COMMENTARY

November 6, 2015

Third Quarter Update in CAD

Investing Environment

The 3rd quarter was a tough market generally for equities around the world, and small caps were not immune from the pullback in what we believe is an aging bull market. We see significant macroeconomic drivers of the pullback including fears of contagion from the slowdown in China and weakening macro fundamentals for additional large Emerging Markets economies tied to commodity prices.

When looking at corporate profits, we are seeing U.S. businesses struggle to find incremental earnings growth while the outlook for profit growth seems stronger throughout Europe and Japan. Additionally, we believe we are starting to see the beginning of a transition from a primarily liquidity driven momentum market as U.S. central bankers consider raising rates even as counterparts in the Euro and Japan continue their unprecedented QE monetary programs.

Within the MSCI World Small Cap universe, Utilities and Consumer Staples were the strongest performers for the quarter, and, perhaps unsurprisingly, the Energy sector was hit the hardest for the quarter.

On a regional basis, we saw the strongest performance out of pockets of Europe, with stocks in Ireland and Sweden leading all countries. In contrast, Hong Kong and Canada were among the worst performing small cap countries, and, in general, the U.S. region underperformed the broader Euro and Asian regions.

Portfolio Performance

Our portfolio largely tracked MSCI World Small Cap index in the third quarter, finishing slightly behind the broad benchmark, however year-to-date as of September 30, our portfolio has outperformed the MSCI World Small Cap index.

The highlight for the quarter was Faiveley Transport, a French based manufacturer and supplier of equipment for railway industry, who was approached with a tender offer by Wabtec. While it's sad to see a business we like as much as Faiveley go, Wabtec's offer came in at a 41% premium to the share price and was our single largest contributor to return for the quarter.

Another top contributor for the quarter was Australian based Treasury Wines, one of the few pure plays on the global wine market. TWE owns brands such as Penfolds, Wolf Blass, Yellowglen, Coldstream Hills, Lindeman's, Seppelt, Santa Barbara Collection, and Seaview to name a few. The business was spun out of the Fosters Group in 2011. A little over a year ago, the company faced an oversupply in the market. In August of last year, KKR revised its takeover proposal at $5.20 per share. The board rejected the lowball offer saying it undervalued Australia's largest listed wine company. We agree with the board as we saw the industry oversupply issue coming to an end. Management was able to execute on both a meaningful cost cutting initiative, while also growing the revenues and market share. A year later, the company is trading above the KKR bid price, and has acquired Diageo's Blossom Hill brand. A year may not be long enough for a wine but can be a long time for any business.

Conversely, Opera Software, a Norwegian-based internet software company, was our top detractor for the quarter. Opera offers consumer browsers for more than 350 million users worldwide. The stock was punished after the topline missed estimates by 7% and guidance was weaker than expected. Being shareholders for over five years, Opera has delivered great performance. The current correction was expected as valuation was rich, a reason we had taken profits and been trimming the stock in a disciplined fashion at recent highs. We continue to be constructive on the long-term growth prospects for Opera. While the company faces headwinds in mobile advertising and had a negative headline of an advertising client making cutbacks, we are of the opinion these are one-off events and are not a crack in the fundamentals of the company.

Portfolio Positioning

Amidst the volatility in the markets, we have identified a number of new investment opportunities and added three new names to the portfolio, including US Physical Therapy (USPH). It's a name we have been following for some time. The recent volatility in the Health Care sector, gave us an opportunity to buy a quality name at a larger discount to its intrinsic value.

Founded in 1990 and headquartered in Houston, USPH operates outpatient physical and occupational therapy in the U.S. It has 3% market share of a large and fragmented market, not far behind the largest player who holds just 6% market share. It offers a unique partnership model with therapist clients, who can then focus on patient care and building their business, while USPH provides all the administrative and marketing support. USPH has 502 clinics in 42 states. CEO Christopher Reading was a physical therapist himself and has demonstrated a deep understanding of the industry and ability to connect with their target clients. He and CFO Larry McAfee joined in 2003 and have done a phenomenal job executing the strategy and the company has tripled both top and bottom line since joining. We believe management will continue to deliver and gain market share in this large and growing market.

Additional names we initiated positions in are Marinemax, and Rayonier. As always, we will be profiling all of our positions in our upcoming weekly commentaries. During the quarter, we exited Nihon M&A Center, Mastec, Bebe Stores and Comstock Resources for better ideas highlighted earlier.

Outlook

As we reflect on the state of markets and the company fundamentals of the types of businesses we like to invest in, we are very excited about the current environment given our fundamental, bottom-up process and historical track record of uncovering unrecognized earnings growth opportunities in small cap companies across developed markets globally.

As mentioned above, we believe the liquidity-fueled bull market rally is aging, particularly in the U.S., and our ability to be highly selective and nimble in our portfolio holdings has us well positioned entering a period which we believe is rife with opportunities for fundamental stock pickers.

The M&A environment will continue to support the small cap markets generally and we have been the beneficiaries of 5 takeover proposal year to date, 3 in the U.S. and 2 in Europe. With the amount of dry powder in the form of committed private equity capital and corporate cash, we expect to see this trend continue.

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

Have a good weekend.

The Global Alpha Team