

# Research Profile: Delaware Small Cap Value Instl



## Fund Snapshot:

**Ticker:** DEVIX

**Firm Name:** Delaware Funds by Macquarie

**Primary Prospectus Benchmark:** Russell 2000 Value TR USD

**Morningstar Analyst Rating:**  Silver

**Inception Date:** 6/24/1987

## Targets:

**Performance:** N/A

**Tracking Error:** Not actively targeted; expected range is 4% - 8%

**Holdings:** 110 holdings, with 20% of assets in top ten holdings

**Position Sizes:** Initial positions typically 0.6% - 1%; maximum weighting is 5%

**Capacity:** Chris Beck estimates \$8 billion total fund capacity. As the fund approaches the \$7 billion level, the team will carefully consider accepting new clients. It briefly closed in 2015 to non-institutional investors. If it closes again, it will first close to retail, then advisor, then institutional investors.

## Overall Comments:

**PlanPilot's Position:** Delaware Small Cap Value is a strong offering in the small-cap value space. Despite its concentrated team, the demonstrated success of the SCV fund lends confidence, as does the cohesiveness and tenure of its team. In addition, the institutional focus of the firm is a large positive, as SCV has achieved long-term outperformance while protecting its institutional investors on the downside.

**Key Differentiators:** The team has a differentiated focus on cash flow and capital deployment. Specifically, the team strives to invest in companies that make favorable decisions for their shareholders with their use of cash (dividend payments/increases, share repurchases, repayment of debt). The team's discipline to mandate and access to management at many portfolio holding companies also provides an edge.

**Key Competitors:** DFA, Fuller & Thaler, and Sycamore

## Investment Style/Philosophy/Process:

The fund is a bottom-up, fundamental research-driven strategy. The portfolio is managed on a team basis, with the investment decisions carried out and research led by the CIO, Chris Beck. Delaware's investment philosophy is based on traditional fundamental analysis, focusing on companies that can deliver sustainable cash flows under various market conditions, with a concentration in highly profitable companies. The team uses a valuation and earnings quality-driven quantitative model to identify stocks for deeper research. The team believes that investing in quality companies that generate strong levels of free cash flow will consistently deliver above market returns, with an emphasis on stock selection as the primary source of outperformance.

The team starts with 2000-2500 securities with market capitalizations ranging between \$300 mm and \$5B. The initial screening process evaluates and ranks the securities based on various metrics in order to form a more refined group to begin a detailed analysis.

The team then further analyzes the roughly 400-500 stocks that make it through initial screening based on historical valuations, where they're able to further narrow down the potential investment options to 200-250 securities. Qualitative assessments such as balance sheet quality, cash flow generation, management quality, and further due diligence are then completed. During the initial research process, the team requires a discussion with company management before adding the name to the portfolio, though the discussion does not have to be face-to-face. A one-on-one conference call with senior management is acceptable. The fund prides itself on intensive in-depth research that is conducted, which is the foundation of its process. The managers of the SCV team employ a low turnover approach, having an annual turnover of roughly 20%; winning stock picks are able to grow into holdings, which typically max out around 3%.

Discussing the addition of new securities for the portfolio takes place after the analyst has concluded his research. An idea is presented to the CIO and it is discussed. The idea is then presented to the rest of the team. The team will ask questions and voice any concerns. The final decision is then made by Beck to add it to the portfolio or not. The incorporation and weighting of each name is made by Beck and the applicable analyst.

## Risk Management:

Risk management is the responsibility of the entire SCV team. The team focuses on companies with solid balance sheets, attractive valuations, and positive cash flow and free cash flow in order to maintain the fund's value discipline and help limit risk. Diversification is used to limit risk; the fund achieves this by limiting sector exposure and holdings to approximately 75-125, controlling liquidity risk. The team is also cautious of using extreme valuations in models in order to limit risk. The Barra model is utilized to evaluate the fund's factor exposures and forecast tracking error in order to control unintended speculations. The Barra Risk Factor Analysis is a multi-factor model used to measure the overall risk associated with a security relative to the market. The model incorporates many different metrics including earnings growth, share turnover, and senior debt rating. The model then measures risk factors associated with three main components: industry risk, risk exposure to different investment themes, and company specific risk. Over the past 10 years, the max drawdown of the SCV fund was 54.4%, which was a period of 21 months between June 2007 and February 2009.

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## Firm Background and Culture:

The Macquarie Group developed MIM in 1985, establishing the organization's capabilities in investment management in Australia. Through Delaware Investments, the firm traces its roots to 1929 in the US, which includes its first fund launch in 1938, and later the pioneering of a number of investment strategies. Today, the firm offers a comprehensive set of asset management capabilities globally, across all major asset classes, in a broad range of market capitalizations and investment styles.

