# Small Cap Growth Investor Letter
## January 2020

- **In a strong year for US equities our performance lagged.**
- **Going forward, simplified portfolio construction rules will keep us fully invested**.

Having surpassed our benchmark in 2017 and 2018, returns in 2019 were disappointing. In three decades of managing growth portfolios this past year was not my first period of underperformance. The best response to these frustrating episodes is to identify the root cause and then decide if any changes need to be made to portfolios or processes.

One such experience twenty-one years ago led to modifying the research process to place equal weight on price momentum and earnings acceleration. Since then the discipline has evolved to take advantage of better tools and new information. The underperformance in 2019 was attributable to the unintended consequences of a minor process tweak introduced in 2016.

Without altering our long established discipline, we hypothesized that returns could be enhanced by prudently deferring purchases if shares we wanted to own were overbought. We tried to improve the timing of orders using several established quantitative measures. Despite a solid theoretical and empirical basis, these historically reliable tools did not deliver as expected. Waiting for better prices that never came, our portfolios held too much cash in a rising market. The cash did reduce portfolio beta, but the cost to our absolute returns was unacceptably high.

**Consequently, in December we revised our portfolio construction rules.** Prospectively, cash will be less than 10% unless our proprietary fundamental and technical measures objectively signal uncommon and unfavorable market conditions. Similar situations arose in late 2000 and early 2008 just prior to the two most severe bear markets of the past forty years.

Drawbridge's fundamental process seeks stocks with accelerating growth and rising price trends whenever and wherever risk is being rewarded. Names with these characteristics are usually plentiful and often among the top performers. Occasionally however, equity investors become fearful, sentiment turns negative and risk gets punished. In bear markets we find fewer investment opportunities, and losses become more likely than gains. During these periods, raising cash to protect against losses seems a compelling alternative.

Anyone can find winners in a bull market. In my opinion the best investors excel at minimizing losses, selling losers early and avoiding extreme drawdowns. When market sentiment turns negative, Drawbridge is committed to playing aggressive defense to protect our clients' capital. But now is not that time.

**At present we are playing offense.** Our constructive outlook does not result from a bullish market or economic forecast. We never make predictions or set price targets because we believe the exercise is counterproductive. Focusing on one expected outcome tends to distract investors from seeing developments that don't fit that forecast. At Drawbridge we capture and absorb new information everyday, and when necessary we adjust portfolios. To paraphrase Winston Churchill, when the facts change, we may change our mind – and sometimes our risk profile.

We focus on earnings, cash flows, margins, and valuations. Today we find sufficient investment ideas that meet our fundamental criteria. While valuations are historically high and markets could be vulnerable, we believe risk can still be rewarded. We remain fully invested in high-conviction names where the potential return justifies the investment.

## US Small Cap Growth Performance Review

**For 2019** Small Cap Growth[1] returned 14.6% compared to 28.5% for the Russell 2000 Growth Index[1] and 21.1% for the S&P Small Cap Growth Index[1].

**Over the past 36 months** Small Cap Growth's annualized return of 10.8% compares more favorably against 12.5% for the Russell 2000 Growth Index and 10.1% for the S&P Small Cap Growth. Risk adjusted performance was more compelling, with Alpha of 3.97% and Beta of 0.51. Our Sharpe Ratio exceeded the Russell benchmark (0.85 vs. 0.72) and the Sortino Ratio was also higher (2.77 vs. 1.42).

| | **1 Year** | **3-Year*** | **Inception*** |
|---|---|---|---|
| Small Cap Growth - Gross | 14.62 | 10.80 | 9.42 |
| Small Cap Growth - Net[2] | 13.11 | 9.38 | 7.97 |
| Russell 2000 Growth | 28.48 | 12.49 | 12.20 |
| S&P 600 Growth | 21.13 | 10.08 | 12.43 |

*Annualized

Despite achieving four of our five investment objectives (listed on page 3), we are disappointed to have fallen well short of our excess return target. The following table shows our estimate of the performance attributable to the equity portion of Small Cap Growth since inception, which shows that Drawbridge's stock selection has been competitive.

**Actual vs. Equity Only Returns**
*Jan 1, 2016– Dec 31, 2019[3]*

| | **SCG Actual** | **SCG Equity-Only** | **Russell 2000 Growth Index** |
|---|---|---|---|
| Annualized ROR | 9.4 | 12.9 | 12.2 |
| Alpha | 3.53 | 4.98 | - |
| Beta | 0.47 | 0.64 | - |
| Volatility | 10.9 | 14.9 | 16.8 |
| R-Squared (S&P 500) | 0.43 | 0.44 | 0.80 |

Now staying fully invested, except under the most adverse conditions, we expect to see much better relative returns.

Thirty years of experience implementing this discipline gives me great confidence that over the long run it will continue to consistently provide higher returns than benchmarks with lower volatility and much lower correlation to the broad equity market.

We appreciate the confidence our clients place in us.

## Investment Objectives

- Excess Return > 300bps
- Alpha > 300bps
- Beta < 1.0
- Volatility < Benchmark
- $R^2$ 20bps < Benchmark

Glenn Fogle

Chief Investment Officer
Drawbridge Asset Management


**Portfolio Manager**
**Glenn A. Fogle, CFA**
**Chief Investment Officer**

**Client Relations**
**Russ Cembrinski**
Russ@DrawbridgeAM.com
917-825-1793


[1] Unless noted, statistics cited are for the Small Cap Growth Composite before management fees. Indices are unmanaged and not directly investable.

[2] Retail advisory clients of Drawbridge's parent company incepted Small Cap Growth. Net of fee returns since inception reflect management fees of approximately 1.45% and are not representative of institutional client fees.

[3] Equity-only statistics are estimated by calculating the equity percent of assets (average of the first and last day of each month) and attributing all of the monthly return to the equity component. Statistics are calculated using monthly returns. Alpha and beta are the y-intercept and slope of a linear regression of returns against the Russell 2000 Growth Index. Sharpe and Sortino Ratio calculations use the 3-month Treasury bill monthly interest rates for the risk-free rate (source: Federal Reserve System). R-squared compares monthly returns against the S&P 500 Index.