Uncovering the big opportunities of a small world …

Why small caps might be a right fit for the 2013 portfolio

This year has gotten off to another good start for the small-cap equity market. Small-cap stocks, as measured by the Russell 2000 index, outperformed large-cap stocks, as measured by the S&P 500 index, during the first quarter, and growth has continued to offer strong returns for shareholders stocks. In this commentary, Portfolio Manager Timothy Miller, who recently marked three years at the helm of the Ivy Small Cap Growth Fund, shares his thoughts on why he believes the current market environment is favorable for domestic small-cap stocks. He also discusses how small-cap stocks perform in a rising rate market, investment opportunities currently available in the U.S. and the recent increase in merger and acquisition activity.

No need to fear a rising rate environment

With all of the talk lately regarding the low interest rate environment and the potential of rising interest rates in the future, there’s really no need to fear the opportunity that small caps can offer. Historically, in a rising interest rate environment, small caps (as measured by the Russell 2000 Index) have outperformed large caps (as measured by the Standard & Poor’s 500 (S&P 500) index). One of the reasons for this trend … when rates are rising, it is typically an indication of an economic upswing and small caps tend to perform well during periods of accelerating economic growth. Generally, as the the economy improves, small-cap earnings improve and then company stock prices tend to appreciate as well.

If you take a look over the past 10 years, in five out of six rising interest rate periods, small-cap stocks handily performed better than their large-cap counterparts.

<table>
<thead>
<tr>
<th>PERIOD</th>
<th>06/13/2003 to 09/02/2003</th>
<th>03/16/2004 to 06/14/2004</th>
<th>06/02/2005 to 06/28/2006</th>
<th>03/20/2008 to 06/13/2008</th>
<th>12/18/2008 to 06/10/2009</th>
<th>10/08/2010 to 02/08/2011</th>
</tr>
</thead>
<tbody>
<tr>
<td>10 Year Treasury Yield</td>
<td>3.13% - 4.61%</td>
<td>3.70% - 4.89%</td>
<td>3.89% - 5.25%</td>
<td>3.34% - 4.27%</td>
<td>2.08% - 3.98%</td>
<td>2.41% - 3.75%</td>
</tr>
<tr>
<td>Russell 2000 Return (Cumulative)</td>
<td>11.39%</td>
<td>-1.38%</td>
<td>11.69%</td>
<td>10.81%</td>
<td>8.56%</td>
<td>19.33%</td>
</tr>
<tr>
<td>S&amp;P 500 Return (Cumulative)</td>
<td>2.72%</td>
<td>2.29%</td>
<td>5.72%</td>
<td>5.25%</td>
<td>5.29%</td>
<td>15.08%</td>
</tr>
</tbody>
</table>

Past performance is not a guarantee of future results. Russell 2000 is an unmanaged index comprised of securities that represent the small-cap sector of the stock market. S&P 500 is unmanaged index of common stocks. It is not possible to invest directly in an index. Source: Morningstar Direct and U.S. Department of the Treasury.

1 Past performance is no guarantee of future results. Diversification cannot ensure a profit or protect against loss in a declining market. Source: ©2013 Morningstar All rights reserved. Used with permission. Large caps = S&P 500 index and Small caps = Russell 2000 index. S&P 500 index tracks the performance of S&P 500 index stocks. The Russell 2000 index tracks the performance of small-capitalization stocks. Index performance may differ considerably from specific stock or fund holdings. It is not possible to invest directly in an index.
Focused on the domestic front

While current U.S. economic growth has been on slow pace upward, we think there are several areas of support for a growing domestic economy as the country is finding renewed strength in consumer durables like housing and autos. Bright spots are emerging in a burgeoning labor force, greater productivity through new technology and growing access to low-cost energy, particularly through natural gas producers. The U.S. is also benefitting from oil exploration activity within its borders. According to the International Energy Agency, with the discovery of stores of crude oil trapped in shale rock formations, the U.S. is poised to become the world’s largest oil producer by 2020.

U.S. manufacturing is another area reaping the benefits of domestic economic growth. Certain conditions, including transportation and energy costs, favor re-shoring research and development and production to the U.S. Localizing production is also helping to mitigate supply-chain disruptions. When compared to China and other emerging markets, the relative standard of living and size of the American market appear to support company decisions (both here and abroad) to invest in domestic production of goods targeted for U.S. consumption.

Increased merger, acquisition activity

In a slow-growth environment, when it is challenging to gain market share organically, it may be easier to obtain growth from buying it. Small-cap growth companies offer the benefits of increased growth rates, cash flow and earnings that larger companies are searching for. In addition, financing is still available at relatively low levels.

Absolute valuations are also not too far above their long-term averages. The level of merger and acquisition (M&A) activity at the end of 2012 was well off its 2007 peak but industry volume was at its highest level since early 2008. The number of deals is also close to 2007 highs. Despite the dip in volumes at the end of March 31, 2013 due to last year’s rush to close deals prior to the tax law changes, we remain encouraged by the increased level of M&A activity as the deal volume backlog is at levels not seen since December 2007 (Source: Goldman Sachs Research). All of these factors are pointing toward an uptick in M&A activity.

