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“We now live in a world where information is potentially unlimited. Information is cheap, but meaning is expensive.”

- George Dyson, technology historian

On Sunday, October 18, 1987, I was enjoying a late birthday celebration with my family. The next day, our investment team huddled around various transistor radios (back then, computers were used only for Lotus 123), as the stock market suffered its worst day ever. Our young team had successfully shepherded nervous clients through the previous week's 10% decline but, to us, “Black Monday” was quite terrifying.

The S&P 500 Index fell 21% that day while the Dow dropped 23%, far exceeding Black Monday October 28, 1929, the onset of the Great Depression (for Canadian readers, the TSE Composite fell 17.3% through Oct 20, 1987). Thirty-seven years later, there is still precious little evidence to support any of the theories or claims on why the collapse occurred.

For most of its existence the investment business has been driven by information. Those who had it hoarded and guarded it. They tended to dominate the markets too, because good information could be so very hard to come by. But the inevitable march of time, alongside the growth and development of information technology, has changed the nature of investing dramatically. Statistical information is now available to everyone instantaneously and is no longer a competitive advantage.

Success is now driven by analysis – or, as noted in Dyson's quote above, “meaning”. It is also driven by investor behavior, but that's a topic for another day.

Howard Marks' concept of second-level thinking is particularly pertinent with respect to small cap analysis. It emphasizes the need to go beyond surface-level evaluations based on widely available information. Instead, successful investing demands a deeper dive into the intricacies of smaller companies. This involves understanding not just the financial metrics but also the qualitative aspects such as management quality, industry dynamics, competitive positioning, and potential growth catalysts.

One of the common misconceptions in investing is the emphasis on “reasonable value.” Valuation is inherently inexact, but a reasonable sense of value is important in the

initial purchase, and ongoing maintenance, of any investment. A longer thread of financial information can be discerned from larger, more mature companies thus lending themselves to a more definitive sense of valuation. However, successful small cap investing is more about identifying companies with the potential for sustaining long-term value creation through consistent and scalable cash flow generation.

Moreover, as we've written many times in the past, the role of management cannot be overstated in small cap investing. Analyzing management decisions, their track record, their alignment with shareholder interests, and their strategic vision for the company is paramount. Experienced and capable management teams can navigate challenges, capitalize on opportunities, and create significant shareholder value over time that cannot be determined by simply studying the financial statements.

Another unique aspect of small cap investing is understanding the industry dynamics and market positioning of the companies in question. Industries evolve, trends emerge, and competitive landscapes shift. Conducting thorough industry analysis helps identify secular growth trends, competitive advantages, and potential risks that could impact long-term investment outcomes.

Assessing the risk-return dynamics constitutes a pivotal aspect of investment analysis, particularly within the small cap domain. While diversification plays a role in mitigating company-specific risks and sectoral fluctuations, significant emphasis must be placed on the concept of “persistence” in managing risk within small cap investments. Persistence refers to the enduring success of a business, which in turn fosters increased investor conviction. Moreover, persistence, characterized by sustained financial performance, enhances stability and supports continuing success over a long-term investment horizon.

Small cap investing demands a multidimensional approach to analysis – the “meaning” truly is expensive. It's about going beyond surface-level metrics and delving deep into company fundamentals. This depth of analysis not only enhances the investment decision-making process but also positions the portfolio to capture the unique opportunities and potential rewards offered by the dynamic world of smaller companies.