2023 Forecast: Long-Term Looks Good

by Kevin Silverman, CFA
CIO & Portfolio Manager

Another year is behind us, and so traditionally a good time to make prognostications about the year ahead. This year we are more optimistic than past years — in part because we've waited to see how January turned out, but also because we recognize the power of mean reversion! Last year was a poor year for our SCV strategies, both in absolute terms and relative to our Russell 2000 Value benchmark. The damage was done in the first quarter as we shared the fate of many long-duration strategies when long bond yields jumped at the fastest pace in at least a generation, and the so-called efficient frontier was efficient in delivering worse-than-average historical results in almost every traditional asset class. We wrote last year that we believed the market performance suggested a recession was coming; that is closer to the consensus now, with two negative GDP quarters behind us. But, as often happens, it may be called over before it is officially declared to have begun. So it's been a tricky period to navigate. Our Director of Research shares his thoughts on recent results about our best and worst performers later in this report.

We have been doing this job a pretty long time. Our SCV-Focus strategy has an inception date of June 2001, and our SCV-Diversified strategy began in December 2006. Before sharing our short-term views, which may be of less interest to long-term investors, it's worth noting that our historical long-term results have been very good relative to the benchmark, as is our performance so far this year *(links located at the end of this letter)*. One of these things we care about, one we care less about.

Unfortunately for the reader, we don't know what will happen this year, which makes these annual prognostication letters a tad awkward. On the other hand, we are confident in long-term predictions of growth anchored around estimates of population growth and productivity growth per capita, some of the few trends that have been somewhat predictable in recent times.

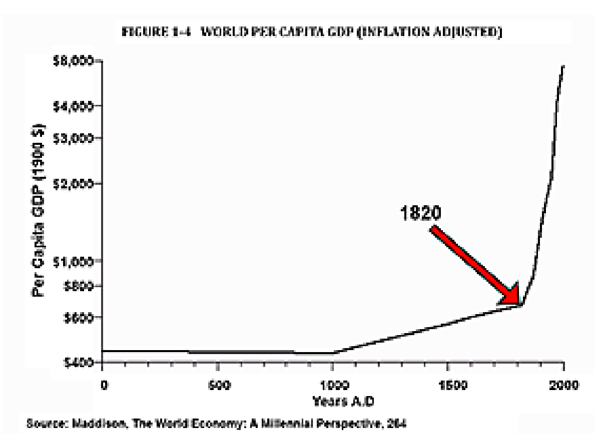


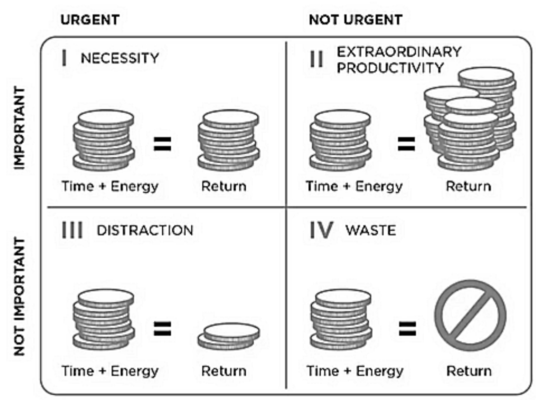
FIGURE 1-4 WORLD PER CAPITA GDP (INFLATION ADJUSTED)
Source: Maddison, The World Economy: A Millennial Perspective, 264

According to British economist Angus Maddison, these trends accelerated around 1820 when a "range of gadgets" swept over England, dramatically increasing the speed and reducing the cost of transportation leading to larger trade areas and a means for best manufacturing practices to spread. The result was an historic shift in world economic growth, as a consistent increase in productivity per capita allowed a consistent growth in population that continues to this day. It seems we may now also be in a period when a "range of gadgets" sweeps over not just England but the entire world at the same time.

