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Master and Apprentice

Two Thrivent managers craft a successful small-cap stock portfolio.

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Undiscovered Manager is a regular profile of a noteworthy strategy that hasn't been rated by Morningstar Research Services' analysts.

At first glance, Matt Finn seems reserved and unassuming. He isn't likely to be making a splash with stock tips on TV. Instead, the Minneapolis-based lead manager of Thrivent Small Cap Stock TSCSX might be found outside the office fishing on a Minnesota lake.

Yet Finn could teach investors a thing or two. Since he took over Small Cap Stock in March 2013, the fund's S shares have gained 11.1% annualized through September 2022, besting all small-blend Morningstar Category peers as well as the Morningstar US Small Cap Extended Index's 7.5%. It's an enviable record—one that Finn has built steadily by beating the index in 77% of rolling 12-month periods over his tenure. The $1.59 billion mutual fund's two share classes are open to new investors and earn Morningstar Fee Levels of Low relative to similarly distributed peers.

Thriving at Thrivent

Finn, a 37-year industry veteran, honed his investing skills along a winding road. The Detroit native made stops at National Bank of Detroit, Advantus (now Securian), Evergreen Investments, and U.S. Bank. Thrivent finally landed him in 2004. "I've been pleased to hold down a job since then," Finn says with self-effacing humor. His success speaks for him: In June 2018, Finn became Thrivent's head of equities. Like Finn, Thrivent flies under the radar of many investors. The firm traces its roots to a Wisconsin group that formed the Aid Association for Lutherans, a life insurance society, in 1902. The association gradually expanded its offerings into investments, and in 2002 merged with Lutheran Brotherhood to form Thrivent. The firm's religious heritage doesn't dictate Finn's strategy or those of Thrivent's more than two dozen other mutual funds. None exclude or select investments based on religious criteria.

Jim Tinucci and **Matt Finn**, portfolio managers of Thrivent Small Cap Stock.

Thrivent has given Finn the freedom and resources to succeed. Initially, Finn managed Thrivent Small Cap Stock solo for two years. In early 2015, his bosses invited him to add a teammate, and without hesitation Finn picked Jim Tinucci,a former analyst who had supported Finn on a large-cap value product from 2010 to 2012. "Jim was my first choice," says Finn, because Tinucci's fearlessness and preparedness had impressed him. Finn recounts a meeting he and Tinucci had with the CEO of a major industrial machinery company. Finn opened the questioning, but before long Tinucci jumped in and started peppering the CEO with follow-up questions. "The rookie guy is an independent," Finn recalls thinking. "He's not a wallflower."

Finn could easily take credit for Tinucci's success. He thinks of the firm's investment business as having an apprenticeship model, where rising talent works closely with seasoned investors to master a particular style. Tinucci, for his part, has a folksy gratitude for the opportunity.

"I got lucky as heck to work for Matt," he says. "He's intellectually honest and keeps things simple—but not too simple." The managers are also intellectually humble. They believe this helps them develop fuller views of their companies.

"We like to think that we're independent thinkers," Finn says—but Tinucci finishes Finn's thought by adding, "We also like to take the best ideas. You can take the concepts you hear and process them against the framework you have."

This testing of ideas extends to the managers' work with Thrivent's equity analysts. Finn wants to have more than one person working on every stock under consideration. "Every position," he says, "should be able to hold up to scrutiny." If an analyst takes a lead on a company, for example, a portfolio manager often joins to press the analyst on their earnings model or dig into the firm's growth prospects or industry conditions. This small-group research model can be quite effective in building team culture while working on lesser-known companies. It's similar—though not intentionally so—to the well-regarded Multiple Eyes approach used at Wasatch Global Investors in Salt Lake City, Utah.

Fishing in Different Ponds

Small-cap investors like Finn and Tinucci have plenty of companies to choose from. Many use screens to narrow down that list quickly, but the Thrivent duo calls their screens the "cornerstones" of their process. The first set looks at valuation (primarily based on free cash flow) and is fairly common. The remaining two, however, are more unique. They have rather downbeat names—"failure" and "neglect"—but they're key to the process. The failure model excludes the worst-run companies, such as those that overspend to build out capacity. The neglect model tries to find overlooked stocks—not simply by measuring analyst coverage, but by looking for firms with modest share issuance or relatively tame stock prices (both of which suggest a lack of investor interest in either buying or selling).

These screens are so effective that the Thrivent team reduces their initial universe from about 2,500 stocks to roughly 15 under careful examination at any given time. Finn, Tinucci, and their analysts then try to discern whether a company's stock has promising upside because the business is improving its operations. Unlike some small-cap managers, however, Finn and Tinucci don't think it's necessary to visit companies. They focus on combing through filings and talking with corporate executives on the phone. The team then checks and cross-checks its assumptions, estimates, and views so that only the strongest prospects survive the scrutiny. For most of their research, Tinucci says, "you get to 'no' more often than you get to 'yes'"—and they're comfortable with that.

One might think such strenuous tests would make for a relatively concentrated portfolio. Not so. The Thrivent team is well aware that attractive-looking stocks can be cheap for a reason, so it invests in a portfolio of 80–120 stocks, with top positions rarely exceeding 2% of assets each. Sector weightings are close but not too tight to the Russell 2000 prospectus benchmark—usually within 5 percentage points. The managers also like to stay fully invested. If they can't find the right deals, they sometimes put small amounts in an index- or industry-tracking ETF just to keep investors' cash deployed.