Despite additional competencies, Delaware continues to be acknowledged most for its strength as a boutique value and fixed income manager with an institutional focus.

People are a critical asset to Macquarie's success. The firm's values – opportunity, accountability and integrity – are reflected in its culture. Within MIM, it translates into teams of dedicated and accountable professionals, empowered to do what is best for their clients. As research-driven investment professionals who firmly believe in active management, they hold each other accountable to the highest ethical and professional standards, above the level expected by their clients and delivered by their peers. Macquarie's experienced investment teams fully align client objectives with an independent, disciplined, and focused approach to investing.

Macquarie as a parent is largely uninvolved in Delaware's investment strategies, though Delaware's fixed income team leverages the parent's global research and receives support with trading.

## Management Team and Dynamics of Team:

The fund takes a team management approach, with Christopher Beck (CIO) leading the team and making all final fund decisions. The team is comprised of four portfolio managers and one research analyst, with the average tenure on the team being 10 years. Dynamically, each member of the team is an analyst and a specialist in their assigned sectors. Sector coverage by manager is as follows Christopher Beck (CIO) (Energy, Financial Services, REITs), Kent Madden (Consumer Cyclical, Consumer Services, Consumer Staples, Healthcare, Transportation), Steven Catricks (Business Services, Technology), Kelley McKee (Basic Industry, Capital Spending, Utilities) and Michael Foley (Financial Services, REITs). Their responsibilities include covering their sector and generating new ideas, which are then pitched to the rest of the team.

Macquarie believes one of its core strengths is its people; accordingly, the firm offers a highly attractive incentive program to retain key employees. Compensation plans are benchmarked against market surveys, ensuring that they remain competitive. In terms of ownership, all portfolio managers are encouraged to invest in MIM's mutual funds, including their specific product. All portfolio managers at MIM have a portion of their retained compensation deferred into the notional investment plan. Out of the team, Chris Beck owns the largest portion in SCV, totaling over \$1 million; Kelley McKee \$100,001-\$500,000 and Kent Madden \$50,000-\$100,000.

## Economic/Market Conditions & Performance Expectations:

### Best Environments for the Fund:

The fund's outperformance is expected to be driven by stock selection. The team's cash flow driven process/philosophy will tend to outperform when strong balance sheets, traditional value-oriented metrics (EV/EBITDA, P/CF), and higher quality securities drive relative performance in the asset class.

While not intentional, the fund has a history of investing in companies that end up as acquisition targets; its favoring of strong cash flow and high ROE companies that are good stewards of cash aligns well with the characteristics sought by acquirers. Therefore, the fund may also perform well in periods where M&A activity is healthy.

### Worst Environments for the Fund:

In low quality rallies, when low-priced, low ROE and high beta securities drive relative performance in the asset class, the fund will tend to underperform. Additionally, when markets are being driven by concepts or fears instead of strong fundamental valuations, performance will be hindered.

### Historical Performance Analysis:

In line with high-quality bias, the fund has historically performed well in periods of market stress. Notably, in 2011, the fund outperformed its benchmark by roughly 3% in a seven-month stretch that resulted in a benchmark decline of -29%. The high quality bias has historically led to underperformance at times where lower-quality small- and micro-cap companies have been rewarded. This was the case in early 2018, when investors flocked to small-cap ETFs over fear of global trade concerns, which would negatively impact larger multinational companies with more global reach.

## Negative Attributes/Observations:

The fund straddles the small/mid-cap divide given the low turnover philosophy of the fund that allows holding value to reach its estimated long-term potential. Most added value has come from companies that had market capitalizations of \$5B+. However, the team doesn't take excessive valuation risk and keeps top position sizes modest. The fund is advertised as a small-cap value fund, so investors should be cautious of this and it should be further evaluated periodically. In terms of search criteria metrics, the team analyzes a company's absolute leverage (debt/total capital and debt/ EBITDA) and relative leverage compared to its respective industry, with a bias towards companies with healthy balance sheets and low debt/leverage.

