January 15, 2016

Investing Environment

With the wrap of the 4th quarter, Global Alpha closes 2015 with yet another successful year to validate our team's investment approach. Amidst a year of market volatility that at times bordered on outright panic, small cap equities turned in strong returns relative to other asset classes.

2015 was marked by the strength of the US dollar, coupled with weakness in commodities and emerging markets. We also saw divergence in Central Bank policies, with the Fed hiking rates for the first time since 2006, while many world central banks implementing further monetary easing. China's economic slowdown has not only sparked sharp equity sell-offs in their local markets, but also raised concerns of contagion to China-dominant aspects of our economy and related companies. 2015 marked the fourth year of global economy growth below its 30 year average of 3.6%. Finally, we saw a record volume of M&A around the world, and of course, the new Star Wars movie.

Specific to the 4th quarter, the MSCI World Small Cap index delivered a return of 8.1%, despite China turmoil and the continued decline of commodity prices. In our view, the strength of small cap returns in the quarter has been driven primarily by the European and Japanese markets, as well as the improving macro conditions in these respective regions. They are also supported by monetary easing and cheaper valuations when compared to the US. European small cap was one of the best performing asset class globally. Japan on the other hand was one of the strong markets showing double digit earnings growth.

During the fourth quarter of 2015 in the MSCI World Small Cap universe, Healthcare and IT were the strongest performers, up 12.0% and 11.4% respectively, and, perhaps unsurprisingly, the Energy sectors was down 3.9% for the quarter.

From a country perspective, New Zealand and Sweden were the best performers during the quarter, with Canada and Norway lagging in last places. In general, the U.S. underperformed the broader Euro and Asian regions.

With just a few days into 2016, the conversation circles back to fears about China, global instability, FX volatility, oil prices reaching new lows, a strong dollar hurting earnings, peak corporate profit margins, Fed hikes, and so on. Investor sentiment appears to be turning negative as evidenced by market volatility at the start of the New Year.

Portfolio Performance

Our portfolio outperformed the MSCI World Small Cap index in the fourth quarter and for the full year as of December 31. As expected, the majority of our outperformance came from stock picking.

Our style of investing in high-quality companies that have a defensible business model and a strong balance sheet was rewarded as we saw a return to quality and the market beginning to discern winners and losers on the basis of business fundamentals. Looking broadly across equities large and small, quality metrics such as high ROE, low beta, and high FCF yields outperformed a welcome return of a trend that has been dormant during recent years of momentum market movements.

The highlight for the quarter was PMC-Sierra, a semiconductor and software solutions innovator. PMC primarily serves the communications service provider, storage and enterprise markets. Its customer base includes communications equipment majors such as Cisco, Alcatel-Lucent, EMC, Huawei and Hitachi. The company received an offer to be acquired by Skyworks Solutions, which turned into a bidding war with Microsemi, who also had their eye on PMC. The final offer price was close to our target price.

Another top contributor for the quarter was Cynosure, the #1 Aesthetic Equipment Devices (AED) company by sales. What makes CYNO stand out from the herd is its wide and comprehensive product offerings. CYNO's products are used for applications such as hair removal, skin resurfacing and scar reduction, body contouring, treatment of vascular lesions, and tattoo removal. The US market alone for non-surgical cosmetic procedures is a $5B opportunity. The company continued to deliver strong results and also launched its non-invasive fat removal product in September. Non-invasive fat reduction is one of the fastest growing non-surgical procedures in the United States. The addressable market for this particular procedure is a global target audience of 1.3 billion overweight adults.

PRA Group was our top detractor for the quarter. Based in Norfolk Virginia, it is one of the largest publicly traded distressed consumer debt buyers in the US. The company buys written-off credit card receivables and other debts, and then collects them. Basically, PRA buys debt for $0.05-$0.10 on the dollar and recovers $0.12- $0.14. Historically, PRA has collected 2.5-3X its purchase price. We think the market is misunderstanding certain aspects of the industry trends; stricter industry guidelines will widen the moat for PRAA. Other misunderstood aspects are the impairment charges taken in each of the last two quarters; however, these are just US GAAP accounting rules which require the charge due to PRAA collecting more than anticipated earlier in the life of the collection curve. We continue to be optimistic on the long-term growth prospects for PRA Group.

Portfolio Positioning

Amidst the volatility in the markets, we have identified a number of new investment opportunities and added nine new names to the portfolio, including Poundland.

Founded in 1990 and headquartered in the UK, Poundland is the largest single price value general merchandise retailer in Europe. Think of it as the "dollar store" of Europe. The company IPO occurred in March 2014 and was over-subscribed 15X. We like that management owns >5% of the shares. Poundland is the market leader in an attractive and structurally growing sector, with high quality national stores. The company has a track record of delivering strong and profitable growth, with a clear strategic vision for the next three to five years. Late last year, the company gave a trading update below estimates, which gave us the opportunity to acquire shares. The weakness was due to persistent weak weather/store traffic. This proved to be a problem for not only Poundland, but for almost all retailers. Short term investors panicked, bringing the share multiple lower than its peers in the industry.

So why are we bullish? First, we believe in the long term strength of their market leading industry position as well as management's ability to execute on strategic growth. Second, the company is experimenting with multiple pricing strategies in a select few stores. If proved successful, this strategy would boost top and bottom line. Third, their integration of 99p Stores is on track, with good timelines on initial store conversions. Having researched and tracked Dollar Tree, Family dollar, Dollarama, Dollar General in North America for quite some time, we feel comfortable in our thesis on Poundland.

Other New Buys and Sells

Additional names we initiated positions in are Caesar Stone, Eagle Materials, Ethan Allen Interiors, Omnicell, Webmd Health, Motorcar Parts of America, Tumi and Orbcomm. As always, we will be profiling all of our positions in 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. This typically validates our investment thesis. In the fourth quarter, we exited PMC Sierra and City National as they were acquired. Message, on the other hand, was sold as its fundamentals have deteriorated and were no longer consistent with our original investment thesis.

Outlook

Looking ahead, our broad outlook on the investment landscape remains largely consistent with prior quarters. We continue to believe the liquidity-fueled bull market rally is aging, particularly in the U.S. Additionally, 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.

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

Our investments in high-quality companies that have a defensible business model and a strong balance sheet greatly helped us outperform our small-cap benchmark. 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. Our fundamental bottom-up process and historical track record, allow us to recognize earnings growth opportunities in small cap companies across developed markets globally.

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