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EP 116 | Playing the plan: Mawer's global small cap portfolio

Disclaimer (00:25):

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Andrew Johnson (00:40):

All right, Playing the Plan: Global small cap, and we have Karan Phadke joining us today, co-manager for the portfolio. Karan, let's jump right in. 2022 has been, well, it's been quite something. And that's following several years now of seemingly heightened uncertainty—whether it's been the pandemic, inflation story, interest rates, geopolitical turmoil. And then of course, all of the volatility that that brings to the stock market itself.

Our listeners, I think, have a pretty good grasp with the broad strokes of what's happening out there so I'll kick things off more in the direction of what we can do about it and how we can deal with all of this uncertainty. And as you know, we often talk about preparing and not predicting, so, what does that mean to you and what are some of the practical ways that help you and the team prepare the portfolio for multiple scenarios?

Karan Phadke (01:28):

Hey Andrew. So, yes, that's a good question. I think to me, it means building a resilient portfolio that can preserve and grow client capital in the fullness of time and across a wide range of scenarios. Sometimes the weather forecast might look stormy, people think there's a chance of rain, but instead of staying indoors all day in fear or going out in a swimsuit, for example, an easy thing to do is just carry an umbrella.

So in more practical terms, from an investment standpoint, it's really about having contradictions in the portfolio and staying balanced. So what does that mean? A couple examples would be being globally diversified, keeping the fund liquid, owning companies that fit the philosophy across sectors and in all parts of that quality return spectrum or "The Matrix" as we call it here at Mawer.

None of these individually are rely[ing] on predicting the direction of interest rates or geopolitical conflicts, for example. They're all pretty sensible things to do in most scenarios. So, to be robust, you really have to avoid any sharp concentrations in any single dimension, because that's what stops all the compounding from happening if you go back to zero.

So again, the key to emphasize here is that resilience doesn't mean that the portfolio will outperform in every scenario, but rather that it can survive any scenario. And that gives you time for the odds to land in your favour.

Andrew Johnson (02:49):

Good overview. I'm assuming here that being a global portfolio, that's helpful in this context because you may have more stones to turn over maybe more places to allocate capital. How does all of that factor in?

Karan Phadke (03:01):

Yes, so being global definitely helps because as you alluded to, it just gives you more options. And a big part about playing defense is actually having options and not getting stuck with the existing positions you're in because you have somewhere else to go to. Another rock to turnover over, I guess. Being global, not only from a diversification standpoint is helpful, on the defense side, but even on the offensive side. It just gives you more opportunities to make money.

Andrew Johnson (03:25):

One observation that some clients have made and others throughout this most recent period is that small caps in general, have performed worse than large caps. Can you talk about why small caps perform differently, and the role that maybe they play in a larger, diversified long-term portfolio?

Karan Phadke (03:43):

Yeah, so I'd lean on an analogy that my colleague Christian uses about risk and liquidity. So, if you take a moment and just imagine sort of an island, a nice sunny island in the middle of the ocean with a big mountain in the middle and think slowly of just the tide rising. In your mind's eye, you can see the water is starting to flood the shores. Maybe the beach house is next, and then slowly move up the mountain.

So, I think you can think about risk and money flowing into or out of asset classes in the same fashion. At the top of the mountain, that's the safest—or what people perceive to be the safest, at least. And that would be maybe U.S. treasuries or perhaps blue-chip large caps. People feel safe in these; the waves of fear don't hit this part of the island first.

On the other end, right at the shore, is maybe micro caps in emerging markets. And that's where investors only go when they're feeling really brave. So in that context, you could hypothesize that small caps are lower down on that island. They feel more of the pain and they feel it earlier when appetite for risk dries up.

As to small caps versus large caps, I don't have a strong view on which one outperforms because really, it depends on the starting and ending point you pick. But at the end of the day, I would say that small caps do zig and zag a little bit differently to large caps. And there is also more potential to find a big difference between the winners and losers. So dispersion, I believe is the term for it. And that can create a lot of value when you add it into a broader allocation.

Andrew Johnson (05:08):

What are some of the specific factors that may provide those different ways that a small cap would zig and zag versus a large cap?

