

MICRO-CAP GROWTH MARKET COMMENTARY

2Q 2021

The Quarter in Review

The Oberweis Micro-Cap Growth Strategy had both a strong absolute and relative performance quarter, returning 10.45% (10.28% net of fees) versus 3.18% for the Russell Microcap Growth Index, an outperformance of 727 basis points (710 basis points net of fees). Year-to-date, the Strategy gained 39.92% (39.42% net of fees), exceeding the benchmark by nearly 2,000 basis points (1,885 basis points net of fees).

The portfolio performed well despite a mixed market backdrop. Overall, smaller cap stocks underperformed large caps and, within the micro- and small-cap universe, value stocks again outperformed growth, driven by companies benefiting from a reopening of the economy. Thus far in 2021, our portfolio has been boosted by disproportionate investments in profitable, higher return-on-equity (ROE) companies enjoying company-specific catalysts. As interest rates declined throughout the quarter, however, the small-cap market shifted a bit, and in June was led by “low quality” stocks including non-earners, high P/E companies, and the lowest ROE companies, creating a bit of a headwind as the quarter ended.

Given how severe the Covid crisis was just six short months ago, the progress made in the U.S. during the second quarter on the vaccination front is nothing short of miraculous. Over 330 million doses have been administered with nearly half the U.S. population fully vaccinated, and it’s projected that the country may enter the zone for herd immunity (those vaccinated plus those infected) later this year. As a result, Americans are quickly returning to everyday life and the economy, bolstered by accommodative monetary and fiscal policies, is booming, with forecasted GDP growth of 7.8% in the second quarter. Composite Purchasing Managers’ Index readings over 60 in the U.S. and the U.K. and over 50 in China, Germany, France, Italy, and Spain suggest strength should continue into the second half of the year.

Stocks largely anticipated this dramatic recovery and have rallied significantly from the Covid panic lows in March 2020. At this point, valuations for U.S. equities are mixed and it’s best to target certain areas of the market. Large cap equities are more expensive versus small caps, and cap-weighted indices like the S&P 500 trade well above 25-year averages on P/E, dividend yield, price/book, and price/cash flow. However, that index is increasingly top-heavy, and beyond the top 10 holdings the rest of the its members are notably less stretched. Importantly, in the micro-cap and small-cap space, we believe our portfolio and our investable universe of stocks remain attractively valued. In particular, we are finding reasonably priced consumer and industrial stocks with the potential for better-than-expected earnings growth because they are levered to a recovering economy.

Against a backdrop of higher valuations for popular stock indices like the S&P 500 and the Nasdaq 100, there are some storm clouds on the horizon that should be carefully monitored. First and foremost, the market appears to be discounting that current vaccine offerings will keep Covid at bay; any variant that sidesteps vaccine protection could have a meaningful impact. Beyond the health risk, the natural outgrowth from an exceptionally strong economy in the short-run is an increased fear of inflation, which quickly became the dominant economic concern in the second quarter as headline CPI approached 5% and core CPI hit 3.8% in May. Debate has raged among economists and self-proclaimed experts in the financial media about whether this is “transitory” or the start of something more persistent and damaging. We believe modest inflation is healthy and is actually welcome given periodic concerns over deflation since the Global Financial Crisis. We also think fears of 1970’s-style double-digit inflation are premature and likely misplaced.

We are concerned, however, that the global economy is struggling to find its proper balance and that global policy makers are impeding equilibrium discovery by maintaining emergency support programs far longer than is necessary. As a result, these policies could cause unintended consequences and the economy may go through periods of “fits and starts” as it struggles to find a natural level of supply and demand. Since the start of Covid, the economy has endured simultaneous supply and demand shocks at the onset of the pandemic, massive monetary and fiscal stimulus efforts to boost demand, and sustained supplements to unemployment insurance in the U.S. that are now artificially constraining labor supply, resulting in labor shortages and rising wages. Combined, the impact of these extraordinary “shocks” renders current economic data difficult to evaluate and extrapolate because the data are at least partially caused by atypical and unsustainable influences. How much of current economic activity is being driven by demand that was pulled forward as a result of stimulus? How much is related to inventory replenishment as companies struggle to overcome last year’s supply disruptions? It will take months for the economy to adjust to these extraneous influences. The sooner that policy makers get out of the way, the better.

So, while inflation readings are perky and companies we speak with are struggling to deal with cost pressures and meaningful supply constraints, it’s a challenge to determine how much of this is real and how much is actually “transitory.” We believe it’s possible that company management teams – who in our experience are usually poor forecasters – could over-react to abnormal demand for their products and supply chain issues by over-ordering and over-producing this year, potentially leading to an excess supply situation in 2022 just as stimulus-supported demand may wane. One must consider the possibility that the very companies panicked by supply shortages today may be speaking of an “inventory correction” a year from now. As the economy struggles to return to a natural balance, we think the potential for stock market volatility increases from here.

