INFORMATION FOR INVESTMENT PROFESSIONALS

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Global smaller companies: a world of opportunities

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With more than 4,500 under-researched small caps from which to choose, we are flush with ideas for investing in highly competitive companies

How have you been finding investing during the pandemic?

The Covid-19 outbreak represents perhaps the largest disruption to the global economy outside of the world wars and is challenging families, companies and governments around the globe. For us as investors, it presents a challenge on several levels.

As long-term investors our goal has been to keep a level head, to try to look beyond the market volatility and focus on what we do best – finding great businesses that we believe will win out over the long term. Fortunately, such high-quality companies have generally held up well compared to the broader market and so relative performance has been strong. In some instances, we've also been able to find some bargains in companies that have, in our view, been oversold.

While market volatility is nothing new, the second challenge is something that we've never experienced before – an entire industry working from home. We pride ourselves on the strong access to company management we have and an open, collaborative working environment. This hasn't changed, but we've had to adapt. The opportunity to speak to analysts and company management hasn't diminished, but we now meet virtually over Zoom and Microsoft Teams. Our internal meetings are done via Skype and we present to our clients via WebEx.

Importantly, the philosophy and processes that underpin how we work and that give us our edge have not changed.

What does the global smaller companies universe look like?

There are a large number of stocks in the global small company universe, which means individual small caps are under-researched by analysts. The benchmark we use for our global smaller companies strategy – the MSCI World Small Cap Index – includes about 4,500 companies.

This is important because by comparison the large cap universe contains fewer stocks, which means you get a much higher intensity of coverage of those names. As small caps aren't so well researched, the small cap market itself is less efficient, leaving more opportunities to buy incorrectly priced stocks.

Can you expand on the benefits of being able to access under-researched stocks?
Take Microsoft, for example. More than 40 analysts cover that single stock, but just two analysts cover the California-based small company WD-40 that makes household goods including its flagship lubricant brand. That gives us a greater opportunity to generate alpha. Also, you can get portfolios that vary significantly from the benchmark's composition, which means we have access to alpha opportunities that are clearly over and above the returns available to passive ETFs through benchmark/index investing. Not many asset classes allow you to have such a high active share.

What other themes are in the strategy?
Small caps give you pure exposure to developing secular trends or themes. You find "pure play" businesses that just do one thing and do it brilliantly. For instance, Freshpet is a US business that makes high-quality, fresh food for dogs and cats. US consumers are spending 4%-5%[1] more on their pets every year as they treat them more like members of the family. But if an investor wanted to invest in this sector through a larger company, they might have to do so via the likes of Nestlé, where pet food only represents around 10% of its revenue.

What do you look for in companies?
I like to keep it simple. When a company has a robust and sustainable competitive advantage it can earn a return on invested capital above its cost of capital for a long time. For example, if you owned the only bakery in a city you would have no competitors and the ability to charge whatever you like for a loaf of bread. But in reality, there are lots of bakers and limited barriers to entry in the baking sector, so there is no competitive advantage and the price of bread is low.

The same principle applies to companies we like. If we find a business with a sustainable competitive advantage, it can compound returns year after year at above the cost of capital. That is where we find alpha.

How do you assess whether a company's competitiveness is sustainable?
We assess the fundamental characteristics of a business and try to understand why it will sustain a return above its cost of capital for the long term. To help us understand the source of a company's competitive advantage, we use Porter's Five Forces – a toolkit for assessing a company's competitive advantage.

Trex, which manufactures composite decking (a mixture of plastic and wood) is a good example of a company with a solid competitive advantage protected by high barriers to entry. Trex obtains all of its plastic resin in the form of beads, processed a matter of miles away at a plastic sorting facility that recycles plastic bags from leading US retailers. It is incredibly difficult to replicate this process as cheaply as Trex does, and by extension the manufacture of the composite decking itself. This gives Trex a huge cost advantage for the long term, in a market that has wafer-thin margins.

Have you done anything differently since taking over as lead manager on the strategy in April 2019?
The investment philosophy hasn't changed, and I have continued the process. We have arguably given more prominence to environmental, social and governance (ESG) factors, not least by using our own proprietary Responsible Investment (RI) ratings.

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[1] Americans Spending More on Pets Than Ever Before: $72 Billion, American Pet Products Association, 21 March 2019

If a company scores poorly on that metric, we interact with our RI team to examine why – RI and ESG factors are at the heart of everything we do. Once we determine what the reason is, we can engage directly with the company itself to see if that issue is being addressed. It's all about engagement. We care about ESG because we believe it reinforces a company's long-term competitiveness.

What's your edge in this market?

We believe it's really important to have local market access and primary research, because with so many stocks available to us – including 30% off benchmark – we must filter down to 70-90 businesses that fit our investment philosophy. The key for us is that we have analysts with up to 25 years of heritage investing in regional small caps, all with the same investment philosophy. We have regional small cap teams in the US, Europe and UK, as well as portfolio analysts in Asia. Their best ideas make their way into the strategy.

What other factors do you consider when running the strategy?

We also like to hold a stock for the long term. The average holding period is roughly two-and-a-half years, but there are lots of companies that have been in the portfolio for more than four or five years. In fact, the biggest contributors to investment returns have been the stocks we've owned for longer than four years – by quite a considerable margin. We believe the best alpha is generated by stocks you own for many years. That's why we try to assess a company's prospects for five or even 10 years. Businesses that I found in 2016 are coming good. The best may even become so successful that they are too big to remain in our universe.

I always like to think about portfolio construction as akin to making a greatest hits album. Rather than struggling to find ideas, we're completely flush with ideas.