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Why Small Cap Now, Part II:
Chaos Creates Opportunities

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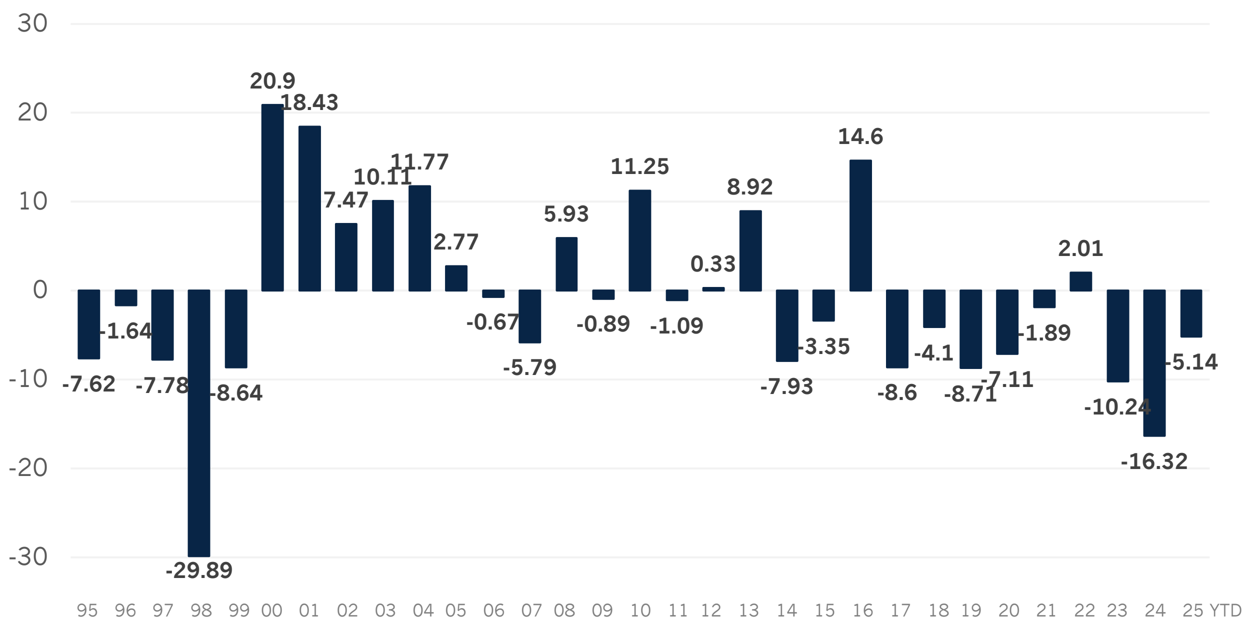
Last July VELA shared the compelling investment opportunity in small cap equities, highlighting an elongated performance and valuation gap relative to large cap equities, the risks and opportunities of investing in small cap equities, and how we believe active management with a long-term view is well-positioned to exploit this opportunity. As we are now nearly one quarter into 2025, small cap equities have extended their longest period of underperformance relative to large caps since the inception of the S&P 600 (in our view the best index to use due to the GAAP profitability threshold for inclusion) in 1995. Absent a brief period of modest outperformance in 2022, the performance of small caps has significantly trailed large caps since 2017.

Figure 1. S&P 500 – S&P 600 Total Return Difference



Source: VELA Investment Management, FactSet

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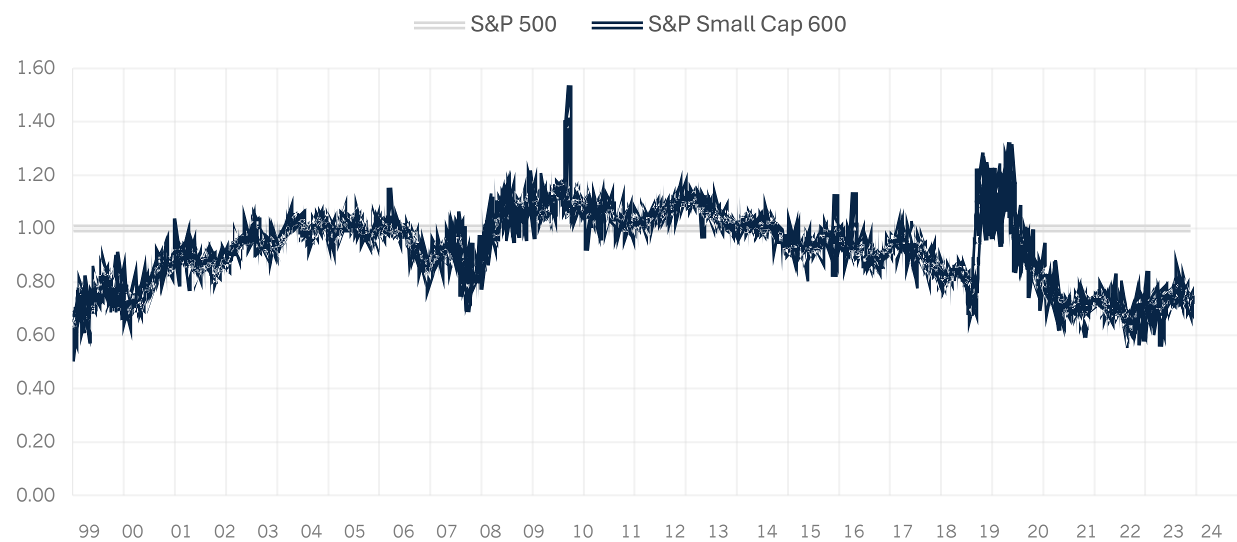
Figures 2 & 3. Forward P/E: S&P 500 vs. S&P Small Cap 600, Absolute and Relative



