COMMENTARY

July 17, 2015

Second Quarter Update in CAD

Investing Environment

The MSCI World Small Cap index delivered positive returns for the quarter, despite a volatile backdrop in equity indices globally. The MSCI Large Cap index posted negative returns for the quarter. With headline news driven by debt repayment and bailout negotiations in Greece, the rapid rise and decline of China's A Shares market and subsequent government actions to bring stability, and talk of a looming Fed rate hike in the US; equity investors must tune out the noise and focus on long-term fundamentals.

We continue to see positive macroeconomic developments across the developed markets, with continued strengthening of the US economy, green shoots budding across European economies, and better than expected inflation data out of Japan.

In the MSCI World Small Cap index, the Telecommunications Service and Health Care sectors led, with a performance of 5.2% and 4.8% respectively; while the Utilities sector was a drag, falling 5.9%. Other sectors that delivered negative returns were Financials, Materials, and Energy. From a regional perspective, we saw strong performance out of pockets of Europe, specifically the UK and Belgium. On the other hand, Australia and New Zealand were among the worst performing small cap markets and we have been scouring these markets for high quality growth bargains.

Portfolio Performance

Our portfolio outperformed the MSCI World Small Cap index in the second quarter, driven by security selection.

One example from the Financials sector is UK-based real estate advisory company Savills PLC, our top contributor for the quarter. Savills is a leading global real estate services provider. Around the World, the company provides Agency services (investment, sales, acquisitions, leasing), Consultancy (valuation, etc.), Property and Facilities management, and Fund management. The company continues to benefit from strong underlying growth from commercial and residential transaction revenues. The space also benefitted from the UK election result, which was a positive for the UK housing market. Savills trades at a discount to global peers such as Jones Lang Lasalle and CBRE. Savills has been one of our core holdings and it continues to deliver.

US-based Cynosure was another top contributor for the quarter and is a name we initiated in October of last year. Based in Westford, Massachusetts, Cynosure is the largest aesthetic medical device company by sales. It is a high quality name that we have been following for some time and we were able to enter at an attractive valuation. One of the attractive characteristics of this company is its diverse product lineup including products for hair removal, skin resurfacing and scar reduction, body contouring, treatment of vascular lesions, and tattoo removal. Its strong historic growth profile has been defined by both efficient proprietary R&D as well as an excellent M&A track record. Today, Cynosure boasts the largest sales force in the company's history. This, combined with numerous discussions with the management team, gives us high conviction in Cynosure's ability to continue its growth trajectory. Most recently, markets have reacted positively to the company's announcements regarding the FDA approval and impending launch of its non-invasive fat reduction device platform called SculpSure.

Conversely, US-based women's clothing retailer Bebe Stores Inc. was our top detractor for the quarter. The stock was punished by the announcement of a cessation of the dividend. Further damaging the name was news that the Founder and current Chairman, who owns 59% of the company's shares, would be stepping aside for new leadership and eventually reducing his equity ownership. While we understand some of the selling was done by yield investors, we believe these are positive developments and have no effect on the fundamentals of the business. The dividend cessation preserves cash and the exit plan puts the majority of share ownership in the hands of institutional investors. Management has been doing an excellent job improving the product line and offering lower promotions, which are helping deliver positive comps. We remain confident in the turnaround and hope to write about Bebe as our top contributor in the coming quarters.

Another top detractor for the quarter was Japan's CyberAgent, an internet conglomerate. It was our largest contributor in the first quarter, with the stock soaring 66% in CAD. Nothing fundamental has changed and we suspect some profit taking took place. As a reminder, we have been shareholders since 2011 and have been well rewarded during that time.

Portfolio Positioning

Amidst the volatility in the markets, we have identified a number of new investment opportunities and added six new names to the portfolio, including UMB Financial. Founded in 1913 and headquartered in Kansas City, UMBF is a century old franchise. It is a unique investment, as it provides exposure to asset management and mid-market commercial banking. The Kemper family bought UMB Financial during World War I and still owns 15%. Other employees own an additional 6%. What differentiates UMBF from the rest of its peers is its deposit franchise and diversified business mix. We anticipate UMBF will deliver organic loan growth in the high single to low double digits range and its latest acquisition of Marquette Financial expands its presence in some key markets. UMBF is also a top ten HSA player, and is growing faster than the industry, an industry that is projected to grow more than 20% through 2017.

Another name we added at the end of the quarter was Carmike Cinemas, the fourth largest cinema name in the US. We like to call it the Cinderella of movie theaters, as it has outperformed the rest of the industry over the last five years with growth driven by roll-up acquisitions, improved operational efficiency, and industry leading concessions margins. At the same time, management has right-sized the balance sheet, paying down debt and focusing on increasing margins and cash flow conversion. We believe CEO David Passman has done a tremendous job delivering on the strategic plan he laid out for investors and we look forward to the opportunities that lie ahead for the business.

Additional names we initiated positions in are Atlantic Tele-Network, Glory Ltd., ArcBest, and Limoneira. As always, we will be profiling all of our positions in our upcoming weekly commentaries.

Two of our favorite exit routes are when one of our holdings is acquired or its market cap reaches our upper bound, which typically validates our investment thesis. In the second quarter, we exited Polypore via acquisition by Asahi Kasei and 3M. Zebra Technologies was exited as it appreciated through our upper market cap bound. Citic Telecom and Cardno Ltd. were sold for some of the better ideas we highlighted earlier.

Outlook

As we look ahead to the second half of the year, we remain optimistic about global financial markets. Key leading indicators point to strong economic growth through the end of the year and this data is supported by the conversations we have had with the management teams of our portfolio holdings.

Especially important for the small cap opportunity set, global M&A activity is up 35% year over year and with significant dry powder on the sidelines, we expect to see continued activity from both financial and strategic buyers.

As long-term investors, we welcome the short-term volatility brought about by concerns of a “Grexit” causing contagion in Europe, and the slowing economy and domestic stock market panic in China. We remain focused on identifying businesses that will grow and outperform through the business cycle. Our holdings have strong balance sheets in order to withstand temporary economic downturns and are well positioned to leverage their competitive advantages to grow market share and operating margins over the medium to long-term.

We appreciate your continued confidence and look forward to speaking with you again soon.

Have a great weekend.

The Global Alpha Team