Karan Phadke (05:17):

Yeah, so the way you think about it is that a large cap typically, just given their scale, they're a bit more diversified across the economy. So maybe they aren't as affected by idiosyncratic factors and they more flow with whatever the industry or the end market is doing, just because they are kind of the end market in a way. Whereas a small cap, again, much smaller; and management might have more influence over moving the ship. It's more like a nimble little life craft as opposed to a tanker. So again, they may feel the effects of the broader end market even more severely, or they may feel it much less because they have a lot of opportunity to take market share, control their own destiny.

So again, not only from a liquidity standpoint would they move differently, but also from a fundamental standpoint they can move quite differently sometimes to what the end market is doing.

Andrew Johnson (06:05):

And I assume small caps, generally speaking, just have less eyes on them as well, so there's perhaps a more of an opportunity to find pricing discrepancies with them.

Karan Phadke (06:14):

That would be the hypothesis, yes, but I think it varies a lot again, by country. So in the U.S., you may have a lot of people looking at small caps, for example. Whereas in another part of the world, you may have less people looking at it. At the end of the day, though, the first filters we use is just the philosophy. So, is it a wealth-creating business, run by an excellent management team, and then that final piece—a discount to intrinsic value—that will be engaged to measure whether there's a lot of people looking at it or not.

Andrew Johnson (06:42):

Just to shift gears slightly and look at our portfolio specifically, it has been behind the benchmark. And I guess a lot of clients are asking, is there anything specific that you see as a portfolio manager to tell you why our holdings may not be performing in line or better than the market more recently?

Karan Phadke (06:59):

Yeah, you're right, Andrew. So, performance on a relative basis especially has not been impressive. And clients may also be surprised to find that their fund hasn't held up as well in a period of weakness, relative to the past where it has been more defensive. So it's not always easy to pinpoint exactly why we're performing differently to an index. I think, it's fair to say that our investment style has been somewhat less popular of late, so that's definitely a contributing factor.

Generally speaking, if you look at all the funds out there that perhaps own higher quality stocks that sometimes come with a higher rating or multiple, they've faced more headwinds than usual. I think COVID introduced a lot of uncertainty and the market continues to grapple with this. And when things are most uncertain, we all have a tendency to herd from one safe place to the next, just to avoid the pain. And we've seen this a lot with the market seeming to swing from one topic du jour to the next. So, whether that was cyclicals right after the vaccine announcement, to commodities more recently on inflation fears.

Karan Phadke:

That being said, I think some of these basic economic principles in our investment philosophy should bear fruit over time. And we've been pretty reluctant to chase the next hot theme. That context or that backdrop being said, it is fair to say that in hindsight, we could have been just quicker to trim on the more expensive names in the fund. So, while we had been bringing down the average multiple of the portfolio for over three years now—so, this is something that we've been doing for a while, not just recently—it really wasn't fast enough. And partly because every time in the past we trimmed an expensive name, it just got more expensive. So behaviourally it was quite painful to follow through on.

So, while we've sharpened our pencil with regards to just valuation discipline, I think it's important to also talk about some of the things that haven't changed. The most important one is just cultivating a culture with high levels of trust and candour, [an] investment philosophy that makes economic sense over time, and then continued execution of a repeatable investment process. So I'm pretty optimistic about the fund over the next five years. My story is that the portfolio has lots of companies that generate superior returns on capital, run by excellent, often owner-run management teams, and have now traded an average multiple that's in line with the market despite being better quality in our view. In our view, again, that sort of setup is akin to what we're always looking for, which is a bargain.

Andrew Johnson (09:17):

You mentioned that trimming some of those more expensive names was behaviourally difficult to deal with. And then you also mentioned continuing investment into culture and building trust. Can you expand on all of that and how you and the team recognize and deal with the behavioural aspects of portfolio management?

Karan Phadke (09:35):

Yeah, so I think the behavioural aspects are often overlooked. At the end of the day, whether you're following a more quantitative approach or even a more discretionary one, like ours, it's people that are making the decisions. People are deciding what data goes into it, people are deciding what evidence to overweight or underweight, and people are deciding what to do about that. And as soon as you involve people, you involve emotions. So that's a big part of why we have a process. It's to really be, number one, aware of the emotions that we're feeling. And then number two, try to reduce that bias and get to the correct or more correct answer so that over time, the odds are in our favour.