Source: VELA Investment Management, FactSet

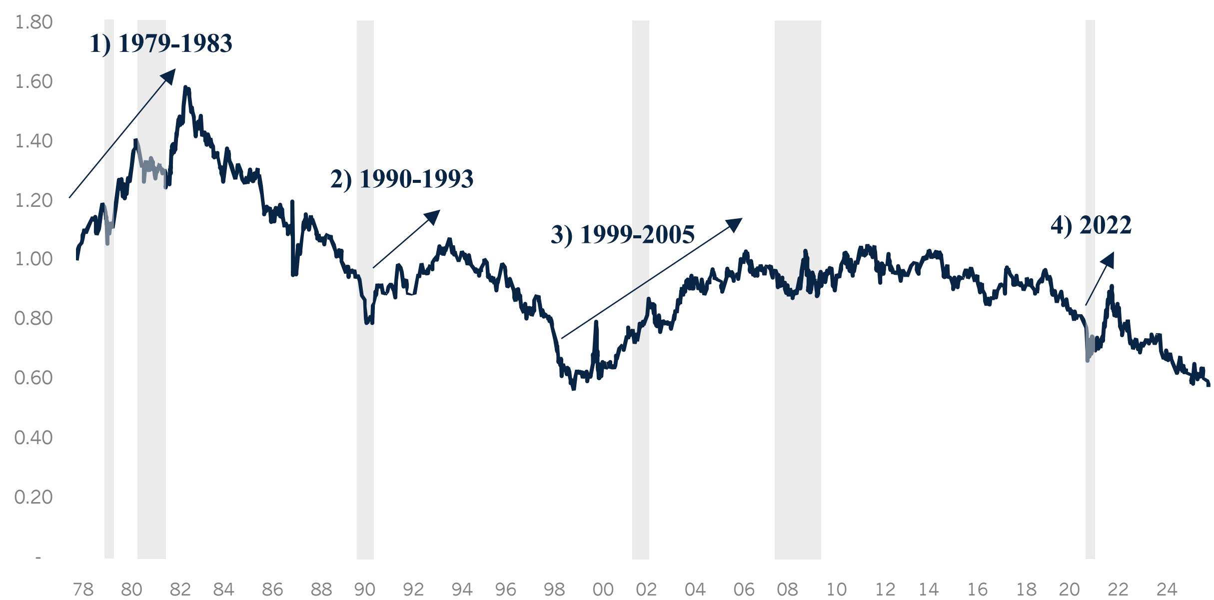
While the election of Donald Trump in November was initially met with a positive market response, equities are feeling the pressure of concerns and uncertainties around the new administration's rapid implementation of new policies. Following historical patterns during times of uncertainty, small caps have declined more than large cap asset classes. With chaos often the prelude to opportunity, we view the recent market disruption as the proverbial icing to what was already a very savory cake.

Why do Small Caps Get Hit Harder?

Small caps are generally viewed as less resilient than large caps due to disadvantageous characteristics such as relatively higher leverage, less scale, and perhaps shorter tenure operating in their respective industries and lower international exposure.

In this case, however, the greater domestic orientation of small caps could work in their favor under protectionist policy stances that aim to incent additional reshoring activity. Add to this the prolonged and historically very pronounced performance and valuation lag versus large caps (even without the Mag 7) and the tendency for small caps to outperform post periods of market turmoil. The periods of time where this pattern was the most pronounced include: 1) 1979-1983 (before the inception date of the S&P 600 but just one year past the inception date of the Russell 2000), a period characterized by high inflation, interest rate volatility and high unemployment; 2) 1990-1993, during a recessionary period that brought on the Savings and Loan Crisis and the start of the Persian Gulf War; 3) 1999-2005 following the tech bust (the prelude to which has some disquieting similarities to the present); 4) 2022, as small caps briefly outperformed their large cap peers on the post-pandemic recovery.