As we've said in past letters, the COVID period has likely introduced a lurch in per capita productivity, as government lockdowns forced even older folks, skeptical of new technology, to learn how to do a few important things faster and cheaper. Like 1820, it is a transportation revolution, but in reverse. Resources used for years to move workers to their most productive location will now be put to better use, as will the time used for that travel. This may not matter much or multiply by billions of people, but it may have started a period of productivity growth that will sometimes be difficult to measure.

One thing that becomes apparent over a long career is that institutional investors, on average, spend too much time worrying about the short term, that is, if maximizing total return is truly their objective. A short-term focus erodes long-term return by extracting a cost for certainty during uncertain times in the form of a lower than "fair" price, which for argument's sake, we could say is defined as average valuation or average P/E. Investors with a long-term focus that buy during uncertain times have traditionally beaten the averages, and the uncertainty that those better returns will continue likely means that they will. Of course, risk-adjusted returns may be the same for buyer and seller if each defines risk differently. The risk of earning sub-par long-run returns and losing more money later today can be mitigated in the same transaction.

Figuring out which information is important in the long run and which isn't is difficult. The amount of news and information that is truly strategically important is but a fraction of what we see. Learning to discern between signal and noise has been important for millennia, and it may be among the most important elements of generating good long-term investment results. The other is not to overpay.



Source: The 7 Habits of Highly Effective People, by Stephen Covey

The Eisenhower Matrix, popularized by Stephen Covey, is a nice tool for organizing decisions into a matrix of "urgent / not urgent" and "important / not important," which may be useful when seeking good long-term equity returns. If we recognize that stock prices are determined by supply and demand, and we re-define "urgent" as being high investor interest and "not-urgent" as low investor interest, we can readily adapt Eisenhower'sand Covey's Matrices to equity markets and call it the Value Investor's, um, Matrix!

The adaptation is that important information when a stock is popular is likely to deliver returns offered by the efficient market, or fair risk-adjusted returns, while important information discovered when a stock is in low demand is more likely to deliver excess returns as demand recovers. Obviously, "not important" information should be avoided. But when every news outlet, pundit, client, co-worker, family member, friend, boss, or stranger holds a strong opinion, all of which are worth listening to under the mosaic theory, it is difficult to determine which information is truly important.

Over time, one of the most important compasses or guideposts in our effort to discern important from not important has been the Consumer Expenditures Survey (CES). When looking for important information, we have found this data is among the most important. Outside opinions are good to hear, but why not also let consumers tell you themselves what they are doing? We like to overweight industries that are growing relative to GDP by investing in the most undervalued companies in those industries. This approach has worked for a long time. Often, even a weak competitor in a good industry can deliver decent relative returns, mitigating the long-term risk of earning sub-par returns. The growth in leisure, gaming, software, internet advertising, e-commerce, healthcare - the list is longer - was trending nicely in the CES, while bargains would regularly appear after a short-term earnings miss or an officer resignation. For us, companies trading at below-average valuations in industries consistently gaining a share of GDP is a nice wind at the back.

As an example, we attach a table that we use as a guidepost in our search for new ideas. Not surprisingly, information services, scientific equipment, and data processing are near the top of the relative growth list since 2019, while construction, petroleum, food and beverage, chemicals, and government are toward the bottom. We organize the table into various economic periods, looking for changes and new trends that may be emerging. These long-term, sometimes well-entrenched trends, in our view, are always a good compass to above-average returns, and so we continue to mine this data for new ideas.

So, thank you for reading our annual Year-End/Forecast letter. One very comfortable prediction is that, especially during uncertain times, our long-term research and focus on long-term returns should help us continue delivering good returns to our clients. Thank you for your interest in our equity strategies.

