COMMENTARY

October 14, 2016

Investing Environment

Fall is finally here, and with each day we get that much closer to the US presidential election – a topic very much on the minds of investors. Historical trends reveal that when a "change" election seems likely, there is increased volatility in the markets both before and after ballots are cast.

Each candidate will have a different impact on different sectors based on their proposed policies. For example, the health care and financials sectors should benefit under Donald Trump's policy of deregulation, whereas consumer discretionaries and industrials would likely benefit under Clinton. A protectionist Trump could also pressure the employment base and productivity, capital goods and transportation.

Moving to the UK, in September Manufacturing PMI hit its highest level since June 2014. It also appears that the implementation of Brexit will soon be upon us. UK Prime Minister Theresa May has announced that the formal process to leave the EU will be triggered by the end of March 2017. This announcement caused the pound to drop to 1985 levels versus the US dollar. The UK government hopes to retain access to the single market *and* regain control over its borders – a tough sell to EU leaders who don't believe these two objectives can be reconciled.

In Asia, the Bank of Japan (BoJ) announced changes to its monetary policy framework. As investors sought to understand these changes, visits to the bank's website increased so much that the site crashed! In a nutshell, the BoJ kept rates at -0.1% and abandoned its monetary base target, but it will continue to buy long-term Japanese government bonds.

Central banks have cut rates 673 times since the Lehman collapse. A low-yield world is forcing investors to seek income-oriented returns, which is pushing them to overpay for any safe and simple cash flows. This trend is seen across a variety of markets. Valuations of large cap low-volatility stocks and REITs are at multi-decade extremes. Currently, US$11.6 trillion worth of corporate and sovereign debt has a negative yield.

On the positive side, leading economic indicators for many emerging markets have moved into expansion territory, suggesting actions taken by central banks in those markets are beginning to bear fruit. Oil markets also found relief with OPEC agreeing to freeze daily output at 32.5MMbbl. The final plans are anticipated to be laid down by November 30 in Vienna.

Back to Global Small Cap

During the third quarter of 2016, the MSCI World Small Cap Index outperformed the MSCI Large Cap Index. Emerging markets were particularly strong during the quarter with the MSCI Emerging Markets Index outperforming both the MSCI World and the MSCI World Small Cap Index.

In the MSCI World Small Cap Index, information technology was the strongest sector, delivering a return of 14.7%. At the opposite end of the spectrum, utilities was the worst performing sector, returning -1.5% for the quarter.

From a country perspective, Finland and Austria were the best performers during the quarter, with Portugal and Canada lagging in last place. The US delivered high single-digit returns for the quarter.

Performance Highlights

In the third quarter, our Global Small Cap Composite underperformed the broad MSCI World Small Cap index. On a year-to-date basis, our Global Small Cap Composite is trailing the MSCI World Small Cap index by a few basis points.

The highlight 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 was a detractor in our portfolio in 4Q/2015. 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 on 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 on the long-term growth prospects for PRA Group.

Another top contributor for the quarter was Disco, based in Japan. It is a world-leading manufacturer of precision cutting, grinding and polishing equipment used in the semiconductor manufacturing process. In Q3/2016, capital expenditures at semiconductor manufacturers in Asia increased more than expected. Demand in China was particularly strong. As a result, Disco achieved record high sales for a single quarter mainly through sales of dicing blades and grinding wheels.

Our top detractor for the quarter was ATN International. Headquartered in Beverly, Massachusetts, ATN invests, owns and operates telecommunication companies in the US, Bermuda, the Caribbean and Guyana. Additionally, the company recently entered the renewable energy space by providing solar power to corporate, utility and municipal customers in the US and India. The company reported quarterly numbers which were slightly weaker than estimates. 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 market volatility, we have identified a number of new investment opportunities and added three new names to the portfolio, including Cambrex.

With 35 years of active pharmaceutical ingredient (API) development expertise, Cambrex and its 1,200 employees across the USA and Europe are poised to benefit from an important secular outsourcing trend in the pharmaceutical industry. Increased regulation is driving big pharma to outsource production. Currently, 50% of downstream processing of APIs is outsourced, with an estimated market growth of 14%.

Cambrex's capabilities include the manufacturing of difficult-to-make drugs, such as Tysabiri by Biogen and Harvoni by Gilead. Thirty percent of the Company’s revenues are derived from the production of these two drugs. Also, Cambrex has recently graduated to the Tier One list of reputable companies in drug development and stable suppliers of high volume blockbuster drugs. Their ability to navigate the biotech industry, hold a wide US plant base and drive regulatory excellence will continue to favour them in a competitive landscape.

Why do we like the health care sector and Cambrex? The relationship between pharmaceutical companies and API manufacturers is sticky as both are required to be included on regulatory filings. However, manufacturers such as Cambrex are not significantly impacted by swings in drug prices. Manufacturing accounts for a small percentage of the overall cost of a drug, and pharmaceutical companies typically hire up to four manufacturers usually under fixed or inflation-adjusted contracts. Tier One suppliers are also less sensitive to volume fluctuations.

The stock has been on a negative trend lately as prescriptions for Gilead’s Harvoni have decreased following a highly successful launch. Nonetheless, the market for Hepatitis C drugs remains large and underpenetrated. We believe this softness represents a buying opportunity as Cambrex continues to open new facilities, win contracts and complete acquisitions.

Other New Buys and Sells

We also initiated positions in Hemfosa and Opera Software, and we will be profiling these companies in upcoming weekly commentaries. As you may recall, we have been a shareholder of Opera in the past but sold our position after the company received a takeover bid from a Chinese consortium. The regulators, however, thwarted the deal, and the consortium ended up buying only certain parts of Opera’s consumer business for US$600M. If the deal passes regulatory hurdles, we believe that the remaining business will still have significant value. This is the reason we re-initiated a position in July. Opera is one of the largest independent mobile advertising companies in the world. We believe that the company is well positioned to enjoy secular growth in the advertising space.

Our preferred way to exit an investment is either via acquisition or when a holding’s market cap reaches our upper limit. These typically validate our investment thesis. In the third quarter, we exited Poundland when it was acquired. On the other hand, we decided to exit Landec and Stella for better investment opportunities, including those mentioned above, as we constantly seek to upgrade our portfolio with our best ideas.

Outlook

During the third quarter, the Global Alpha team was on the road again doing on-the-ground research. 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 over 200 companies, we didn't see anything to make us change our outlook on the investment landscape. Markets have been volatile, but this has also presented opportunities to acquire quality businesses at a discount to their intrinsic value.

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 a record-breaking M&A environment. Additionally, we continue to see increasing scrutiny of large cap multinationals from a regulatory and tax perspective. Globally, the blended statutory tax rate is roughly 30%, but the aggressive tax practices of large multinationals has resulted in them paying an average of approximately 20% tax. We feel this figure could move higher as tax jurisdictions crack down on some of the more aggressive practices. Large caps in most sectors are also facing increasing regulations and political scrutiny.

Our investments in high-quality companies with defensible business models and strong balance sheets should help 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