Figure 4. Russell 2000/Russell 1000 Relative Total Return



Source: VELA Investment Management, FactSet, St. Louis FRED®

One could draw the conclusion that small caps tend to discount turbulent times before they happen, essentially overcorrecting, and then rebound faster as conditions neutralize. These factors combine to create what is, in our view, a constructive backdrop for an enduring period of small cap outperformance.

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The Opportunity in Active Management

There is no denying that small cap companies, in general, are more vulnerable to macro disruptions as noted above. However, we often find that turbulent environments, when navigated methodically and responsibly, with discernment, can provide the best opportunities to add value for investors. While periods of higher market and asset-class volatility tend to expose companies without the right fundamentals to succeed, they also create favorable buying opportunities for companies which have the capacity to withstand and grow through an out of favor cycle—the key is in having the correct methodology and temperament to determine which is which. We think our organizational and investment discipline is especially well suited to meet these requirements.

VELA's Investing and Organizational Framework

- Our definition of risk is the permanent loss of capital. The first safeguard against this outcome is to *always* buy businesses at a margin of safety of our estimate of their worth. The next is to avoid taking balance sheet risk, most especially for companies where the range of cash flow outcomes is wide. The average leverage of the companies the VELA Small Cap strategy is invested in is 1.2x; the average leverage of the Russell 2000 index is 3.8x and the average leverage of the S&P 600 index is 3.4x[1]. We want to own companies that will withstand market cycles and have balance sheet flexibility to take advantage of opportunities presented by market disruptions.

- The VELA investment team gravitates to companies that generate high returns on capital, as this ultimately drives free cash flow. It is a laborious effort to calculate the weighted returns of investment capital for the small cap indices to compare it to our Fund, but we did look at the more simple calculation of returns on equity on a relative basis (and given the low average leverage of the VELA Small Cap Fund vs. the small cap indices, we think this is more than fair). Here we see evidence of what we would characterize as a quality bias. The weighted average ROE of the Fund's holding is 12% vs. 4.8% for the Russell 2000 and 10.3% for the S&P 600[2].

- We can't underscore enough the value added by the members of our investment research team and their incessant efforts to monitor existing and uncover new ideas. In short, they help identify investment ideas that meet our criteria. We have acted on many of their findings, many of which are (or were at the time of investment) not or sparsely followed by sell side analysts. It is our confidence in our investment discipline and their work that allow us to confidently buy larger positions in our high conviction names and run a relatively concentrated portfolio of 50-60 names with a consistently high percentage (on average 30%) of the Fund invested in our top ten positions.

- The relatively small size of the Fund allows us to work at the low, less liquid end of the market cap spectrum when we find compelling opportunities to do so. In fact, 13% of the Fund's holdings are sub $1 BN mkt. cap. We want to preserve our flexibility to utilize the full range of our investable universe. As we did in our past roles in portfolio management, we will close the Fund when we determine that size is a detriment to performance. As the Founder, CEO of VELA, and Co-PM of the Fund, Ric Dillon, wrote in his piece Structuring for Outperformance, we believe this discipline is integral to our potential to drive favorable relative long-term performance.

[1,2]Factset

- An enhancing element to our framework is our ability to use covered calls in the Fund. While there is not an active options market for every security we own in the Fund, we do often identify opportunities to write covered calls on many of our holdings. We have found that broader inefficiencies in small cap equities also extend to the options market for many small cap securities. If we see an opportunity to write a covered call at a strike price that is at or above our estimate of intrinsic value, and receive a premium that provides an attractive yield, we have the ability to write covered calls on a portion of our underlying position. This can provide extra income, some downside protection, is net additive to our tax efficiency, as well as reinforces our sell discipline. In short, having the flexibility to write covered calls gives us another tool to navigate volatile markets.

- Last, we would be remiss if we didn't mention that we are investing alongside our investors. From the day they join us, VELA employees can only invest in VELA strategies for all asset classes in which we participate. The managers of the Fund each have an investment in the Fund, so we are truly investing alongside our clients.

Concluding Remarks

The market is inherently fickle; adding dramatic and widespread shifts in policy greatly intensifies its vagaries. We view the task of precisely predicting the duration and outcome of this added element of complexity as next to impossible. While we could indeed see more volatility ahead, we are optimistic about the long-range prospects for small cap equities. We don't know when the market will align with our views, but we do know we have an investment framework that, through a variety of market cycles, has generated favorable long-term, risk adjusted returns for our investors. In the meantime, we continue to work as diligently as ever to continue to deliver this outcome. As the great Aristotle said, "Patience is bitter, but its fruit is sweet."

