COMMENTARY

January 13, 2017

Investing Environment

2016 in the rear view mirror

January provided a brutal start to 2016 for global equity markets, which lost $4T in value in just ten trading days. Several converging events generated fear of a global recession, such as China's economic slowdown, slumping oil prices and the Bank of Japan embracing negative interest rate policies.

As the year continued, negative sentiment only grew as investors were surprised by the outcome of the Brexit vote and in August the Bank of England's revival of quantitative easing led to $13.4T of negative-yielding debt. But the year of surprises did not stop there, as attention moved to the unexpected outcome of the US election. Many pundits predicted doom in the wake of a Donald Trump victory but were swiftly proved wrong as investors embraced the idea of a Republican-controlled Congress. "Trumpflation" is the new buzzword as the new government's fiscal policy is anticipated to supercharge the economy.

In early December, Italy voted "no" to reforms, leading to the resignation of Prime Minister Matteo Renzi. Then came OPEC's decision to cut oil production, and a subsequent agreement with non-OPEC producers was reached which boosted oil prices further.

Amid all of this turmoil, most equity markets managed to shrug off fear to end 2016 on a positive note.

What is 2017 expected to bring?

A lot has happened in the last 12 months. Global markets appear to be more stable as we enter 2017, but there are still many unanswered questions. The full consequences of Brexit will not be known for some time, and Donald Trump has yet to provide details of his various plans for the US. Both France and Germany will hold elections this year, and the fear is that they will become referendums on the future of the European Union.

While we cannot predict if there are black swans on the horizon, we remain optimistic about global small cap companies given their valuation and growth prospects.

Back to global small cap

During the fourth quarter of 2016, the MSCI World Small Cap Index outperformed the MSCI Large Cap Index. Emerging Markets underperformed, with the MSCI Emerging Markets Index delivering negative returns for the quarter compared to the positive returns delivered by the MSCI World and the MSCI World Small Cap indexes.

In the MSCI World Small Cap Index, financials was the strongest sector, delivering a positive return of 17.4%. At the opposite end of the spectrum, health care was the worst performing sector, returning -5.5% for the quarter.

Performance Highlights

In the fourth quarter, our Global Small Cap Composite outperformed the broad MSCI World Small Cap Index. On a year-to-date basis, our Global Small Cap Composite has outperformed MSCI World Small Cap Index.

While stock picking contributed positively to performance for the year, regional portfolio weights, especially in Europe and North America, had a negative impact on performance. As you know, 70%-80% of our expected added value comes from stock selection. However, there can be periods when minor asset allocation by country and/or sector may play an unexpected role in added value.

From our point of view as bottom-up stock pickers, the highlight for the quarter was UMB Financial (UMBF). Founded in 1913 and headquartered in Kansas City, UMBF is a century-old franchise. The Kemper family bought UMB Financial during World War I and still own 15% of the company. Other employees own an additional 6%. The Kemper family has provided four generations of consistent leadership. Mariner Kemper became the CEO in 2004 and has transitioned the bank into a fully diversified financial firm.

UMBF is a unique investment as it provides exposure to asset management and mid-market commercial banking. It should continue to benefit from rising interest rates due to its commercial heavy loan mix, deposit base and conservative securities book.

Our original thesis for UMBF was simple. We anticipated loan growth would continue and that UMBF would benefit from active participation in Health Savings Accounts (HSA). UMBF's HSA business is very unique relative to other mid-cap banks and provides the company with approximately $1.5B in HSA deposits (approximately 10% of its deposit mix) which can be used to fund other parts of the business. We also expect operating leverage to improve. We continue to be optimistic on the long-term growth prospects for UMBF.

Another top contributor for the quarter was SodaStream. Based in Israel, SodaStream is the world's leading manufacturer of drink makers, carbonators and concentrates for made-at-home sparkling drinks. The business model is the razor-razorblade model, similar to Nespresso and Keurig. You sell the maker, and then you sell the consumables, which in this case are CO2 cylinders and flavoured syrups.

