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Gaining an Edge in International Small Caps

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A relentless pursuit of unappreciated and under-valued companies in Europe and Asia aims to provide long-term growth.

Investors are always looking for an edge, and small caps are frequently an area they turn to for potential outperformance. The search for that edge often leads beyond established markets and large caps, and in the case of Mackenzie Investments includes a strategy dedicated to international small caps (excluding North America). Members of the European and International Equities team at the firm tend to have considerable tenure in the space and a genuine passion for investing in small cap stocks. The strong investment team has boots on the ground in its areas of focus, and II recently spoke to two of its leaders, Martin Fahey, Senior Portfolio Manager, Team Lead, based in Dublin, Ireland, and Bryan Mattei, Portfolio Manager, based in Hong Kong.

What's the upside of an international small cap strategy that excludes North America?

Martin Fahey: There's a very large and distinct universe of small cap companies in Europe and Asian markets, and they tend to be more diversified by country and by region — and a bit more exposed to other countries and regions — compared to North American small caps. And we have specialist regional expertise that benefits investors because each market has its own unique characteristics.

How do you see investors using international small caps in their overall portfolios?

Bryan Mattei: Many investors have a small allocation to international small cap equities through global equity mandates where these stocks are underrepresented, and we think that makes sense because the risk-return profile has been favorable — over the last twenty years, international equity small caps have generated superior risk-adjusted returns compared to their large cap counterparts.

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— Martin Fahey, Senior Portfolio Manager, Team Lead, Mackenzie Investments

A big part of your investment philosophy revolves around identifying companies that are overlooked and under-loved by investors, and that have favorable return profiles and a sustainable competitive advantage. You're not the only asset managers looking across the landscape for those companies, of course — so what is your competitive advantage in that sense?

Fahey: For starters, we've been at it a long time. The track record of this strategy goes back to 2002, and personally I've been looking at small caps in Europe for more than 20 years. Bryan has been looking at Asian stocks for a considerable period of time as well. That's complemented by our people on the ground in Europe and Asia, so we can meet with about 500 companies every year, some of which we meet with two or three times in a given year. We spend a lot of time with companies to understand the management in great depth and what drives their business. We use financial metrics to assess the performance of the business. For example, one of the key metrics we look at is returns on invested capital. We like companies that have reasonably high returns on invested capital — or at least a realistic pathway to higher returns — and that also have appropriate balance sheets relative to their business models, and with reasonable liquidity. One of the ways we separate the wheat from the chaff is that we exclude companies that might optically have low price-to-book ratios but will also have low returns.

Of those 500 companies, how many of those names are on what you might call a watch list as opposed to being currently in your portfolio?

Mattei: Ours is a bottom-up fundamental strategy. We run a portfolio of between 70 and 100 names at any time, and maintain a deep watch list of companies that we think have unique business models or a sustainable competitive advantage, but that aren't currently trading at valuations that allow for upside. The analysts and the portfolio managers in the relevant regions follow these companies based on country or sector expertise, and we regularly review whether each merits inclusion in the portfolio.

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— Bryan Mattei, Portfolio Manager, Mackenzie Investments

Do the analysts specialize by region or business sector, or a combination of the two?

Mattei: It's a hybrid approach. For example, on a sector basis, we have specialist expertise in financials and technology, which require a unique type of analysis or have very integrated cross-border supply chains. On the other hand, some markets which are fairly homogenous, such as Japan, Hong Kong and China, or Australia, for example, are better covered by a country specialist. Having Japanese, Cantonese, and Mandarin language skills on the team is an advantage in these markets, particularly given the emphasis we place on company interaction. A hybrid model with some flexibility like I'm describing fits well into our investment process.

Fahey: We're flexible in the sense that we utilize our resources to get the optimum output. For example, we have a fluent German and Austrian speaker on our team, and that person helps with our analysis of the German, Austrian, and Swiss markets. One of the other team members is fluent in Finnish and Danish, and therefore covers Nordic markets, among others. At the same time, we have people who look at sectors where it makes sense.

Mattei: In terms of the investment process, it's a huge advantage to have regional teams entirely focused on small caps in their region. This allows us to collaborate to form a portfolio of our best bottom-up ideas with deep underlying research in respective regions.

You mentioned a very large number of meetings with companies. What value do you and ultimately investors derive from those meetings? And what is your approach in them?