Best Regards,

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Click the following links for our most recent performance:

December 2022
January 2023

Sterling Small-Cap Value Diversified 4Q 2022 Summary* Listed from Highest to Lowest contribution within the performance category	
Top Contributors	**Bottom Contributors**
1) QuinStreet, Inc.	1) Lions Gate Entertainment Corp.
2) EVI Industries, Inc.	2) Atlas Technical Consultants, Inc.
3) Meritage Homes Corporation	3) Xperi, Inc.
4) The Bancorp, Inc.	4) Green Dot Corp.
5) InMode Ltd.	5) National Storage Affiliates Trust

Sterling Small-Cap Value Focus 4Q 2022 Summary* Listed from Highest to Lowest contribution within the performance category	
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1) Patrick Industries, Inc.	1) Green Dot Corp.
2) Meritage Homes Corporation	2) Atlas Technical Consultants, Inc.
3) MasterCraft Boat Holdings, Inc.	3) Lions Gate Entertainment Corp.
4) QuinStreet, Inc.	4) Xperi, Inc.
5) InMode Ltd.	5) Calavo Growers, Inc.

Top Contributors

QuinStreet Inc (QNST)

Sterling Small-Cap Value Diversified
Sterling Small-Cap Value Focus

QuinStreet Inc is an online performance marketing company that provides customer acquisition services for its clients in the United States and internationally, primarily in the auto insurance and home services industries. The company offers online marketing services to its clients in the form of qualified clicks, leads, calls, applications, or customers through its websites or third-party publishers.

Despite the headwinds continuing for QuinStreet's Insurance vertical throughout the quarter, investments in Home Services and Credit-driven categories largely offset these losses. Auto-related revenue fell 20%, while Home and Credit services revenue was up 20%. Management believes the insurance segment has reached its trough and should see growth returning in the coming quarters.

As QuinStreet continues to diversify its business outside of Auto into Credit and Home services, the Company's prospects remain quite promising. We see the Auto segment undergoing a re-rating in 2023 which should catalyze spending and growth in the coming quarters. In addition, as the Auto-Insurance segment returns to growth, we expect continued execution in Home and Credit services. This positions QuinStreet extremely well as consumers become more cost-conscious in a higher-rate environment.

Meritage Homes Corporation (MTH)

Sterling Small-Cap Value Diversified
Sterling Small-Cap Value Focus

Meritage Homes Corporation designs and builds single-family homes in the United States. It acquires and develops land; and constructs, markets, and sells homes for first-time and first-move-up buyers. The company also offers title insurance and closing/settlement services to its homebuyers. It builds and sells homes in Texas, Arizona, California, Colorado, Florida, North Carolina, South Carolina, Georgia, and Tennessee under the Meritage Homes brand name.

Meritage Homes had a record quarter despite a challenging housing market, interest rate hikes, and supply chain issues highlighting The Company's durability and resiliency. Meritage achieved its highest quarterly home closing revenue (3,487 homes, up 12% YoY), highest quarterly diluted EPS ($7.10, up 35% YoY), and a record SG&A leverage of 8.1%.

Despite Meritage's top-of-the-line execution, management did note that they are seeing market pressure on the sales side as orders fell sharply during the quarter. They added that increasing mortgage rates, inflation, and economic uncertainty temporarily outweigh demand. However, we continue to like Meritage's geographic footprint and its ability to grow its market share long-term on the back of favorable demographics and the low supply of new and resale housing inventory.

InMode Ltd (INMD)
Sterling Small-Cap Value Diversified
Sterling Small-Cap Value Focus

InMode Ltd provides minimally and non-invasive surgical aesthetic and medical treatment solutions in the United States. Its products and solutions address three energy-based treatment categories that include face & body contouring, medical aesthetics, and women's health. InMode has developed products using its technology for plastic surgery, dermatology, gynecology, and ophthalmology. Its product platforms include BodyTite, Optimas, Votiva, Contoura, Triton, EmbraceRF, Evolve, Evoke, and Morpheus8. The majority of its revenue comes from the United States.