**Stay tuned for some examples of new and existing holdings that we think are uniquely well suited to outperform in this environment post quarter end.*

Jenny Hubbard, CFA

Portfolio Manager & Research Analyst

Experience – *29 years industry experience*

Jenny Hubbard is Lead Portfolio Manager of the Small Cap Strategy and a Research Analyst. Prior to joining VELA, Jenny served as a Research Analyst and Assistant Portfolio Manager of the Small-Mid Cap and Mid Cap Strategies at Diamond Hill Capital Management. Jenny has industry experience since 1996, including positions with ABN/AMRO LaSalle Bank and Avondale Partners.

Education

Stanford University, M.A., University of Colorado, B.A.

Disclosures:

Investors should carefully consider the investment objectives, risks, and charges and expenses of the fund before investing. The prospectus contains this and other information about the fund, and it should be read carefully before investing. Investors may obtain a copy of the prospectus by calling 833-399-1001.

The fund is distributed by Ultimus Fund Distributors, LLC. (Member FINRA). VELA Investment Management, LLC and Ultimus Fund Distributors, LLC are not affiliated.

Performance data quoted represents past performance. Past performance does not guarantee future results. The investment return and principal value of an investment will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost. Current performance may be lower or higher than the performance data quoted.

As of 12.31.2024 the annualized Total Return for the I-Shares 1-year was 10.77%, 3-year was 5.19%, and since inception (09.30.2020) was 17.19%.

The expense ratio of the VELA Small Cap Fund (Class I) is 1.12%.

Important Risk Information: An investment in the Fund involves risk, including possible loss of principal. The principal risks of investing in Funds include equity, market, management and non-diversification risks. The market value of a security or instrument may decline due to general market conditions that are not specifically related to a particular company, such as real or perceived adverse economic conditions, changes in the general outlook for corporate earnings, changes in interest or currency rates or adverse investor sentiment generally.

A complete list of portfolio holdings can be found at www.velafunds.com.

The VELA Small Cap Fund invests in a diversified portfolio of small capitalization stocks. Investments in smaller companies may be riskier, less liquid, more volatile and more vulnerable to economic, market and industry changes than investment in larger, more established companies.

The Russell 2000 Index is an unmanaged market capitalization-weighted index comprised of the smallest 2,000 companies by market capitalization in the Russell 3000 Index, which is comprised of the 3,000 largest U.S. companies by total market capitalization.

The Russell 1000 Index is a U.S. stock market index that tracks the highest-ranking 1,000 stocks in the Russell 3000 Index, which represent about 93% of the total market capitalization of that index.

The S&P 500 Index is a composite of the 500 largest companies in the United States. The S&P 500 Index is unmanaged and does not represent the performance of any particular investment.

The S&P 600 Small Cap Index is a stock market index established by S&P Global Ratings. It covers roughly the small-cap range of American stocks, using a capitalization-weighted index.

You cannot invest directly in an index.

Total Return is the actual rate of return of an investment over a period of time; it includes interest, capital gains, dividends, and realized distributions. **Total Return Difference** in this piece refers to the difference in total return between two indexes. **Absolute Return** measures an investment's performance in isolation, without considering any benchmark. **Relative Return** measures an investment's performance compared to a specific benchmark, like a market index, showing how much better or worse it did than the comparison point.

Intrinsic Value is a measure of what an asset is worth, arrived at by means of an objective calculation or complex financial model. Intrinsic value is different from the current market price of an asset. However, comparing it to that current price can give investors an idea of whether the asset is undervalued or overvalued.

GAAP stands for Generally Accepted Accounting Principles. It's a set of accounting rules and standards that companies in the United States use to report their finances. In the context of GAAP, a **Profitability Threshold** refers to the point where a company's total revenue equals its total costs, marking the transition from losses to profits, or when a product or service becomes profitable.

The **Forward Price-to-Earnings (P/E) ratio** uses a company's projected earnings for the next 12 months to calculate how much investors are paying for each dollar of future earnings; it's calculated by dividing the current stock price by the estimated earnings per share (EPS) for the upcoming year.

Free Cash Flow (FCF) represents the cash a company can generate after accounting for capital expenditures needed to maintain or maximize its asset base.

Return on Equity (ROE) is a measure of a company's financial performance. It is calculated by dividing net income by shareholders' equity.

Option refers to a financial instrument that is based on the value of underlying securities, such as stocks, indexes, and exchange-traded funds (ETFs). An options contract offers the buyer the right (but not the obligation) to buy or sell—depending on the type of contract they hold—the underlying asset. For a **Call Option**, the option buyer purchases the right to buy a security at a specified price at any point before an agreed-upon expiry date in return for a premium which is paid to the option seller. A **Covered Call** is an options trading strategy where an investor sells call options on a stock they already own. The **Strike Price** of a call option is the price at which the security can be bought by the option holder.

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