So, as you alluded to, there's these economic principles of...look, it's not just about having a good business, it's about having a good price and that's what makes a good investment. And while we are aware of that and we definitely kept that back of mind, the other side of it is that the market was rewarding stocks that were expensive and they would keep going up more. So, you have to balance those two. On the one hand, there's like an economic truth that's evident. But that can be over [a] 5, 10, 20-year period. And on the other hand, you're getting instant feedback from the market on whether you've been right or wrong. And that's really where the culture comes in. And that's where having experience from different teammates is helpful, too. So Christian, as an example, the lead manager—he's been in this market for 20+ years. So he's seen this go around before and having that oversight was really helpful because it pulls you back and say, "Hey, this has happened before let's not get carried away". So again, I think it is something we were aware of, something that we were doing. We were actively switching into names that were cheaper. But again, in hindsight, it's easy to say that you could have done it quicker.

Andrew Johnson (11:20):

Thanks for that. And I just want to keep building on this topic of performance: generally speaking, when you reflect on things in the most recent period, has there been anything that has surprised you either negatively or positively within the portfolio so far this year?

Karan Phadke (11:34):

Yeah, I think the one area where I continue to be surprised with is just businesses that sell scarce skills. I think Warren Buffet in a recent interview said that "the best hedge against inflation is having a skillset that people want and need." Maybe the second-best way to do that is to own shares in companies that provide this sort of skillset. So, many of the service providers we own—whether that's accounting firm, CBIZ, or payroll service provider, Insperity, or even some IT consultants—they've done really well in a tight labour market by selling skills to customers that need them. The immediate response or first-level thinking might be that, hey, if you have a lot of labour in your COS space, then inflation is bad, and your margins will get squeezed. And that's true—unless you're actually directly selling the labour of the talent. In that case, you actually benefit from some nice pricing power because you control a scarce resource or skillset that customers want.

Andrew Johnson (12:30):

Can you talk a little bit more? You mentioned two of those names. So I think it was CBIZ and Insperity. Talk more about specifically what their businesses do and give a little bit more colour on how they may be doing well in this environment as you just alluded to.

Karan Phadke (12:42):

Yeah, so CBIZ [is] pretty straightforward. The bulk of their business is audit and tax services for mid-market businesses. So, for example if you're Mawer, let's say, or if you're some other small mid-market company in the Midwest in the U.S., typically, you're going to need an accountant to file all your taxes to audit your financial statements. And you could go with the Big Four, but they could be pretty expensive, they may not have a lot of "in-person feel" or strong relationships in your smaller town. So perhaps you won't choose them. Or you could go with a mom-and-pop accounting provider, but they just won't have the scale or necessarily the expertise to pull from all around the country to do some of your work.

So that's where CBIZ fits in, they're a mid-market player. They sit in the middle of those and really, they're providing a mission critical service. You have to do your taxes or you get in a lot of trouble; you have to get your financial statements audited, and there's just no ways about it. Having that skillset and those relationships really helps them deliver value for clients and then price for it so that they get their fair share too. So that's CBIZ.

Karan Phadke:

Insperity—so this is also a U.S. company—it's a little bit unique. One of the unique aspects of the U.S. is that the healthcare system is pretty tricky to navigate, especially if you're a smaller business, an employer and you have to do payroll, you also have to figure out health insurance and just all of the administrative stuff that goes along with that. It's just a big headache. Wouldn't it be easier if you could just outsource that and just pay a service provider a fixed fee per month that you negotiate on? And then you still have the employee, you still do everything you need to, but all of that headache is with someone else. So that's what Insperity does, they're a[n] outsource services provider, doing payroll, health insurance, things of that nature.

And again, they're providing the administrative skill set both in terms of people as well as technology to make the lives of small business owners a lot easier. And they've been benefitting too in this period because again, it's something that employers particularly want in a tight labour market, and it's a skillset that frankly they don't want to have to do themselves—they'd rather use someone else. So that would be in Insperity.

Andrew Johnson (14:48):

Both great examples of trying to find a scarce resource that's in high demand, and obviously there's more to it in terms of finding a good management team to run those types of businesses as well.

I just want to shift gears over into more of a portfolio construction conversation. And one other observation when looking at portfolio from a top-down perspective at least, is that there's an overweight to stocks in Europe versus U.S., for example. And one of the questions and discussions that comes up in client meetings, or even internal meetings with us is that just given the more challenging situation that Europe appears to be in—whether that's higher inflation than here, or gas prices that are staying higher—those may hurt consumers more than in the U.S. What's your take on the strength of the end markets of our European holdings?

