Inside the portfolio

Delaware Small Cap Core Fund*

Portfolio manager Frank Morris discusses the role that small-cap stocks can play for investors seeking investment growth and his team’s approach to this often under-researched area of the stock market.

Key fund features

- A core solution focused on uncovering opportunities across the traditionally under-researched US small company market
- Daily review of the Fund’s risk exposures ensures results are driven by stock selection
- Securities are selected by a highly experienced small-cap investment team, averaging 29 years of industry experience

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Francis X. Morris
Chief Investment Officer – US Core Equity

Frank Morris considers opportunities in the small-cap equity market and how he and his team approach portfolio construction, as well as:

- Investing in today’s uncertain marketplace
- Identifying opportunities through hands-on, fundamental research
- Building a portfolio across the value-growth spectrum of the small-cap universe.

Delaware Small Cap Core Fund has historically provided investors with a strong long-term performance track record. The team focuses on stock selection to help drive the Fund’s returns.

Not FDIC Insured • No Bank Guarantee • May Lose Value
How would you describe Delaware Small Cap Core Fund (the Fund)?

I would say it’s a stock-picker’s fund, an expression of our belief that markets misprice securities. In the small-cap space, mispricing is more common than in the mid- and large-cap market given the dramatically lower percentage of analyst coverage of the 2,000-plus names in our benchmark index (the Russell 2000® Index). Our Fund seeks to deliver a high risk-adjusted return for investors in both up and down markets.

More than 2,000 names — that’s a large universe to cover.
It is indeed, and we approach it with a well-defined process that builds from quantitative screening to hands-on fundamental analysis. We are efficient with our time and resources. Screening is one method that we utilize to help us uncover new ideas.

So you use a model to sort through the small-cap universe?
Yes, it’s a proprietary model that we developed internally more than 15 years ago. No manager’s model is perfect, but we believe that ours has proven to be an effective way to identify good companies trading at attractive multiples. We believe the hands-on fundamental work that my team and I conduct truly makes a difference, as our experience, insight, and knowledge of the businesses give us an advantage.

Is your fundamental research really hand-to-hand?
Yes. We know the space and we know the sectors. Each member of the team is considered a sector specialist. Our fundamental work is really a continuous evaluation of each company’s fundamentals combined with a strong feeling of what’s going on in our sectors: trends, issues, regulatory matters, pricing, competition and product development. Importantly, we evaluate each sector based on specific financial metrics. In other words, we don’t apply a one size fits all research approach.

Do you apply any type of top-down view during the process?
We’re intimately aware of the macro issues — Federal Reserve policy, consumer and business spending trends, capital markets and the financial landscape, and that serves as top-down (stock-by-stock) guidance in our thinking. It does have some influence on how we evaluate individual names. But we’re in the trenches with the names we follow, identifying those we want to know better and keeping close to those we know well.

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How does the team work? How do you manage new ideas?
The essence of our team is continuity of the process. And all of us are aligned with the portfolio, either invested directly or through incentive compensation, or both. We’ve been together for a long time and individually following the small-cap equity space for even longer. When we are out in the field, meeting with management teams, examining business models and a company’s financial strength, we know that when we come back to the office it is our job to present what we believe are the best ideas that we have to the other members on the team. We respect that each of us has areas of specialization, and ultimately, I weigh in as the lead manager on what we’re adding or what we’re retiring.

Your Fund is core, not value, not growth. How do you construct and manage the portfolio. Do you avoid names that are considered too growth-y or too much in the value camp?
Not at all, we’re an end-to-end investor, deliberately participating in all the sectors in the Russell 2000® Index. It’s through portfolio construction that we make sure we are style consistent. Engrained in our portfolio construction approach are tight bands around sectors and risk factors to ensure we are adding value through stock selection versus allocation.

It’s a dynamic space, the small-cap arena. What sort of turnover does the Fund go through?
We want to be long-term owners of a company, not short-term renters. Our turnover has ranged between 30-55% annually for the past several years. Sometimes we’ll own a name until it becomes a mid-cap, at which point we will sell the stock to keep the Fund purely small-cap. We may also sell a company when there’s a change in the company’s fundamentals or business model, or it hits our price target.
As the chart shows, you can draw a tight circle around our Small Cap Core Fund and the Russell 2000 Index.

You and your team must have a lot of interesting meetings with management teams.

Absolutely. Being an active, research-driven manager with scale and tenure has meant that we get a seat at the table. We even find that managements seek us out to be owners of their stock because they know if we agree with their business model and direction, we could own that company for several years.

Or until the thesis you developed changes...

Or until that happens. Managements who know our small-cap practice know that we typically won’t sell a stock based on one bad data point; rather we’re looking at that data to ensure that new piece of information doesn’t break our original thesis. And if it doesn’t, that disconnect could create a buying opportunity.

How do investors put your Fund to work in their portfolio?

With many advisors indexing in large-cap, we have been seeing investors allocate to small-caps for their alpha potential. Also, our Fund in particular has benefited from portfolio consolidation. What I mean is that many advisors and consultants are reducing the number of funds they have in their portfolios. Combining a small-cap value and small-cap growth allocation to one good small-cap core manager may make sense. Research shows that most advisors are looking for some degree of reliable upside participation in the equity market — particularly in the United States. That plays right into our strengths: we believe the way we manage the Fund provides participation in bull markets and the potential for protection in a bear market.
For more information call us at 877 693-3546 or visit our website at delawarefunds.com

*Effective at the close of business on Oct. 19, 2018, Delaware Small Cap Core Fund was closed to certain new investors. Existing shareholders of the Fund and certain eligible investors, as outlined in the prospectus, may continue to purchase additional shares in existing or new accounts, including purchases through reinvestment of dividends or capital gains distributions and exchanges. Please read the latest prospectus and the summary prospectus for more information concerning this event. Please request a prospectus by calling 800 523-1918 or visiting delawarefunds.com.

The views expressed represent the Investment Team’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 data 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.

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