InMode reported a record quarterly revenue of $121.2 million, an increase of 29% year over year, driven predominantly by growth in their proprietary surgical technology platforms that engage in minimally invasive and subdermal ablative treatments. Management noted that demand remained strong for their products despite anticipated seasonality and supply chain constraints. Momentum doesn't appear to be slowing for InMode as management reiterated their confidence in demand – raising full-year guidance for 2022 to a range of $445 million to $450 million from $425 million to $435 million.

InMode continues to expand its product offerings from aesthetics into wellness and improved quality of life categories. Their women's health EmpowerRF product continues to exceed optimistic expectations, while their Morpheus 8 offering is becoming one of the most popular minimally invasive procedures in North America. We see InMode's unique product line-up continuing to gain a share of the robust and rapidly growing non-invasive and minimally invasive cosmetic market. The Company's momentum should carry forward as they further invest in increasing its brand awareness. The Company added Eva Longoria as their new brand ambassador - an additional sign of customer commitment and positive consumer perception.

EVI Industries, Inc (EVI)

Sterling Small-Cap Value Diversified

EVI Industries, Inc. distributes, sells, rents, and leases commercial and industrial laundry, dry-cleaning equipment, and related services. EVI is positioned for continued success as demand and growth across the commercial laundry industry remain robust. We view EVI as an essential business that will continue to have a need regardless of the economic cycle.

Throughout the quarter, EVI continued to execute its buy-and-build growth strategy - completing two new acquisitions, increasing market share, and driving revenue and earnings to record highs. The outstanding quarter comes from the synchronization of their businesses through implementing new technologies (i.e., ERP system), cost-cutting strategies, and new customer sales contracts.

We see additional synergies in the future and driving EVI's growth as they continue to make accretive acquisitions and consolidate within a fragmented industry.

MasterCraft Boat Holdings (MCFT)

Sterling Small-Cap Value Focus

MasterCraft Boat Holdings, Inc. designs, manufactures, and markets performance sport boats and outboard boats. The company is based in the United States and operates in three brand-specific segments, MasterCraft, Crest, and Aviara. The MasterCraft segment generates most of the company's revenue and includes inboard boats for water skiing, wakeboarding, and wake surfing. Crest boats are their growing pontoon brand, delivering high-quality, stylish, and comfortable boats at an attractive price point. Aviara is their luxury day boat segment, creating an elevated open water experience by fusing progressive European style and effortless comfort with American engineering. The majority of the company's sales are made in North America.

MasterCraft reported its eighth consecutive record-setting quarter for both sales and earnings despite the macroeconomic volatility and a dynamic business environment. Record results were driven by MasterCraft's increased efficiency in their production and throughput, allowing them to progressively replenish dealer inventories and enhance product availability at better price points. The Company also realized structural improvements to its growth potential and margin profile in the quarter with the sale of its NauticStar business.

We view MasterCraft's portfolio as uniquely attractive - providing cross-segment selling synergies that allow them to navigate tougher macro environments through adjustments.in pricing, volume, and product mix. Long-term secular trends for the recreational marine market remain attractive, and MasterCraft's portfolio provides an edge. The Company's operational flexibility and pricing power have positioned them to grow market share over the distant future.

Patrick Industries, Inc (PATK)
Sterling Small-Cap Value Focus

Patrick Industries manufactures and distributes components, building products, and materials for the recreational vehicle, marine, manufactured housing, and industrial markets in the United States and Canada. Its Manufacturing segment sells furniture, shelving, wall, countertop, fiberglass bath fixture, hardwood furniture, RV painting, fiberglass and plastic component, and electrical system components. The Distribution segment distributes and offers logistic services for pre-finished wall and ceiling panels, drywall, wiring, electrical and plumbing products, laminate and ceramic flooring, interior and exterior lighting products, and other products.

Despite a $110 million decline in RV revenues in the third quarter, Patrick was still able to grow sales by 5%, demonstrating their resiliency as their marine and housing end markets remained strong. The Company's strategic end-market diversification initiatives have allowed them to remain buoyant in a tough macroeconomic environment.