Over time, revenues should shift from the soda maker to the consumables, which will increase profitability as consumables have higher margins. For example, SodaStream has been operating in Switzerland for 15 years and currently about 80% of its Swiss revenue comes from consumables.

The company continues to regain positioning as they grow sales of soda makers to lay the foundation for improved use of the higher-margin canisters and flavors. Concentrated efforts to rebuild the US business are beginning to yield results, with a push in advertising and marketing, plus a possible expansion into Whole Foods and Costco this year. As expected, the stock is tracking results relative to expectations.

Our top detractor for the quarter was Cyberagent, an internet conglomerate based in Japan. The key driver of the company's growth, the Ameba SNS platform, is moving to smartphones and becoming an open platform offering several third-party games. Ameba is the number one blog service in Japan, and the Ameba Pigg attracts the attention of celebrities. Cyberagent has 25.7% of the smartphone advertising market. The company gave guidance which was slightly weaker than the estimates, but conservative in our opinion. While one quarter does not change our long-term thesis, in the short term Mr. Market was not happy with the results.

New Position

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

BTG has two highly cash-generative businesses:

1) Specialty Pharma: providing antidotes for snakebites and Digoxin overdoses
2) Licensing: 7% royalty on Zytiga, Johnson & Johnson's $2.3B per year drug for prostate cancer, and a 6% royalty on Sanofi-Aventis' Lemtrada

These two streams combined contribute approximately £150m per year for R&D/M&A in the exciting interventional medicine business.

Interventional medicine uses complex devices—often in tandem with assisting biological agents—to perform surgeries. This market is very attractive as accelerating technology offers large market opportunities to small players. Interventional medicine products enjoy a long commercial lifespan as there are no generics, they are safe for patients, profitable for hospitals and often more effective than drugs. These markets are still underpenetrated. To put this into perspective, BTG is using interventional approaches for the treatment of cancer and blood clots which have a multi-billion dollar addressable market but are currently less than 2% penetrated.

We think BTG can increase its market share, which will help reduce the valuation discount to the two other operators in the interventional medicine space. The company should also benefit from a stronger US dollar as most of its revenue base is in US dollars.

Other New Buys and Sells

Additional names we initiated positions in are Senior, Fuji Seal, THK and Summit Materials. 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 fourth quarter, we exited Faively Transport as it was acquired. On the other hand, we decided to exit Gulfmark 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 Eagle Materials as its market cap approached the upper limit of the Index. We have bought and exited this name twice since the inception of the portfolio. As you know, we spend a lot of time conducting research prior to entering into new positions, and after we exit a position, we do not always try to "reinvent the wheel" by finding new stocks to research. Instead, we continue to follow a company's developments and will buy it again when Mr. Market is in a bad mood.

Outlook

The Global Alpha team was on the road again during the fourth 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.

In all the data points we collected during the quarter, and in our meetings with various companies, we didn't see anything to make us change our outlook on the investment landscape. Companies in general appear extremely confident and anticipate good growth in 2017. While there are dark macro clouds that could derail the rally in the short term, we remain prepared to take advantage of these opportunities.

Looking ahead, we believe that the liquidity-fueled bull market rally is aging, 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 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 the current M&A environment.

Additionally, we have continued to see large cap multinationals under increased scrutiny from a regulatory and tax perspective. Globally, the blended statutory tax rate is roughly 30%, while the aggressive tax practices of large multinationals have resulted in them paying an average of approximately 20%—a figure we see moving higher as tax jurisdictions crack down on some of the more aggressive practices. Large caps are also facing increasing political scrutiny and regulations from the banking and financial services sector to the pharmaceutical industry and beyond.

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 are very excited about the current environment and future growth opportunities.

We appreciate your continued confidence in us.

The Global Alpha Team