

## MONTHLY COMMENTARY | OCTOBER 2020

*"The ideal business is one that earns very high returns on capital and that keeps using lots of capital at those high returns. Those become compounding machines."*

- Warren Buffett

In a recent consultant conversation, I wondered why Canadian investors had shied away from small cap strategies over the past half-decade. Three reasons, I was informed: the general move away from public markets led institutional investors to private equity investments over public small caps; performance of small cap strategies relative to large caps; and, the ability to hire "all-cap" investment managers to participate in small cap stocks as part of an overall investment strategy.

Over time, small cap investing has typically outperformed for a variety of reasons: better structural growth prospects compared to large cap companies; with an inefficient asset class, the ability for high active share as the universe is so large; and, strong regional diversification as small cap businesses tend to adapt more quickly to market confluences. In North America, given the narrow index construction, periods of outperformance by small cap vary – in international stocks, given the larger opportunity set, outperformance is consistent.

Of course, the larger opportunity set provides a diverse array of manager "styles", leading to a wide dispersion in manager returns. Given the very strong markets supported by loose financial conditions (following the global financial crisis), the return dispersion has narrowed. However, the expected weak economic outlook post-pandemic, combined with political and social risk, will create an environment that will, once again, widen return dispersion.

As to hiring "all-cap" managers, we contend this jeopardizes long-term allocations to the more growth-oriented small cap universe. An extensive research effort is crucial in analyzing small and mid-capitalization companies - they are underfollowed, have fewer resources and frequently less sophistication with regard to controls and procedures. Therefore, deep fundamental research and careful stock selection will create the potential for excellent long-term returns. This is very different than managing mature large

cap stocks, where yield and valuation is much more paramount than future growth.

Further, small cap managers impose constraints on the amount of assets undertaken with a particular strategy to ensure adequate liquidity. As an "all-cap" manager experiences success and assets under management ("AUM") grow, their bias will drift to larger capitalization stocks allowing AUM to expand in the strategy. The investor will then, over time, likely experience a very different portfolio than what was originally purchased.

Finally, why would an investor choose a public small cap investing over private equity? Private equity investing is typically a transformational, active investment strategy ranging from simple seed capitalization to replacement capital in small or micro-cap private businesses. Ultimately the goal is a buyout at a higher valuation. While broadly accepted as an established alternative asset class within many institutional portfolios, there are considerable trade-offs: assets are illiquid for very long periods which may, or may not, fit the cash flow requirement of the investor; investors must forsake a lot of potential upside for high fees; there is limited transparency to the underlying holdings; and, most important, private equity managers have been held hostage by their own success – rising cash levels from investors have created an environment with a greater number of private equity companies chasing fewer opportunities, leading to higher valuations and lower potential returns for the investors.

We contend that a dedicated small cap allocation provides better opportunities to garner alpha for the investor. While such a strategy must be capped in size, the investor can adjust a defined allocation to meet needs in specific periods of the cycle.

With the recent addition of our fourth strategy, international small cap, Laurus is now truly a specialized global small cap investment firm. The global universe of small cap stocks is large and relatively under-researched - our deep, fundamental process, refined over decades, focuses on the nuances necessary to be successful in small cap investing.