Laurus
INVESTMENT COUNSEL

GLOBAL SMALL CAP SPECIALISTS

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"It's not whether you're right or wrong that's important, but how much money you make when you're right and how much you lose when you're wrong." *– George Soros*

We are frequently asked why the average market capitalization of our small cap portfolio is "so high". And our equally-frequent response is that, being long-term investors, some of our small cap investments have grown to be mid cap investments. If their growth and competitive positioning has not changed, why should we sell?

Mid cap stocks are generally valued between $2 billion and $10 billion market capitalization. We believe this range to be too wide but, regardless of definition, it's an area that is widely disregarded between the well-known, headline-news large cap companies and the high-growth-potential, lesser-known small cap companies.

To paraphrase an old children's story, at one end of the investment spectrum are the well-established large cap stocks which are more likely to pay dividends and typically exhibit more limited growth potential along with lower volatility. Hmm, that group is too cold. At the other end of the spectrum are small cap stocks with high growth rates but also much higher volatility. Ouch, that group is too hot.

But the third bowl of porridge – mid cap equities – are small enough to have relatively high growth rates but mature enough to have proven business plans. Yes, just right. Mid-caps have had an impressive run over the past couple of decades and deserve a continued presence in a portfolio, where they may help boost return and lower risk. This belies the traditional belief that owning stocks in the large and small categories gives investors sufficient exposure across the spectrum.

Because mid-cap equities are relatively overlooked in the market, they offer significant opportunities for active portfolio managers to add value. Similar to small cap stocks, mid-size companies generally receive less research coverage than the large caps. Our experience has shown that small cap stocks growing to mid-cap size, do not necessarily attract greater research coverage. Like small cap stocks, these holdings remain less-followed and therefore provide a value-added opportunity for active managers.

As we've written many times before, one of the key investment themes in today's investment environment is innovation and disruption. At times of heightened innovation and disruption, such as today's technology-fueled wave, companies can rapidly increase in value, leading to multi-year outperformance.

However, disruption generally involves a business strategy of heavy upfront investing, which can initially obscure long-term profitability. Combined with the fact that today, many disruptive companies are staying private longer and may implement their IPO as a mid cap or larger company, it requires extra focus on identifying the start of such cycles to take advantage of opportunities.

In the case of our current portfolios, the present weighting in the mid-capitalization holdings offers a unique opportunity. Beginning as an initial investment as a small cap business has allowed us time to better understand the quality and attributes of the company leading to deeper conviction and subsequently higher portfolio weight. And, our philosophy of owning high quality businesses ensures the underlying fundamental characteristics will lead to greater risk-adjusted returns.

Make no mistake, our weight in mid-cap stocks is by design and represents our comfort with their present position in their "life cycle" – in short, small cap companies that have succeeded. Because they have survived the small-cap phase, mid caps are in a position to benefit from enhanced access to the capital markets, potentially giving them a financial advantage over small caps. Compared to large-cap companies, mid caps are often in the growth phase of the business life cycle where they may be experiencing higher cash flows and earnings growth rates. And yet they are sufficiently small enough to adapt easily to changes in their industry.

As long-term investors, we would expect many of our existing holdings to eventually reach the mid-cap stage and ultimately require us to find replacement holdings within the small cap spectrum. It stands to reason that our small cap portfolio would, at any given time, include a number of holdings that have attained mid-cap market valuations.

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