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Returns	1 Year	3 Years	5 Years	10 Years	15 Years	20 Years
Delaware Small Cap Value Instl	17.15	15.19	12.00	10.41	10.40	11.00
Russell 2000 Value TR USD	20.05	15.73	11.72	9.27	9.60	10.27

Excess Returns	1 Year	3 Years	5 Years	10 Years	15 Years	20 Years
Delaware Small Cap Value Instl	-2.89	-0.54	0.29	1.14	0.81	0.73
Russell 2000 Value TR USD	0.00	0.00	0.00	0.00	0.00	0.00

Standard Deviation	1 Year	3 Years	5 Years	10 Years	15 Years	20 Years
Delaware Small Cap Value Instl	10.51	13.33	12.89	18.43	16.70	16.64
Russell 2000 Value TR USD	10.63	13.68	13.60	19.68	17.88	17.55

Sharpe Ratio	1 Year	3 Years	5 Years	10 Years	15 Years	20 Years
Delaware Small Cap Value Instl	1.45	1.07	0.89	0.54	0.54	0.54
Russell 2000 Value TR USD	1.70	1.08	0.82	0.45	0.46	0.47

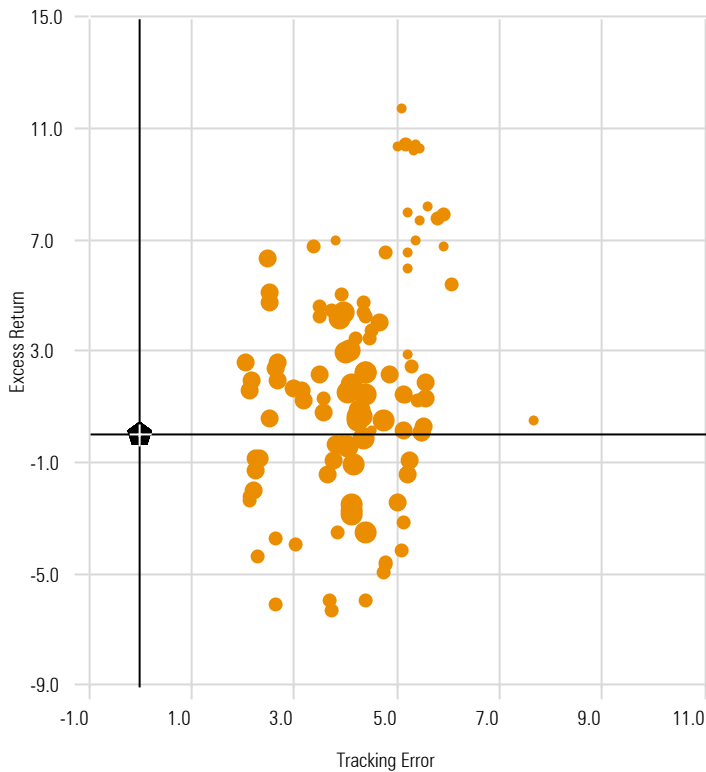
Information Ratio	1 Year	3 Years	5 Years	10 Years	15 Years	20 Years
Delaware Small Cap Value Instl	-0.59	-0.12	0.07	0.23	0.17	0.12
Russell 2000 Value TR USD	—	—	—	—	—	—

Tracking Error	1 Year	3 Years	5 Years	10 Years	15 Years	20 Years
Delaware Small Cap Value Instl	4.11	3.89	3.95	4.58	4.31	5.73
Russell 2000 Value TR USD	0.00	0.00	0.00	0.00	0.00	0.00

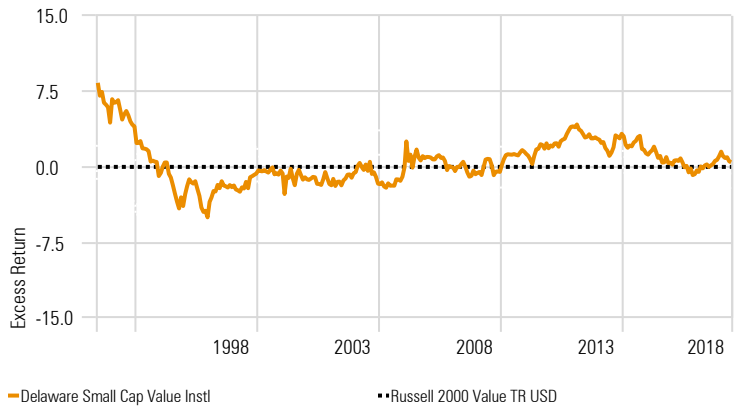
## Tracking Error - Excess Return (10-Year)

Time Period: 9/1/2008 to 8/31/2018



● Delaware Small Cap Value Instl    ◆ Russell 2000 Value TR USD

## 5-Year Rolling Excess Return



## 10-Year Rolling Excess Return



— Delaware Small Cap Value Instl    - - - Russell 2000 Value TR USD