We believe Patrick is positioned to grow market share as their diversification initiatives and investments in automation and innovation accelerate. Long term, our thesis remains that Patrick will be a beneficiary of the entrenched favorable trends surrounding the housing, recreational vehicle, and marine markets.

The Bancorp, Inc. (TBBK)
Sterling Small-Cap Value Diversified

The Bancorp is a provider of financial services to non-bank financial service companies. We enjoy owning companies involved with non-banking services with card and other payment processing fees. The Bancorp is recognized in the payments industry as a top issuer of prepaid cards and top ACH originator.

Over the recent quarter, The Bancorp benefited from higher net interest margins as lending volumes steadily increased and new payment partners were added to their ecosystem. Management sees these tailwinds continuing throughout 2023 as highlighted by The Company's guidance for the year of $3.20 in earnings per share, a roughly 40% increase YoY.

As more payment partners are added to their ecosystem, we see The Bancorp continuing to drive growth in 2023 on the backdrop of higher interest rates and increasing processing fees. In addition, management noted they plan to boost their share repurchasing program from $15 million per quarter to $25 million per quarter in 2023 - further supporting their attractive positioning.

Bottom Contributors continue on the next page...

Bottom Contributors

Lions Gate Entertainment Corp. (LGF-A)

Sterling Small-Cap Value Diversified
Sterling Small-Cap Value Focus

Lionsgate is a global content platform whose films, television series, digital products and linear and over-the-top platforms reach audiences around the world. Our thesis is that part of the growth of leisure, entertainment, and the content that drives it, will continue to gain share of the economy.

Lionsgate's earnings were adversely affected during the quarter as revenues slowed and the company faced one-time charges related to international restructuring and an impairment to the goodwill of STARZ. The $219 million restructuring charge was a result of their decision to exit seven international territories. Management noted this should assist in streamlining their international business and returning it to profitability quicker. On the other hand, the $1.48 billion goodwill impairment charge related to STARZ reflects a reduction in future free cash flow projections and comparable company valuations.

Despite these issues, we believe Lionsgate is uniquely positioned with a fresh library and studio that will be able to drive revenue growth moving forward. The Company has an attractive pipeline of content and is set for several big box office releases in 2023, such as the new John Wick & Hunger Games installments. We remain confident in the long-term prospects of both Lionsgate and STARZ operations; however we anticipate management will complete the spin-off of STARZ media group late this year in an attempt to unlock value for the subscription streaming platform.

Atlas Technical Consultants, Inc. (ATCX)

Sterling Small-Cap Value Diversified
Sterling Small-Cap Value Focus

Atlas Technical Consultants is a leading infrastructure and environmental services provider with solutions to public and private sector clients in the transportation, commercial water, government, education, and industrial markets. They specialize in testing, inspection, engineering, environmental impact, and program management consulting services.

Atlas had a resilient quarter with organic revenue growth of 10% and record operating results driven by strong execution and benefits of scale. Their record backlog growth continued reaching $864 million, fueled by cross-selling and sustained success in winning larger projects.

We see the infrastructure and environmental end markets remaining strong and continuing to supply growth for Atlas through 2023. Secular trends such as the aging infrastructure and increased focus on environmental sustainability remains favorable. Sustained execution on cross-selling initiatives, winning larger projects, and integration efforts will drive the success of Atlas's growth strategy and earnings potential long term.

Green Dot Corporation (GDOT)

Sterling Small-Cap Diversified
Sterling Small-Cap Value Focus

Green Dot Corporation, a financial technology, and bank holding company provides various financial products to consumers and businesses in the United States. It operates through three segments: Consumer Services, Business to Business Services, and Money Movement Services. The company offers deposit account programs, including consumer and small business checking account products, network-branded reloadable prepaid debit cards and gift cards, and secured credit programs. In addition, the company offers tax processing services comprising tax refund transfers, which provide the processing technology to facilitate the receipt of taxpayers' refund proceeds.

