COMMENTARY

May 11th, 2010

Dear clients and colleagues,

This week, we would like to talk about the notion of risk. Managing Global Small Cap, we often hear people saying they prefer large caps because it is less risky.

Although long term studies confirm the better "risk-adjusted" returns of small cap, we decided to look at the last 10 years (2000-2009). What we found is quite interesting.

For the past 10 years, global small cap, that is the MSCI World Small Cap index, outperformed the MSCI World 7 out of 10 years. Total value added annualized is 6.4% for the 10 year period.

We decided to look at down years to verify the hypothesis that large cap outperforms small in down markets. In the last 10 years, Global Large Caps were down 5 years. In those years, small cap outperformed 3 out of those 5 years and were even positive 2 out of these 5 years. Total value-added is even higher in down years than up years.

So more risk? We are not sure.

So with the last 10 years being so good for small cap relatively, one could say, time to buy large cap, or I missed it, I should not chase it…

We believe that there are secular factors that might drive Global small cap outperformance in the years ahead. We recently read an article entitled "Trillion-Dollar Pension Crisis Looms Large over America" in the latest issue of Institutional Investor, http://www.institutionalinvestor.com/pensions_and_endowments/Articles/2442415/Trillion-Dollar-Pension-Crisis-Looms-Large-Over-America.html

Essentially, the article describes how large companies will face a huge burden and will have to shift a large portion of their profits and cash flow to fund their pension funds. This has already bankrupted GM. Many smaller companies will not have this obligation and therefore should experience much faster EPS growth.

Another reason in our opinion is the important weight of large banks in the MSCI World Large Cap (21%) and how they might potentially be impacted longer term by the financial crisis as well as the impact of future financial reforms.

On another subject, we would like to describe the latest company we added in the portfolio. NBTY, one of the World's largest vitamin and nutritional supplements company.

Business Description

NBTY, Inc. is a leading global vertically integrated manufacturer, marketer and retailer of a broad line of high quality, value priced nutritional supplements in the United States and throughout the world. They market approximately 25,000 products under numerous brands, including Nature's Bounty, Vitamin World, Puritan's Pride, Holland & Barrett, Rexall, Osteo Bi-Flex, Sundown, MET-Rx, Le Naturiste, Ester-C, etc.

Market Data

NTY US: $34.80. Market cap: US$2209M, LTM Sales: $2789M 5-yr sales CAGR 9.3%, p/e (2010) 9.4x, roe 19.6%, ev/t12 sales 0.8x, ev/t12 ebitda 5.4x, gross margin 45.4%, operating margin 13.9%, profit margin 8.3%, 1-year return 34%, www.nbty.com

Target Market

The nutritional supplements market is worth over US$75B, and grows at more than 10% annually, according to analysts. Developed markets growth is driven by aging demographics and emerging markets exponential growth is driven by increased awareness of health benefits.

Competitive Advantages

- Vertically integrated: The company manufactures over 90% of its products.
- Product diversification and innovation: over 25 000 different products.
- Diversified channel of distribution, Wal-Mart is around 18% of revenues. The company is #1 or #2 at all major retailers and drugstores in the US.
- Own brands and white label
- Retail network of over 1 500 stores in the US (Vitamin World and Nutrition Warehouse), Canada (Le Naturiste), the UK (Holland&Barrett, Julian Graves, GNC), etc.
- No 1 international web site for supplements, www.puritanpride.com

Competition

The supplement market is very competitive and fragmented. The company competes with some of its customers such as Wal-Mart and Walgreen, other competitors include Herbalife, Usana, etc.

Growth Strategy

The company has a distribution strategy, expanding geographically and in new channels. It is using its scale and vertical integration as competitive advantages.

Management

Average tenure of senior management is 16 years. And average tenure for the Board is 21 years. They own 7% of the outstanding shares.

Risks

- Customer concentration. Wal-Mart is 18% of sales
- Quality control risk.
- Soft demand due to economic slowdown.

Investment Theme

We like NBTY for its exposure to demographics and increased awareness of the importance of a healthy diet. The market is growing at close to 10% a year and the company is growing even faster. Emerging markets also represent an interesting opportunity.

Valuation

Target price = US$74, using DCF model at growth rate of 9% for 9 years, 6% at maturity, and risk premium of 8%. The company at 5x ebitda is an extremely attractive acquisition target for a financial buyer but also for a large pharma interested in more consumer otc products.

Have a good week.

The Global Alpha Team