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One Small-Stock Fund Crashes the Big-Tech Party

Hood River fund places No. 6, the outlier among the large-cap funds whose heady gains have been driven by the 'Magnificent Seven'

By Lawrence Strauss
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U.S. large-cap growth funds continue to dominate the mutual-fund landscape, thanks to surging holdings from the "Magnificent Seven" technology stocks like Nvidia and Meta Platforms.

The latest edition of The Wall Street Journal Winners' Circle—a ranking of the top-performing stock-fund managers over the past 12 months—illustrates that trend.

But at least one fund cut against the grain. Of the top 25 funds on that list, only the $3.5 billion Hood River Small-Cap Growth Fund (HRSMX) broke through from a different category. The fund, which holds about 100 stocks, returned 51.8% over the 12-month period ended Sept. 30, good for sixth place out of 1,218 funds.

"It's hard to outperform large-cap when you're in small-cap and you don't have the Mag Seven," says Brian Smoluch, a longtime co-manager of the small-cap growth fund.

He was referring to the Magnificent Seven, nearly all of which had at least double-digit returns over the prior 12 months and helped boost a lot of large-cap growth portfolios. The exception was Tesla, which gained about 5%.

Nevertheless, Smoluch and his longtime co-manager, David Swank, have been able to consistently beat their peers with strong stock picking. The fund has been at the top or near the top of its Morningstar small-cap growth category based on one-, three-, five- and 10-year results.

At the same time, there are some familiar funds at the top of the latest Winners' Circle. Alger Focus Equity Fund (ALGRX) placed first with a 56.4% result over the past 12 months. In the previous survey, released in early July, it came in third.

The rules

To qualify for inclusion in the Winners' Circle, funds must be actively managed U.S.-stock mutual funds with more than $50 million in assets and a record of three years or more, as well as meet a handful of other criteria. The survey excludes index and sector funds, funds that employ leverage strategies and most quantitative funds. The results are calculated by Morningstar Direct.

This quarterly competition, as usual, isn't designed to create a "buy list" of funds for readers, but to demonstrate the ways that specific investment strategies benefited from recent market trends.

Alger Capital Appreciation Fund (ACAAX) came in second this time around, having taken the top spot in the previous survey. Third place went to the Alger Capital Appreciation Institutional Fund (ALARX); it finished No. 2 previously. Alger Capital Appreciation Portfolio (ALVOX) finished fourth, just as it did in the previous survey.

These Alger funds have shined with the help of technology stocks such as Nvidia, which returned 180% over the period covered in the survey; Microsoft, up 37%; and Facebook parent Meta Platforms, which climbed 91%.

The Magnificent Seven accounted for 41.2% of the S&P 500's total return of 36%, including dividends, over that period, according to S&P Dow Jones Indices. Of the 11 sectors in the S&P 500, 10 had double-digit returns over the previous year and only one, energy, fizzled, returning around 1%.

A rising tide lifted all boats. Of the 1,218 funds in the latest survey, none lost money, with the worst performer notching a one-year return of 8.49%. The average 12-month return among the funds meeting the survey's criteria was 29.1%.

How Hood River did it

Smoluch and his Hood River Small-Cap Growth Fund team look for inefficiencies among small-cap stocks—in particular earnings estimates they deem to be too low compared with the consensus forecasts over the next few years. This part of the market isn't covered nearly as closely as large-caps are, he adds.

"The forecasts for how those companies are going to perform over the next 12-24 months tend to be more erroneous," says Smoluch. "You can buy good companies at good valuations and capitalize on the inefficiency."

One example is FTAI Aviation, which more than tripled in value during the period charted in the survey to a recent $134 and change. The fund has held the stock since 2020.

Smoluch says the stock is a good example of "a perfect storm for a small-cap stock to do really well"—notably an attractive valuation when he initially bought it, what he considered to be lower-than-consensus earnings estimates and subsequently delivering strong financial results.

He has cut his exposure to the stock, but it is still the fund's largest holding.

Smoluch also favors initiating positions in stocks with annual earnings growth of at least 15% and market capitalizations of up to $5 billion.

Winners' Circle

Best 12-month total return through Sept. 30, 2024, actively managed U.S.-stock funds

- Alger Focus Equity (ALGRX) **56.4%**
- Alger Capital Appreciation (ACAAX) **54.8%**
- Alger Capital Appreciation Inst'l (ALARX) **54.6%**
- Alger Capital Appreciation Portfolio (ALVOX) **54.2%**
- Alger Spectra Fund (SPECX) **52.0%**
- Hood River Small-Cap Growth (HRSMX) **51.8%**
- Marsico Growth Fund (MGRIX) **50.6%**
- Hartford Growth Opportunities (HGOYX) **50.2%**
- Chase Growth Fund (CHASX) **50.1%**
- Fidelity Focused Stock (FTQGX) **48.5%**Source: The Wall Street Journal, from Morningstar Direct data

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To gather more information on potential holdings, Smoluch and his colleagues like to speak to suppliers, competitors and customers, among others. They also meet with about 450 companies each quarter, often at investment conferences.

Another winning pick for the fund has been ACI Worldwide, which has registered a 126% return over the previous 12 months. An important part of the software company's business is digital payments for banks, merchants and other customers.

The HRSMX share class has minimum initial investment of $25,000, but the investor shares (HRSRX) have a much lower minimum of $1,000.

Rounding out the top 10 finishers in the latest survey are Alger Spectra Fund (SPECX) at No. 5, Marsico Growth Fund (MGRIX) at No. 7 and Hartford Growth Opportunities Fund (HGOYX) at No. 8. Chase Growth Fund (CHASX) finished ninth, followed by Fidelity Focused Stock Fund (FTQGX) in 10th position.

A small-cap contender

One fund that was vying for a No. 1 finish is Hennessy Cornerstone Mid Cap 30 Fund (HFMDX), which was in the lead with two weeks to go in the quarter and then was overtaken. It finished in 40th place, but it was still in the top 4%.

The $1.5 billion fund, with a 12-month return of 43.89%, is in the small-cap value category. Like the Hood River fund, it doesn't hold any of the Magnificent Seven.

The fund is reconstituted once a year with each of the 30 holdings initially weighted equally at 3.33%. The portfolio managers look for stocks with market caps between $1 billion and $10 billion, price-to-sales ratios below 1.5 and annual earnings that exceed the previous year's result. They also want stocks that have appreciated over the past three and six months.

Holdings include retailer Abercrombie & Fitch, which gained nearly 60% in the first three quarters of this year; grocery store operator Sprouts Farmers Market, up about 130% over the period; and Modine Manufacturing, which appreciated 122%.

"We're not going to identify the next company that's going to turn but rather, once a company already has some momentum behind it, we participate," says Ryan Kelley, one of the fund's managers.

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