COMMENTARY

April 7, 2017

Dear clients and colleagues,

Investing Environment

2017 started with a high level of euphoria, especially in the US, spurred on by hopes of lower taxes and the expectation of a generous infrastructure budget. Anticipated policy changes led many investors to reposition their portfolios in favour of the US versus the ROW (rest of the world).

On the flip side, some investors are concerned about a market correction, which is not surprising when you consider that the combined market cap ($2.67T) of Apple, Amazon, Google, Facebook, and Microsoft exceeds the GDP of all but four of the world's countries (US, China, Japan and Germany). The sharp rally in US stocks over the past three months has propelled valuations to levels not seen since 2004, with the S&P 500 now trading at three times book value.

With a widespread rally, US large caps have outperformed US small caps this quarter. At the sector level, this represents a reversal of trends as compared to last year. In terms of performance, energy lagged in last place, while health care came in first. Compared to large caps, small caps are cheaper and should benefit from a healthy economic recovery in the US.

Economic data out of the US has been positive, which led to the US Federal Reserve raising its benchmark interest rates. In Europe, the UK has triggered Article 50, starting the formal process to leave the European Union. Economic data out of Europe also indicates an expansion in the European economy. Small cap valuations in Europe are not pricing in a strong economic recovery.

In Asia, Japanese industrial production beat expectations in February. A weaker yen and strong global growth should boost earnings for Japanese companies. China reported the highest PMI data since April 2012. Emerging markets inflation fell sharply last month, but this was driven almost entirely by a New Year-related drop in food inflation in China. In aggregate, emerging market inflation remains stable, aside from a handful of countries such as Mexico. Inflation is not a major concern for emerging markets policymakers.

While we cannot predict market reactions to unknown future global events, we remain optimistic about global small cap companies given their valuation and growth prospects.

Back to global small cap

During the first quarter of 2017, the MSCI World Small Cap Index underperformed the MSCI Large Cap Index. Emerging Markets outperformed both the MSCI World Small cap and the MSCI Large Cap Index.

In the MSCI World Small Cap Index, health care was the strongest sector, delivering a positive return of 11.2%. At the opposite end of the spectrum, energy was the worst performing sector, returning -9.9% for the quarter.

Performance Highlights

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

The highlight for the quarter was Savills (SVS LN). Following the Brexit announcement, the company was one of our top detractors for 2016.

Savills is a UK-based real estate advisory company. It provides transactional services (investment, sales, acquisitions and leasing), consultancy services (valuation, etc.), property and facilities management and fund management in countries around the world. Ten years ago, Savills was mainly focused on the UK property market. Fast forward to today and only 40% of its revenue comes from the UK, with its UK residential segment accounting for about 15% of total sales.

We expect the geographical diversification of Savills' revenues to mitigate any weakness from its UK real estate exposure. Since 48% of its revenue comes from the US and Asia, Savills should benefit from a weaker pound.

Savills is well exposed to various markets, which means it is more resilient to regional bumps and adverse economic trends. In our view, the current valuation makes Savills inexpensive for a leading player that now has a global platform from which it can continue to grow its business.

Another top contributor for the quarter was IWG Plc, a name that also underperformed after the Brexit announcement. Better known as Regus, it is the world's largest provider of workspace solutions. It offers workstations, office support services and communication access through approximately 3,000 business centres in 100 different countries. In addition to utilizing office facilities, customers can utilize the various professional support services such as catering, mail delivery, office supplies and more.

The majority of Regus' revenue is derived from clients renting workstations in its business centres, but a multitude of other services are available. Small and medium enterprises account for 70% of its client base, but a large number of blue chips also use its services (Google, Toshiba, GlaxoSmithKline, Danone, etc.).

Our top detractor for the quarter was PRA Group, 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 on the dollar. Some of our readers may recollect PRA being a detractor in 4Q/15. At that time we laid down our thesis and emphasized what we thought the market was missing. Even after a strong comeback, PRA trades at a big discount. If we were to apply the current European peer multiple to its European business, which accounts for half of the company's revenue, it would mean we would be getting the US business at a big discount. We continue to be optimistic about the long-term growth prospects for PRA Group.

New Position

Amid the market volatility, we have identified a number of new investment opportunities and added four new names to the portfolio, including Lindsay Corporation.

Founded in 1955, Lindsay is based in Omaha, Nebraska. It provides water management and road infrastructure products. Its irrigation division sells products that are focused on preserving precious, natural fresh water resources by using very efficient irrigation methods to grow crops. Products include center pivot and lateral move irrigation systems. Through its infrastructure division, Lindsay also sells road safety products such as moveable barriers. The San Francisco Golden Gate Bridge road zipper is one of Lindsay's products.

Lindsay gives us exposure to the long-term drivers for the irrigation side of the business. Their products maximize water efficiency and crop yield per acre, tapping into global demand for fresh water conservation and increased food production. Meanwhile, through their infrastructure division we are exposed to the US infrastructure expansion plans.

Lindsay has been on our radar for over three years. However, we remained on the sidelines as crop prices and farmers' balance sheets have been experiencing a cyclical downturn. But now that the agricultural market appears to have bottomed, things seem to be changing. In addition, growth in the infrastructure division of Lindsay is offsetting weakness from the agriculture division, and should help drive strong earnings growth.

Other New Buys and Sells

Additional names we initiated positions in are Globus Medical, Verifone Holdings and Carriage Services. As always, we will be profiling these companies in upcoming weekly commentaries.

Our preferred way to exit an investment is either via acquisition or when a holding's market cap reaches the upper limit of the index. These methods typically validate our investment thesis. In the first quarter, we exited Cynosure as it was acquired. We decided to exit Nutrisytem and Heska for better investment opportunities, including those mentioned above, as we constantly seek to upgrade our portfolio with our best ideas. Another name we exited was Disco Corp. as its market cap approached the upper limit of the Index.

Outlook

The Global Alpha team was on the road again during the first quarter, doing on-the-ground research and attending conferences. We met with the management teams of existing holdings, their competitors and potential new investment candidates.

Even when markets are strong, we continue to search for names that fit our investment criteria. The small cap universe still holds a large number of investment opportunities. Some companies, regions and industries have not participated very strongly in the recent rally and could prove to be interesting future investments.

Economic data and our "ears to the ground" investment approach lead us to believe that fundamentals are improving in most regions of the world, which should support earnings growth for the near future. The market remains a pendulum, sensitive to global news releases. Overall, for the last few quarters, the market has been more optimistic than pessimistic in terms of world events.

The market remains liquidity-fueled, particularly in the US. Our ability to be highly selective and nimble in our portfolio holdings leaves us well-positioned to enter a period of great opportunity for fundamental stock pickers.

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

Our investments in high-quality companies with defensible business models and strong balance sheets have helped us outperform our small cap benchmark. As we reflect on the state of markets and the fundamentals of our target companies, we remain positive about the current environment and future growth opportunities.

We appreciate your continued confidence in us.

The Global Alpha Team