Green Dot faced challenging comparisons in the past quarter due to the significant government stimulus in the prior year. Active accounts fell in the quarter by 19%, in addition to, purchasing volume declining 12% related to the loss of stimulus. We continue to believe in Green Dot's growth runway given the size of their markets, changing needs and demands of customers, and their unique position and capabilities as a low-cost provider.

Green Dot achieved initial milestones in the quarter with the implementation of their end-to-end, cloud-based modern banking platform. This should transform their capabilities and expand their range of solutions and speed-to-market. Further, management expects the resulting organizational simplification to reduce costs and enhance the ability to serve their customers and partners through 2023.

Xperi Holding Corp. (XPER)

Sterling Small-Cap Value Diversified
Sterling Small-Cap Value Focus

Xperi Holding Corporation invents, develops, and delivers technologies that enable experiences in the home, the car, and on the go. Xperi successfully completed their separation from their Adeia business (via spin-off) - their intellectual property licensing segment – on October 1st. Xperi remains as just their Product/Solutions business, divided into four categories based on the products delivered and customers served: Pay-Tv, Consumer Electronics, Connected Car, and Platform Solutions.

Xperi was able to grow its revenue year-over-year by 3% yet continued to struggle in producing a profit for the quarter, with earnings coming in at a loss of $400m. The loss was due predominantly to their separation from Adeia, as they booked a non-cash charge for goodwill impairment of $354m.

With the spin-off behind them, we see Xperi's position as a pure-play non-linear media company pushing them to profitability in 2023. Their growth drivers moving forward remain enticing with further monetization opportunities from TiVo, higher ARPU IPTV solutions, greater penetration of HD Radio, and the rollout of connected media (AutoStage) and monitoring solutions (AutoSense). Management also noted that they were able to win some key customers during the quarter and that they continue to see increased traction and momentum on their strategic growth initiatives.

Calavo Growers, Inc. (CVGW)

Sterling Small-Cap Value Focus

Calavo Growers is a global avocado-industry leader and provider of value-added fresh food service serving retail, grocery, food service, club stores, mass merchandisers, food distributors, and wholesalers worldwide.

Calavo's Grown business segment continued to struggle in the fourth quarter of 2022 as avocado prices and volumes came in lower year-over-year, down 20% and 4.2%, respectively. On the other hand, their Prepared segment improved slightly as they benefited from price and mix improvements – driven by their operational initiatives and declining input costs. Management sees their Grown segment improving in 2023 as input costs come down and volume increases on an expected 10-20% larger Mexican avocado crop.

While we see some seasonality headwinds for Calavo moving into 2023, we believe the company can drive profitability through further pricing initiatives, SKU rationalization, procurement and labor efficiencies, freight consolidation, and administrative synergies. In our view, Calavo Growers remains attractively positioned as the premier public company supplying fresh avocados and prepared products to a growing United States consumer base.

National Storage Affiliates Trust (NSA)

Sterling Small-Cap Value Diversified

National Storage Affiliates Trust is a Maryland real estate investment trust focused on the ownership, operation, and acquisition of self-storage properties in the United States metropolitan areas. National Storage's portfolio comprises more than 1050 self-storage properties across 42 states and Puerto Rico, designed to offer convenient, affordable, and secure storage units.

National Storage's earnings were adversely affected in the quarter due to increased depreciation, interest, and casualty-related expenses. Depreciation increases resulted from their acquisition of 153 self-storage properties between October 2021 and September 2022. On the other hand, their additional interest expenses reflected the current rising rate environment. NSA incurred outsized casualty-related expenses that were due to certain events, including floods, fires, and hurricanes Fiona and Ian. Management believes overall fundamentals and the core business remains healthy and unaffected despite these recent headwinds.

Despite a more challenging economic backdrop for National Storage, we remain confident that the self-storage sector remains healthy and that NSA is well situated to navigate the dynamic operating and capital environment. As occupancy rates return to a more realistic level from inflated highs, NSA is positioned to drive growth in existing customers through further rent increases.

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