Risk management is serious business at Thrivent. "We want to do right by our clients," Finn says. "Our clients do business with us for a reason. We want to generate alpha without undue risk."

To that end, Thrivent regularly monitors at least 30 factors, including allocations to high-growth stocks and cyclical businesses, exposure to debt, and liquidity. Finn expects all of his equity team's portfolios to have less risk than their respective benchmarks. Thrivent Small Cap Stock delivers that: Its overall Morningstar Risk rating (an assessment of a strategy's downside volatility over multiyear periods) is Below Average.

To evaluate prospects, his portfolio, and risk, Finn uses one other lens: Drawing on lessons learned more than 40 years ago, he separates stocks into 12 "homogeneous groups" for more relevant comparisons. Seven are familiar sectors or industries that face specialized market conditions: insurance, banks, diversified financials, biotechnology/pharmaceuticals, oil/gas exploration and production, real estate investment trusts, and utilities. The remaining five are business traits: low quality, cyclical, stable, hybrid [of cyclical and stable], and high growth.

According to Finn, "High-growth companies, for example, act in a certain way regardless of what industry they're in. That's also true of stable companies. Ecolab ECL is in the basic materials sector, but 3M MMM is in industrials. Both, however, are stable businesses and should be compared with one another regardless of sector." Finn admits with a smile that not all of his Thrivent colleagues fully embrace this approach. "The growth side of the house is less enamored with that classification system," he says, "but they do know their high-growth exposure relative to the benchmark."

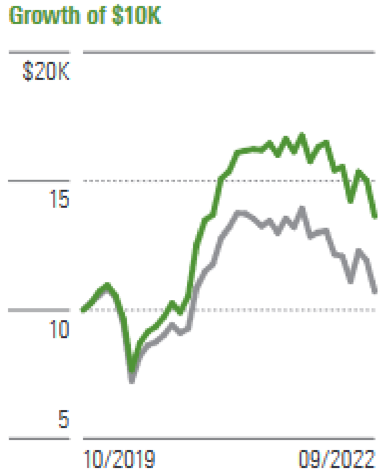
Putting Principles Into Practice

One of the fund's top performers in 2022, Lantheus Holdings LNTH, epitomizes the team's approach. The company makes healthcare imaging tools—a market in which General Electric GE is a major competitor. But unlike GE, which operates various complex business lines, Lantheus focuses on imaging, and the Thrivent team saw significant cash flow potential. When Lantheus got on their radar in early 2021, they saw that the key to unlocking the company's value was the potential regulatory approval of its Pylarify injection for prostate cancer screening. Convinced that a green light was likely, Finn and Tinucci first picked up the stock in March 2021. The U.S. Food and Drug Administration gave Pylarify the go-ahead two months later.

Yet the stock wasn't an immediate hit. Yes, investor interest in the company started to build, but Finn and Tinucci knew that the stock could run farther as the speed of Pylarify's adoption became apparent. They added to their position throughout 2021, and when Lantheus announced blowout fourth-quarter sales in February 2022, the stock surged. The managers began to trim their stake in Lantheus by mid-2022, partly because their thesis was playing out, but also to control the fast-rising stock's impact to the portfolio's overall risk profile when it became the fund's top holding in April.

The team's investment in ThredUp TDUP, a digital clothing reseller, has been what Tinucci calls "an amazing learning opportunity" despite being a big detractor so far. They began buying the stock in mid-2021 just a few months after it went public; it has since lost nearly 90% of its value. But Finn and Tinucci had always classed the stock in their high-growth bucket, and as such, they recognized the need for taking a long view. Tinucci lays out the thesis succinctly: "Consignment shops are inherently local, but ThredUp's platform gives sellers the ability to sell to customers all over at the best price. We like the scalability of their platform." The managers have added to their ThredUp stake as its share price has fallen, and they sound ready to be patient. "ThredUp just opened its sixth distribution center in Dallas.

Thrivent Small Cap Stock TSCSX



Thrivent Small Cap Stock
13.62

Morningstar US Small Core
10.71

Morningstar Category
Small Blend

Morningstar Rating
★★★★★

Expense Ratio (%)
0.80

Source: Morningstar Direct. Data as of 09/30/2022.

It's also adopting a kind of 'retail as a service' model where retailers can unload unused inventory through the platform," argues Tinucci. "Some key efficiency is coming here."

A Lasting Influence

While Finn's influence is clear, Tinucci sounds ready to take up the reins when the time comes. The two work closely on every portfolio decision, and much as in that meeting with the industrial company CEO years before, Tinucci readily supplements his boss' words with comments and insights of his own. Their team's third member, Michael Hubbard, shifted to a growth-equity strategy at Thrivent in August 2022 after three years here; he's been replaced by Katelyn Young, a new hire from William Blair with experience covering technology and industrials.

Finn's independent streak remains strong, though. When asked who he sees as peers in the small-cap space, none immediately come to mind. That's not smugness; instead, it's a reflection of his heads-down attitude toward his work at Thrivent. When pressed, he admits he looks up to some colleagues in the Twin Cities, particularly Andy Adams, who helped launch the successful Mairs & Power Small Cap MSCFX fund in nearby St. Paul. The two still swap ideas every once in a while, but "Andy doesn't need any tips from me," says Finn.

Tinucci again goes to bat for his mentor. "Matt has quite the coaching tree around here," he says on Finn's behalf. With Tinucci now part of that coaching tree, Thrivent Small Cap Stock looks to be in good hands for years to come.

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