Inside the portfolio

Delaware Small Cap Value Fund

Portfolio manager Chris Beck offers insight on investing in the small-cap space and the role that an actively managed portfolio of value-oriented small-cap stocks can play for investors.

Key fund features

- Highly experienced team of value investors, averaging more than 21 years of industry experience
- Focus on a company’s ability to generate sustainable free cash flow
- A disciplined process honed over nearly two decades, with a history of strong performance

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Christopher S. Beck, CFA
Chief Investment Officer, Small-Cap Value / Mid-Cap Value Equity

Chris Beck discusses investing in the small-cap equity space and how he and his team approach portfolio construction, as well as:

- Identifying opportunities through hands-on, active research
- Focusing on the importance of free cash flow in evaluating small cap businesses
- Allocating across value sectors in the small cap universe

Delaware Small Cap Value Fund has been providing investors with strong performance since its inception in 1987. The Fund focuses on stock selection to drive portfolio returns.
How would you describe Delaware Small Cap Value Fund (the Fund)?
We focus on exploiting pricing inefficiencies in the small-cap market. We believe that investing in quality companies that generate strong levels of free cash flow will consistently deliver above-market returns. Our fundamental research-driven process emphasizes stock selection as the primary source of strong performance while we always maintain a keen focus on downside protection.

What makes your investment style unique?
We believe that our focus on cash flow and capital deployment as well as each team member's discipline and adherence to the process makes us unique. During the investment process, we incorporate the concept of capital deployment in the analysis of company fundamentals and cash flow generation. We really strive to invest in companies that make favorable decisions for shareholders with their use of cash.

What are some shareholder-friendly uses of capital?
Shareholder-friendly uses of cash include, but are not limited to, dividend payments or increases, share repurchases, and repayment of debt. We definitely believe that this focus on capital deployment and cash flow generation has helped the strategy generate strong returns.

How do you begin your research process?
We are focused on small-cap companies with solid balance sheets, attractive valuations, positive cash flow, and free cash flow. To start, we screen the universe to identify the names with the most attractive valuations. As a value manager, our focus is on valuation and quality. Then the real work begins.

By real work you mean fundamental research?
Yes, this is what we spend 99% of our time doing, and it’s what we are best at. The average number of years of experience on the team is currently more than 20 years. One of our competitive advantages is that each team member is a focused sector specialist. We all apply our extensive industry experience with the same cash flow-focused investment discipline. We want to own companies with high-quality management that are deploying capital in shareholder-friendly ways. Our fundamental work is used to identify these companies and understand their future cash flow generating ability which help us to uncover any disconnect in current market pricing.

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Have you ever strayed from this investment process?
Not as long as I have been managing this Fund, which is over 20 years. We know that we are entrusted with people's money, and often times those are retirement assets. We have a fiduciary duty to uphold. We believe that by sticking to our discipline, even when it is temporarily out of favor, we will deliver the long-term results that we strive to achieve for our investors.

You spoke about identifying high-quality management teams, how do you go about this?
We definitely feel that our access to management and the volume of meetings that we conduct with companies’ executives is an advantage. Once we have done our fundamental work, we then come up with a list of questions that we would like to have answered to help support our investment thesis. We will talk to the CEO or CFO and ask them these questions to help us confirm if this is the best new name for the Fund.

Once you made the decision to buy a company, how do you size it?
We are very sensitive to security specific risk. The typical weight for an initial purchase is between half of one percent and one percent. Security weightings reflect our conviction, tempered by our assessment for business and valuation risk. The analyst will compare securities within his or her sector to determine the relative attractiveness of each security. Our principal concern is capital preservation, we don’t want to own a company in the Fund which will put the shareholders capital at risk.
Companies with higher cash flows tend to perform best over time

Free cash flow yield—performance by quintile

Quintile 1 / 18.5%  
Quintile 2 / 14.3%  
Quintile 3 / 12.0%  
Quintile 4 / 10.0%  
Quintile 5 / 5.7%

When it comes to portfolio construction, what type of top-down elements do you employ?

Overall, 90% of the process is based on the bottom-up fundamental analysis conducted by us. In constructing the portfolio, we follow the goals of monetary policy (both in the U.S. and globally), economic growth prospects, relative valuations, and cash flow within sectors. When I came into this business in 1981, the fed funds rate was 19%! The Fed over these past eight years have made this part of my job very easy, they have been extremely accommodative!

It’s a dynamic space, the small-cap arena. What sort of turnover does the Fund go through?

It’s typically pretty low, less than 30%. We have no problem owning a company for many years. In fact, that is ideal. We want to let our winners work for us. If we’ve bought a stock and the valuation is still attractive, we want to own it for a long time — reap the rewards for all the work that we’ve done.

What would cause you to sell a holding?

A company’s reduced ability to generate free cash flow or deterioration in the quality of a company’s balance sheet, which may come as a result of macroeconomic events, industry changes, or management actions. Those are our main concerns. If we no longer believe the company has the ability to resolve fundamental issues, we will get out. We may also identify a name in a sector that provides a more attractive risk-return profile than something we currently own.

That’s great insight. Lastly, how do investors put your Fund to work in their portfolios?

We are a traditional value manager. Our focus is on research and protecting capital. However, we know that historically the small-cap value space has been an extremely strong performer for long-term investors, typically with less volatility than the growth segments of the market (Source: Morningstar). We have found that more conservative investors will use our Fund as their sole small-cap fund because of the risk-return profile and strong cumulative returns that we have produced and hope to continue to generate.
For more information call us at 877 693-3546 or visit our website at delawarefunds.com

The views expressed represent the Manager’s assessment of the Fund and market environment as of the date indicated, and should not be considered a recommendation to buy, hold, or sell any security, and should not be relied on as research or investment advice. Past performance is not a guarantee of future results. Current performance may be lower or higher than the performance quoted. Performance data current to the most recent month end may be obtained by calling 800 523-1918 or visiting delawarefunds.com/performance.

Carefully consider the Fund’s investment objectives, risk factors, charges, and expenses before investing. This and other information can be found in the Fund’s prospectus and its summary prospectus, which may be obtained by visiting delawarefunds.com/literature or calling 800 523-1918. Investors should read the prospectus and the summary prospectus carefully before investing.

Investing involves risk, including the possible loss of principal. Narrowly focused investments may exhibit higher volatility than investments in multiple industry sectors. • Investments in small and/or medium-sized companies typically exhibit greater risk and higher volatility than larger, more established companies. • REIT investments are subject to many of the risks associated with direct real estate ownership, including changes in economic conditions, credit risk, and interest rate fluctuations. Indices are unmanaged and one cannot invest directly in an index.

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