quarter, not owning the more expensive stocks and owning the cheapest stocks cost around 375 basis points in relative performance. Stock selection accounted for the rest of the underperformance.

Federated Investors declined more than 30% in the quarter after missing elevated estimates. We still like the business and will re-evaluate the position after the company reports on July 26th. Manpower Group, another long-term holding, started to experience severe competition in the marketplace, which hurt their margins. We have since exited the name. Essent Group, a private mortgage insurance company, declined under the threat that the government-sponsored mortgage programs would become government insured. This may take a few quarters to sort out, and we believe the market overreacted. Meta Financial Group had appreciated significantly since we bought it, but they missed estimated earnings, resulting in an 11% decline during the quarter. Ultra Clean Holdings was a casualty of the trade war with China, but we believe this is an opportunity over the next few quarters. The market has continued to reward companies that are expensive and of lower quality.

Portfolio Review

It was a very busy quarter for the small-cap strategy. We have not performed as well as the market and have completed some analysis to understand why. We are not changing our strategy, but we have included 2 additional criteria to our portfolio in an effort to increase performance in this momentum favored market. We decided to stay away from high short interest names because research has shown that high short interest is often evidence of an unknown, especially in small caps. We are focusing on names that had positive price momentum but still met all our other criteria. We created some turnover, and the portfolio looks similar but more robust on several metrics. The market cap of the portfolio is lower now, and estimated earnings growth is significantly closer to the benchmark than before. We maintained a significant value bias in the portfolio and our higher quality bias with lower leverage (on average) and higher profitability. Below are our most recent trades.

Sold:

BGC Partners (BGCP) – A brokerage company with falling EPS estimates and negative price momentum. We bought it for \$9.09 and sold for \$11.78.

Deluxe Corp (DLX) -A low growth consumer staples stock with increasing short interest. We bought it for \$54.82 and sold for \$67.87.

Lazard (LAZ) – An investment bank with a low growth outlook going forward. We trimmed some at \$52.62 after purchasing at \$45.78 and \$43.25. We are using this name as a source of funds as we find new things to buy.

Portfolio Review continued

Kemet (KEM) -A capacitor producer with strong earnings growth. We bought it for \$15.34. We still like the name but trimmed the position size to control risk at \$25.40.

Lear (LEA) – An auto parts supplier with a slowing growth outlook. We bought the stock at \$101.38 and sold for \$200.

Manpower Group (MAN) -A global staffing company with slowing EPS growth caused by an increasingly competitive environment that is hurting margins. We bought for \$79.93 and \$68.39, then exited at \$92.22.

Bought:

CoBiz Fin. (COBZ) -A quality regional bank which got an 8% premium takeover bid the day after we bought it.

First Financial Bancorp (FFBC) -We bought a 2% position at \$32.60. The stock is cheap, with solid trailing and expected EPS growth.

United Community Financial Corp. (UCFC) – A smaller cap size bank with a cheap valuation, attractive trailing, and expected growth. We bought at \$10.81.

Univar (UNVR) – A chemical and ingredients distributor with solid expected EPS growth. In an expanding global economy, chemical production should increase with pricing power.

Victory Capital (VCTR) -A Small RIA/Asset manager with a new deal licensing their custom index series with Nasdaq. They will get broader distribution. The stock has an ROE of 23 and trades at 6x forward EPS. We bought at \$10.69

Closing Comments

We continue to maintain what we view as an attractive portfolio of holdings. We are frustrated that lower quality higher momentum stocks have dominated the market and that high quality small-cap value has been out of favor. We will lag the benchmark over short periods of time, 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, with the potential to outpace the market. Although the growth style has outperformed value, we prefer to pay less for better earnings growth. We believe our portfolio represents excellent value with better fundamentals than the market. Our strategy is to buy high quality companies with solid balance sheets that are growing faster than the market at a discount. We believe that, over time, our portfolio will perform attractively.

Sincerely,

Chad Deakins, CFA **Portfolio Manager, CIO**



**Second
Quarter
2018**

Capstone Global Investments High Quality Small Cap Strategy

As of June 30, 2018 (net of fees)			
	2Q 2018	1 Year	Since Inception*
HQ Small Cap	0.30%	0.74%	11.00%
Russell 2000	7.75%	17.56%	14.68%
Russell 2000 Value	8.30%	13.30%	14.50%
*Annualized with Inception Date 12/01/2015			

**Top/Bottom 10 Contributors to Return
High/Low - Port. Contribution To Return
30-MAR-2018 to 29-JUN-2018**

Ticker		Average Weight	Total Return	Contribution To Return
	Total	100.00	0.67	0.67
	5 Highest	16.24	24.63	3.64
KEM	KEMET Corporation	3.91	33.20	1.19
SHOO	Steven Madden, Ltd.	3.92	21.40	0.86
NCS	NCI Building Systems, Inc.	2.83	20.00	0.58
AEL	American Equity Investment Life Holding Company	2.69	22.62	0.53
FDEF	First Defiance Financial Corp.	2.89	17.56	0.48
	5 Lowest	14.31	-18.47	-2.99
FII	Federated Investors, Inc. Class B	2.80	-29.42	-1.05
MAN	ManpowerGroup Inc.	2.70	-18.36	-0.69
ESNT	Essent Group Ltd.	2.71	-15.84	-0.53
CASH	Meta Financial Group, Inc.	3.92	-10.70	-0.42
UCTT	Ultra Clean Holdings, Inc.	2.18	-13.77	-0.31

Capstone Global Investments Performance Results:

High Quality Small Cap Equity - December 1, 2015 through June 30, 2018

Year	Gross of Fee Return (%)	Net of Fee Return (%)	Russell 2K Return (%)	Russell 2KV 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	-5.02	1	0	<1	<1	<1	<1
2016	32.3	31.02	21.32	21.32	3	0.01	2	2	3.5	3.5
2017	7.98	6.91	14.63	14.63	5	0.01	2.5	5.8	6.3	9.6
YTD 2018	-1.21	-1.7	7.67	5.49	7	0.12	2.9	6.2	8	11.3

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 June 30, 2018. 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.
11. Upon request, Capstone Global Investments will provide a list of all securities recommended for the previous year. It should not be assumed that recommendations made in the future will be profitable or will equal the performance of the securities discussed herein.