Pending and completed M&A activity

Includes U.S. companies that are either the acquirer or the acquiree.

Source: Bloomberg.

For a number of years now, U.S. corporations have also been in the business of money hoarding. Domestic company balance sheets have high levels of cash on the books from several years of cutting costs and maximizing efficiencies. This has meant avoiding any capital commitments for new projects until at least some of the economic uncertainty has been resolved. According to Bank of America Merrill Lynch Small Cap Research-March 2013, for small caps, cash as a percentage of market cap of the Russell 2000 sits at 15%.

While the Ivy Small Cap Growth Fund doesn’t specifically seek out small-cap growth companies that are prime M&A targets, our investment approach is conducive for potential M&A candidates. We focus on companies with strong top-line growth driven by unit volume, not pricing, which can indicate that an industry may be growing faster than the economy and the company is growing faster than the industry. This can result in an upward momentum in margins as a company leverages its fixed costs. We also look for companies with cash flows that are generated by internal funding as opposed to external financing. All these attributes also stand out in M&A candidates as a whole.
Our process

The Ivy Small Cap Growth Fund seeks to purchase successful small-cap growth companies with strong business models that have the potential for large-market opportunities.

We believe characteristics of success are typically found in companies that:

- Serve markets that are growing at rates substantially in excess of the average industry and/or the general economy.
- Are leaders in their respective industries. They are increasing their market share and creating barriers to entry either through technological advancement, marketing, distribution or some other innovative means.
- Produce solid financial returns. This is evident through sales, margins and cash flows.

We utilize a bottom-up stock picking approach that focuses on domestic companies that are positioned in new or emerging industries where there appears to be sustainable long-term growth potential. These companies appear to be highly valued in the market and are driven by the following components:

- Sales unit growth,
- Margins showing upward momentum,
- Cash flow by internal funding, and
- Strong company management.

The result of this bottom up, research driven stock selection process is a portfolio of 75 to 85 higher quality names.

Highlighting current themes, stock selection investments

Energy and industrials, a multi-year trend

- There are numerous high-growth exploration companies in the Bakken oil formation located in western North Dakota, eastern Montana and southern Saskatchewan, Canada.
- Most new shale producers are small-cap companies.
- The necessary infrastructure for success, such as refining or storage facilities to keep up with the growth of production, is currently lacking.
- As a result, we are looking for companies that are part of the infrastructure construction efforts and those who manufacture equipment.

One stock we currently like is Gulfport Energy, an Oklahoma City-based oil and natural gas exploration and production company with its principal producing properties located along the Louisiana Gulf Coast. It has also acquired acreage positions in the Niobrara Formation of northwestern Colorado and the Utica Shale of eastern Ohio. We believe the opportunities in the Utica Shale area of eastern Ohio will provide further catalyst for reserves and production growth. Gulfport Energy has a strong balance sheet with low leverage and strong cash flow.

Another company we like is equipment and services provider, Dril-Quip, a manufacturer of offshore drilling and production equipment that is well suited for use in deepwater, harsh environment and severe service applications. This is a domestically based company with worldwide offshore market exposure. It has manufacturing stations close to key demand centers such as Houston, Texas; Macae, Brazil; Aberdeen, Scotland and Singapore. It has a consistent track record of revenue growth, a strong balance sheet with no long-term debt and great margins (superior operating income margins as compared to its peers.)

Autos

We are seeing a tailwind in autos with new car sales improving based on:

- The age of existing cars on the road,
- Low interest rates and extremely attractive financing options,
- The availability of new makes and models, and
- An increased number of licensed drivers.
Lithia Motors is the ninth largest automotive retailer in the U.S., selling 27 brands of new vehicles and all brands of used vehicles at 87 stores in 11 states. Lithia also arranges finance, warranty and credit insurance contracts; and provides vehicle parts, maintenance, and repair services at all of its locations. Fourth quarter 2012 results revealed that the company had increased same store sales by 25% and recorded the highest fourth quarter earnings per share in the company’s history. It’s 20.8% same store gross profit growth year over year is better than most of its peers. This company is also shareholder friendly, paying out more than $12 million in dividends and repurchasing its shares.

Technology
In this sector, we are interested in SAS (Software as a Service) models. There are a number of companies that are able to provide software as a service, which is a far more efficient and cost effective means of deploying enterprise wide software, whether it be by human resources or marketing departments. One such holding in the Fund is Ultimate Software, a leading cloud provider of people management solutions, most notably payroll. It is a subscription-based model that provides for a higher percentage of recurring revenues.

Outlook on small caps
While small-cap stocks will always be viewed as more risky and volatile than their large-cap counterparts, they have also proved to offer stronger returns over time. Regardless of the economic environment, we believe there will always be opportunity for small-cap innovators to generate excitement in the market and build upon the foundations of the U.S. economy.

Percent of net investments as of 03/31/2013: Gulfport Energy Corporation 1.5%, Dril-Quip 1.4%, Lithia Motors, Inc. 1.8% and Ultimate Software Group, Inc. 2.7%.