Fahey: As I mentioned, we've been looking at international small caps for a long time now, and over the years we've created a tremendous knowledge base about what a company does, how the management thinks and acts, the company culture, and its strategy. That's important because all companies approach things in different ways. Some companies tend to always be conservative in their guidance and their outlook, but at the same time they tend to exceed their original expectations or their guidance. We tend to like companies that are conservative in that context — not just in terms of their outlook, but how they manage their business. In other cases, we'll encounter management that is outright and overly bullish, and that tends to lead to disappointment. That knowledge only comes with the experience of meeting with companies.

When we meet with management we spend a reasonable amount of time going through their strategy, the way they think, the competitive outlook — but we're also focusing on financial details as well. Maybe the company has a few different business divisions, and maybe management is reticent to reveal what the margins are in certain divisions. For example, if one of a highly profitable division's major customers is a government, they might put that division within a bigger division because they don't want to show the extent to which it is profitable. That's the kind of detail we're examining to properly assess the risks of the company, and have a clear picture of off-balance sheet items.

Mattei: It's also important to remember that many small caps in some parts of Europe, and particularly in Asia, provide the bare bones in their public disclosures — they have fairly poor disclosure requirements, and limited English disclosure practices. When you sit down with them you can dig beyond what the limited public evidence tells you. The history of the company and its management, and really understanding the industry environment are not things you learn from looking at their website, annual report, or regulatory filings. In addition, many of these companies often have limited investor relations functions — the executives don't travel, you have to go to them, and they can be in remote areas. And it's not as if you'll see them at a conference — they are too busy running the business. Because we have a footprint in many places where our competitors don't — or at least a deeper footprint — that gives us an advantage in securing these invaluable meetings.

You also look for investment themes that go a little deeper than the usual suspects. How does your regional/local presence help those themes come to light?

Fahey: We do try to look beyond the obvious for what we might call emerging themes. Historically, for example, rail was considered a low-growth industry, but in recent years in Europe rail traffic is really starting to grow again, while internal airline traffic is starting to decline, particularly in Scandinavia and Germany.

All of this is somewhat related to ESG, so we've been tracking for example, Alstom, which historically was a conglomerate company that had exposure to a problematic division in gas turbines. We always felt the rail business within Alstom was a good one, and once they agreed to sell their problematic turbine business to G.E. about five years ago, we invested in Alstom — but we had been monitoring what we thought was a positive trend within rail. Alstom had been growing its order backlog for close to 10% for 10 years, but the market never really gave them any credit for that. That's an example where we picked up on a theme early, and also something that had been historically negative and turned positive.

The video gaming theme has become really important, too, as people spend more money on games than they do going to the movies or watching TV. We have two companies in that area — one that makes video games, and another that is one of the world leaders in peripherals for people who play games.

Mattei: In Asia, Japan has a significant demographic challenge with its aging population. We look at ways to benefit from aging societies where there are pockets of growth in consumption, and we keep an eye on industrial automation and outsourcing, which are ultimately solutions to a demographic problem. In Japan's case, too, inbound tourism trends have been of interest, particularly from China and, until recently, Korea.

Fahey: A final thought on themes is that it's important to get into the details. For example, if you took the view 10 years ago that you want to be exposed to solar power, which seemed like a growth area — and it is — you needed to look very closely at the companies that supplied the solar industry. We started considering solar as a theme by looking at the dynamics of the industry structure and ended up with a view that we didn't like many of the suppliers to the industry.

You mentioned ESG, which is a major concern for many investors, in Europe in particular. How do you incorporate ESG into your strategy?

Fahey: It's integrated into our strategy. We do a thorough review of all the stocks in the portfolio, and there are no serious ESG issues with any of our companies. We have a formal ESG rating for each stock in the portfolio. We've always engaged with our companies from a corporate governance perspective, and we're increasingly looking at companies both from a positive and negative perspective environmentally and socially.

In the end, after all the meetings and research, you have to construct a portfolio. Is there a particular elegance or nuance to assembling the whole of the parts?

Mattei: Ultimately, we're trying to maximize exposure to where we think we have an edge. We do that through bottom-up fundamental idea generation, while at the same time minimizing unintended risks and large factor bets where we don't have an edge. If you look at the risk analytics of the portfolio over the long term, greater than 80% of our active risk is from stock selection rather than factors like style, country or sector calls. That is related to the guardrails we have in place for portfolio construction — for example, country and sector bets can't be more than 10% above the benchmark, single stocks can’t be more than 3% position sizes, and so on. That forces us to focus on generating good bottom-up ideas rather than taking outsized risks with country or sector calls.

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