COMMENTARY

April 8, 2016

Investing Environment

Global equity market performance during the first quarter is being described as a "wash, rinse, repeat" cycle. Markets were spinning in circles, concerned about China, global instability, exchange rate volatility, credit, a strong US dollar hurting earnings, peak corporate profit margins, Fed rate hike concerns, and let's not forget energy prices. Investor sentiment turned bearish, and talks of a global recession were back.

However, around mid-February the cycle was broken as investors started to believe that US dollar strength looked capped and that oil prices had temporarily stabilized. This led equities to recover most of their losses. The first quarter probably felt more like a year to traders, but for long-term investors it presented an opportunity to buy quality companies at a discount.

During the first quarter of 2016, in the MSCI World Small Cap universe, utilities was the only sector to deliver a positive return (3.94%). On the other hand, health care was the worst performing sector, delivering -15.8% for the quarter.

From a country perspective, Canada and Singapore were the best performers during the quarter, with Hong Kong and Italy lagging in the last places. In general, the US performed in line with the broader Euro and Asian regions.

Performance Highlights

As of March 31, our Global Small Cap Composite has outperformed the MSCI World Small Cap Index. As expected, the majority of our outperformance came from stock-picking.

The highlight for the quarter was Opera Software, a Norwegian-based internet software company. Opera offers web browsers to more than 350 million users worldwide. Some of our readers may recollect that Opera was a detractor to our performance in 3Q last year. At that time, we highlighted our thesis on the company and explained why we had been shareholders for over five years. Opera was acquired during the first quarter at a 53% premium, which put the value of the company at NOK 1.2B or NOK 71 per share. We first initiated the position at approximately NOK 23 in 2010, and continued to build our holdings. We were also profit takers when the stock was trading around NOK 80-90.

Another top contributor for the quarter was Tumi, a premium lifestyle brand known for its high quality luggage. Increased volatility in the markets during Q4 of last year gave us a chance to buy TUMI at an attractive valuation. It appears we were not the only ones who found the valuation attractive; the company was acquired by Samsonite in March 2016 for $1.8B.

Our top detractor for the quarter was UK-based real estate advisory company Savills plc. The company provides transactional services (investment, sales, acquisitions, leasing), consultancy services (valuation, etc.), property and facilities management and fund management in countries around the world. The company delivered a 21% increase in profits in 2015, which was ahead of consensus. The stock has been impacted by Brexit fears, as an exit from the EU could lead to lower volumes for UK residential and commercial transactions. However, we anticipate the transaction and consultancy divisions in the US, Asia and EU should offset any weakness in the UK. We also anticipate Savills will benefit from its investment and property management business. Furthermore, Savills has outperformed its global peers such as Jones Lang Lasalle, Midland, and CBRE. The company continues to have strong fundamentals and pays a 3.2% divided yield. We find the valuation extremely attractive.

New Position

Amid the volatility in markets, we have identified a number of new investment opportunities and added three new names to the portfolio, including SolarEdge Technologies.

SolarEdge is a US-based manufacturer and distributor of electrical inverters and DC optimizers for rooftop solar panels. SolarEdge is the market leader in an attractive and structurally growing sector and is well established as a supplier to large, top-tier rooftop installers. The company has a track record of delivering strong and profitable growth and has a clear strategic vision for the next three to five years. SolarEdge's addressable market is expected to increase from 2.6GW in the US (17 GW worldwide) for 2015 to 5.5 GW (23GW worldwide) in 2016. SolarEdge shipped 900MW in 2015.

Already established as a leading supplier of electronic inverters for residential and commercial rooftops solar installations, SolarEdge's long-term investment thesis is based on becoming geographically diversified in order to service future high growth areas (South and Southeast United States, Southern Europe and ultimately rest of world). Globally, solar is a fast growing energy sector, but it is characterized by rapid regulatory changes that affect regional growth rates. Large solar deployments in California are presently supporting SolarEdge`s mid-term (2-3 year) undervaluation thesis. SolarEdge also participates in the replacement market in Germany and has partnered with SolarCity on the global home battery launch just starting in Australia. We also like that management owns 4% of the shares.

Other New Buys and Sells

Additional names we initiated positions in are Perpetual Ltd, and Bavarian Nordic. As always, we will be profiling these companies in upcoming weekly commentaries.

Our favourite way to exit an investment is either via acquisition or when a holding's market cap reaches our upper limit. These typically validate our investment thesis. In the first quarter, we exited Carmike Cinemas and Tumi as they were acquired. Treasury Wine Estate was sold as its market cap exceeded our upper bound. Nabtesco and NCI Building Systems were sold for better investment opportunities.

Outlook

During Q1, the Global Alpha team once again spent a considerable amount of time doing on-the-ground research on several continents. We meet with the management teams of existing holdings and potential new investment candidates. We noticed changes happening in various countries such as:

While visiting Japan, we saw that companies were becoming more investor-friendly, placing additional emphasis on improving ROE, shareholder return and corporate governance. We saw infrastructure development taking place in Tokyo as it readied for the 2020 Olympics. We feel a weaker yen has helped the tourism industry which saw a 47% increase in foreign visitors last year. We have been to Japan nine times since 2009, but we have never seen such long queues for buses to hotels at the Narita airport. And for the first time our bus came late! This is something you would never learn by just reading the newspaper.

Our visit to Europe gave us a chance to meet with over 45 companies located across Europe. While many companies seemed cautiously confident about the short-term outlook, management's tone varied quite substantially from industry to industry. For example, in the technology space, applications within Smart Mobility, communications, medical enhancement, smart energy and the Internet of Things continue to be very promising. Additionally, suppliers to the auto industry are finding opportunities as auto makers increase spending to comply with tougher emission regulations and to keep up with broad industry trends to upgrade technology and shift to materials and techniques that reduce vehicle weight.

On the negative side, apparel companies that are exposed to Chinese consumers face tough pricing conditions. Ready-to-wear seemed to be the most impacted segment. Companies continue to look for ways to keep their prices competitive and to invest in product range, brand image, store network and internet sales. On the flip side, we found companies exposed to leisure, travel and durable goods are adopting a more optimistic tone.

In all the data points we collected during the quarter, and in our meetings with over 150 companies, we didn't see anything to make us change our outlook on the investment landscape. Markets have been volatile, but this has also presented opportunities to acquire quality businesses at a discount to their intrinsic value.

We continue to believe that the liquidity-fueled bull market rally is aging, particularly in the US. Additionally, our ability to be highly selective and nimble in our portfolio holdings leaves us well positioned when entering a period which we believe could be full of opportunities for fundamental stock pickers.

Within equity markets, we think small cap names offer greater opportunities when compared to their large cap peers given their attractive relative valuations, expectations for higher profit growth and a record M&A environment.

Our investments in high-quality companies that have defensible business models and strong balance sheets greatly helped us outperform our small cap benchmark. As we reflect on the state of markets and the fundamentals of the companies we like to invest in, we are very excited about the current environment. Our fundamental, bottom-up process allows us to recognize earnings growth opportunities in small cap companies across developed markets.

We appreciate your continued confidence in us.

Have a great weekend.

The Global Alpha Team