Karan Phadke (15:36):

You're right. So, we do own more in Europe relative to the index, unless in the U.S. And it does certainly seem that the dominance of the U.S. economy, particularly on relative terms, has continued. It's definitely a portfolio exposure that we do think of. On the other hand, it's important to note that as investors, as owners, we're not buying Europe, we're not buying the U.S., we're buying companies that might be located in those regions. Some might say, "that's just semantics," but it is an important distinction. I think individual companies, they could be headquartered in a specific country, but they sell globally. Or they may sell to a specific end market within a country that's essential and can't be avoided whether or not there's a severe macroeconomic shock.

Karan Phadke:

As an example, we own RS Group. This is a UK-listed distributor of how to find electrical and industrial components. Two thirds of their business sits in Europe, but despite this, they continue to grow their economic profits quite strongly. So you might be wondering why is that? Well, because they help clients find small items like a resistor let's say, or a display, or perhaps even a surge protector that they urgently need when something in the factory breaks, as an example. So their average ticket is less than a hundred dollars and it can be delivered in under 24 hours when the customer needs it most. This sort of criticality and convenience ensures that market leaders like RS, they'll find ways to make money because they're doing something really valuable for their end customer—even if the broader economic backdrop is weak.

So again, you're right that the end markets in Europe probably are facing more headwinds. It seems like today than other parts of the world. But at the end of the day, it really does come down to the business model itself, how important it is, how much value it adds to the customer, and then the management team and the actions that they take. And that, in our view over the long run, will swamp some of these macroeconomic shocks.

Andrew Johnson (17:31):

Yeah, that certainly strikes me as a great example of the type of business that we're looking to hold for the long term and benefit from that compounding over a long time period. And it's also a good segue into the last topic that I wanted to touch on, which is security selection in particular, and how you're preparing the portfolio moving forward. You've mentioned CBIZ, we've talked about Insperity, you just talked about RS group. Are there any other holdings that come to mind that can illustrate the types of businesses that we're looking for out there in the global small cap universe?

Karan Phadke (18:00):

Yeah, maybe another fun one to chat about here is a more recent edition over the past year. It's a company by the name of Synsam, so I may make some puns here because it's an eyewear retailer based in Sweden, so you'll have to bear with me.

At its face, it's a pretty straightforward business: eyewear retail, so glasses, sunglasses, contacts. And in our experience, this business model does pretty well around the world because there are some regulations around who can test and prescribe glasses, which means that companies need the financial standing to attract and train highly paid optometrists. And there's also a medical element here, so it creates a book of customers which forms repeat relationships. (Some things often lacking in just general retail.) So again, the business model benefits from stable demand, people need to see through thick and thin, and the base rate is pretty good just for the business model.

I think Synsam is interesting because it takes a step further, since half their business comes from a subscription plan where the customer can mix and match three or more different glasses and sunglasses, and just pay monthly with the option to swap out a pair every year. So, customers seem to find this [a] great value, and the company benefits from more revenue that's very high visibility, no pun intended [laughs].

Synsam—they're already the market leader, but with this program they're growing their share even further because it is actually pretty tricky to build a subscription service. It's harder than it looks. So the current management team, they're the architects of the concept and they're also shareholders alongside us, which we quite like. The alignment. And the valuation in our view looks pretty attractive because the trades add or below market multiple and could generate double digit IRRs looking ahead.

So, overall it fits nicely into the portfolio, it's a resilient business, it has good upside, and it's not a direct bet on what commodities are going to do or what Putin is going to do with Russia and Ukraine. And it's a pretty resilient business; people continue to need this. They're a market leader, they do something unique and scarce, and they're run by an aligned management team, trading at a discount to intrinsic value. So that's Synsam.

Andrew Johnson (20:02):

Excellent. Yeah, that's a great example of also focusing on what we can control, which is sticking to our philosophy, as you just outlined, understanding the fundamentals of the business, and finding a long-term spot for it in the portfolio. And obviously, keeping an eye on it as we move forward, (no pun intended [laugh]). It's also a great place to wrap things up. As always Karan, thanks for joining us, we really appreciate your time.

Karan Phadke (20:25):

Great, I enjoyed the chat.