AVERAGE ANNUAL TOTAL RETURNS (as of June 30, 2021)

	QTD	YTD	1 Yr	3 Yr	5 Yr	10 Yr	Since Inception 1/1/1996
Micro-Cap Growth (gross of fees)	10.45%	39.92%	104.01%	22.27%	25.80%	18.55%	13.67%
Micro-Cap Growth (net of fees)	10.28%	39.42%	102.86%	21.21%	24.76%	17.52%	12.63%
Russell Microcap Growth Index	3.18%	20.57%	65.78%	17.29%	18.82%	13.01%	N/A

Past performance is not necessarily indicative of future results. Performance is historical and includes the reinvestment of dividends and other income. Unusually high returns may not be sustainable. The strategy invests in rapidly growing smaller and medium-sized companies that may offer greater return potential. However, these investments often involve greater risks and volatility. Foreign investments involve greater risks than U.S. investments, including political and economic risks and the risk of currency fluctuations. Advisory fees are disclosed in Part II of Form ADV.

Oberweis Asset Management, Inc. (“OAM”) is an independent investment management firm that is not affiliated with any parent organization. The composite returns are comprised of all fully discretionary accounts with a minimum value of \$5 million. Performance results, from 1-1-96 until 12-31-03 and 9-1-11 to present were derived solely from the performance of the Oberweis Micro-Cap Fund, a registered, open-end mutual fund, for which OAM serves as investment adviser. Prior to November 4, 2001, James D. Oberweis was the sole portfolio manager for the Micro-Cap Fund during the period of the performance results noted. Accounts are dollar-weighted within the composite and reported in U.S. dollars.

The Russell Microcap Growth Index measures the performance of those Russell Micro Cap companies with higher price-to-book ratios and higher forecasted growth values. The performance data includes reinvested dividends. The Russell Microcap Index is represented by the smallest 1,000 securities in the small cap Russell 2000 Index plus the next 1,000 securities. Each index is an unmanaged group of stocks, whose performance does not reflect the deduction of fees, expenses or taxes.

The Quarter in Review (continued)

While sentiment may indeed swing wildly in the short-run in response to incremental economic data, comments by the Federal Reserve, headlines, and TV soundbites, our bottom-up investment strategy focuses instead on companies demonstrating better-than-expected earnings power driven by transformational change. The P/E multiples afforded such companies may vary from quarter to quarter, but we believe a diversified portfolio of these investments is likely to outperform the market over the longer-term.

Portfolio Highlights

As of June 30, 2021, the portfolio was 97.0% invested in 77 different positions. The portfolio had its largest over-weightings in producer durables (22.2% average weighting during the quarter versus 9.5% for the Russell Microcap Growth Index), consumer discretionary (17.7% versus 10.5%), and technology (27.3% versus 22.3%). The portfolio was most underweight healthcare (18.6% versus 43.4%, primarily due to our significant biotech underweighting), financial services (2.6% versus 5.3%) and consumer staples (0.4% versus 3.1%).

Overall performance in the second quarter was positively impacted by strong stock selection, particularly in producer durables (where our holdings returned 15.43% versus a 0.86% return for the benchmark's producer durables holdings), healthcare (15.64% versus 4.17%), energy (20.04% versus -27.29%), and technology (4.1% versus 1.0%).

Some of the top performers during the second quarter included: Lydall (LDL), which returned +67% and contributed 98 basis points to portfolio return; Entravision Communications (EVC), which returned +66% and contributed 86 basis points to portfolio return; and RadNet (RDNT), which returned +55% and contributed 85 basis points to portfolio return. In contrast, some of the leading detractors for the quarter included: VOXX International (VOXX), which returned -27% and detracted 35 basis points from portfolio return; Organogenesis (ORGO), which returned -9% and detracted 27 basis points from portfolio return; and Magnite (MGNL), which returned -31% and detracted 23 basis points from portfolio return.

Organization Update

There was no change to the team during the quarter.

Oberweis Asset Management's Investment Philosophy

We believe that investing in smaller companies driving revenue and earnings growth in excess of expectations results in superior investment performance over long periods of time. We believe that innovation is the key to economic growth and wealth creation and are committed to investing in companies at the forefront of innovation – smaller company stocks that offer the potential for extraordinary revenue and earnings growth.

The entrepreneurial spirit is alive and well at these companies. Many are nimble and uniquely address the needs of their customers with patented new products and services. Successful investing, however, demands more than finding companies with good growth prospects. We must also buy these stocks for our clients at prices that make sense. By paying careful attention to companies' valuations in relation to expected earnings growth rates, we seek to purchase stocks when they still have considerable appreciation potential.

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