Investment Management of Virginia

Small Capitalization Portfolio
2nd Quarter, 2022

The Small Capitalization Portfolio Composite was down 12.92%, net of fees, for the quarter, and ahead of the 17.20% loss for the Russell 2000 Index.[1] The Portfolio Composite was ahead of the Russell 2000 Index for the year-to-date and over the 1, 3, 5-year and since inception periods.[2]

The Small Capitalization Portfolio Composite outperformed the Russell 2000 Index substantially this quarter, but that is faint praise in a very difficult quarter. Looking on the bright side, the market volatility did give us a shot at several new positions that are normally too expensive for us. For the past 18-24 months, we have talked about the portfolio's having a more defensive bias; this quarter, given the swift pullback, we went on offense and bought some companies that appear to have compelling risk/reward profiles than those of our more defensive exposure. JPMorgan Chase recently published a couple of charts showing that small capitalization stocks currently trade at valuation levels last seen in 2008 (the global financial crisis) and also at the deepest discount to large capitalization stocks in past twenty years.[3] We agree with them; this appears to be a reasonable opportunity for long-term investors to take advantage of market volatility.

The Portfolio[4]
Purchases during the quarter included:

We added to our position in MDC twice during the quarter, once in April and again in June. Housing stocks have underperformed the broader market this year due to rising mortgage rates and fears that home prices have peaked. Nonetheless, we continue to like MDC; management has shown their ability to serve a lower price buyer while maintaining margins. The balance sheet is in great shape, the dividend appears sacrosanct (and the dividend yield near an all-time high), and the stock is trading below tangible book value. Despite the near-term industry dynamics, the U.S. housing industry is not producing enough homes to meet demand and existing home inventory remains low; we think demand for new home construction is solid for the foreseeable future.

In April, we initiated a new position in Tidewater, Inc. (TDW). TDW is a leading global marine support and transport (boat) company servicing the offshore energy industry. The offshore energy market has been in a sustained slump since around 2014, but we see improving fundamentals going forward. On the supply-side, about one third of the global offshore vessel fleet has been scrapped or dry docked over the past eight years. The vessels that have been dry docked typically are the oldest, smallest, and least efficient vessels, so they are not likely to be refitted (even if there was room in the ship yards). On the demand side, the war in Ukraine has oil consumers (businesses and governments) looking for new sources of supply; offshore is a likely area for investment. TDW has been experiencing consistent day-rate increases for the past few quarters; this should continue, given the

[1]Past performance is no guarantee of future results, and no representation is made that results similar to those shown or discussed can be achieved. To receive a complete list and description of Investment Management of Virginia, LLC's composites and/or a GIPS report, contact Investment Management of Virginia at (804) 643-1100.
[2] Portfolio inception is 1/1/94.
[3] JPMorgan Research from Bloomberg Finance, LP. 6/22/22.
[4]The transactions/securities discussed in this section are generally portfolio-wide transactions for the accounts in this Portfolio and have not been selected by any performance criteria. It should not be assumed that all accounts in the Portfolio had the same transactions or that transactions in the future will be as profitable or will equal the performance of the securities mentioned.

overall tightness in the market. TDW has one of the largest and youngest fleets in the industry; we believe they are very well positioned.

In April, we added to Cass Information Systems (CASS). CASS was a new purchase in the Small Capitalization Portfolio in the first quarter. The company's primary business is transport management for companies and truck owners. CASS makes money on payment terms, spreads, and transaction volumes and normally sees higher margins when fuel prices and interest rates are moving up. The company is not currently followed by any traditional Wall Street firms; we think investors will notice as earnings growth accelerates in the current environment.

In May, we initiated a new position in Inogen (INGN). We had previously purchased INGN prior to the initial Covid lockdowns, but the business suffered in 2020 as fewer people were going to the doctor or traveling (general oxygen demand to treat COPD is the primary driver of Inogen's business). INGN now has a new management team in place, and we believe the business fundamentals are set to improve as we put Covid in the rearview mirror.

In May, we initiated a new position in Semler Scientific (SMLR). SMLR provides a patented testing platform to hospitals and doctors' offices; this testing system is used to screen patients for chronic diseases, primarily Peripheral Artery Disease (PAD). The company has grown its revenue and earnings through the pandemic lockdowns, and we think growth is poised to reaccelerate as more patients resume in-person doctor visits. The company's products have the potential to become the standard of care, which could produce compelling revenue and earnings growth for the foreseeable future. SMLR is developing other cardiovascular tests to increase top-line growth potential. The company is profitable, has no debt, produces consistent free cash flow, and has high inside ownership.

In June, we added to Standard Motor Products (SMP). SMP primarily sells electronic infrastructure (wiring) and HVAC equipment into the automotive industry. The business is growing organically and through strategic acquisitions. When the stock sold off with the market in May, SMP reached valuation levels not seen since the Great Financial Crisis in 2008. We do not foresee that type of demand destruction at SMP this time around and added to our position.

Sales during the quarter included: Intrepid Potash (IPI), Magnite (MGNI), iShares Russell 2000 Index ETF (IWM), and ProShares Russell 2000 Dividend Growers ETF (SMDV).

In April, we trimmed our position in Intrepid Potash (IPI). IPI sells potash into the U.S. agriculture market and water services, including recycling, into the upstream oil and gas industry. The stock has been in the sweet spot of the commodity complex and reached our maximum single-stock position size of 6%. We remain bullish on the company's long-term fundamentals in both fertilizers and water recycling. The balance sheet is very strong, and management is looking for ways to unlock further shareholder value through land sales/leases and investments outside of the core potash market. Insider ownership is high, and we like the company's commitment to shareholders.

In April, we liquidated our position in Magnite (MGNI). The stock had declined on lower online advertising spend. The slowdown continued into the second quarter and was exacerbated by a change in Apple's privacy policy.

Throughout the quarter, we reduced our position in the iShares Russell2000 index (IWM). We use the IWM in lieu of high cash balances in order to stay more fully invested in the small capitalization market. The market gave us opportunities this quarter, and we used IWM to fund our individual stock purchases.

We also reduced our position in the ProShares Russell 2000 Dividend Growers ETF (SMDV). SMDV has delivered defensive small capitalization exposure, but, given the volatility in small capitalization stocks, we saw better risk/reward profiles for certain individual stocks. SMDV remains a meaningful position in the Portfolio.

The Equity Market

The first six months of 2022 are in the history books, and, from the perspective of equity investors, it has been a rough ride. But, we need to remember that 20% market declines come around, on average, every three years. Looking ahead, in years where the first half of the year experienced large losses, the second half, historically, is often pretty good. Nonetheless, the experience of reasonably diversified investors in the second quarter was definitely unpleasant, and those who loaded up on the hottest technology stocks and other "long duration" assets (like cryptocurrency) experienced a very ugly reversal.

The current list of investor concerns is longer than usual:

- The Federal Reserve seems determined to control inflation, even at the risk of a recession. In other words, the Fed is focused on price stability over full employment. Federal Reserve Chair Jerome Powell hopes to cool the economy enough to bring inflation back to 2% without putting our economy into a recession (two consecutive quarters of negative GDP growth). This outcome is the elusive "soft landing" (possible, but probably unlikely). Chair Powell seems to want us to remember "don't fight the Fed" more than he wants a soft landing.
- The war in Ukraine continues with no end in sight (but we need to be careful about predictions). The human tragedy in Ukraine is stunning, and the war's effect on commodity prices may multiply the tragedy to include famine in some countries and the possibility of severe economic hardship in Europe this coming winter, if energy prices stay where they are.
- The culture war in the U.S. is getting hotter (is that possible?) as we head into mid-term elections. It is hard to translate these issues into potential economic outcomes and investment strategies, but the partisan divide in the U.S. is growing, and the possibility of wise and objective governance, through cooperation and compromise, seems like a pipe-dream at this point. This kind of dysfunction is not good for productivity improvement, the key ingredient for long-term GDP growth.
- Global warming, our massive government debt (with rising interest expense), a threatened election system, and ominous threats of nuclear war fill out the list.

We are long-term investors and try to prepare for this kind of volatility with a thoughtfully positioned portfolio (depending on each client's risk tolerance) and the understanding that we should not try to predict the market's direction in the short or even medium-term. But, the equity market may be less risky for long-term investors than it was six months ago. Investor (and consumer) sentiment is very negative, valuations are lower and more interesting (especially for small capitalization stocks), commodity prices seem to have peaked (this will help cool inflation), speculators in risky assets have taken a historic beating, and the “wall of worry” seems too high to see over. We cannot say if the equity market rally off of the bottom in June will hold (few market commentators think it will), but we believe that the prospects for reasonable long-term returns for equity investors have improved from the end of last year. This is not a hugely bold prediction given the losses in the market so far this year, and the U.S. market is unlikely to replicate the equity returns of the past decade, but we suspect the forward outlook, long-term, is considerably better than it was on 12/31/21.