

# Four major lessons from two decades managing small cap portfolios

## AN INTERVIEW WITH INVESTORS MUTUAL'S SENIOR PORTFOLIO MANAGER SIMON CONN

At its recent 2017 Fund Manager of the Year Awards, Morningstar awarded Investors Mutual the prestigious Domestic Equities Small Cap Fund Manager of the Year award, citing IML's ability to deliver consistently excellent results in a variety of conditions.

IML has been running Small Cap strategies alongside its flagship Australian Share Fund since the firm began in 1998, marking nearly two decades of small cap investing. Simon Conn is the Senior Portfolio Manager for IML's small and mid-cap funds. He is supported by IML's equity analyst team who are based in Sydney and whose responsibility it is to carry out continuous detailed research on stocks that fit IML's mantra.

The IML mantra, as stated below, has been in place since IML's inception in 1998 and ensures we focus on companies that have:

***...a competitive advantage, with recurring earnings, run by capable management, that can grow and that are trading at a reasonable price.***

This philosophy has served IML's investors well over the last 20 years by ensuring that IML's portfolios have always been

focused on owning good quality stocks at the right price.

Strictly adhering to this mantra has enabled IML's portfolios to avoid being caught up in many booms and inevitable busts that have occurred since IML's inception in 1998 – such as the tech boom and bust in 1999 to 2001, the era of highly leveraged vehicles of 2005 to 2007 and more recently the Resource boom and bust that occurred between 2011 and 2014.

Reflecting after the Morningstar award, Conn says there are four key lessons he has learnt after almost two decades picking small cap stocks that form the base of IML's strategy.

### **1. Always buy quality industrial companies**

The first is that good quality industrial companies, bought at reasonable prices deliver superior outcomes over the longer term. Through market share growth, cost cutting, sensible acquisitions or restructuring, these companies can often grow off their own steam over time and

aren't beholden to macro events or the vagaries of the wider economy.

"We want to buy companies like Steadfast Group, Pact or Shopping Centres Australia (SCA Property Group) where we would expect to get steady earnings growth over the long term and a solid regular income along the way by way of dividends, as opposed to tying your future to some commodity price rally which may or may not be sustained."

For companies to generate growth in the relatively mature Australian economy, they need to "do something a little special" such as have a strong competitive niche, grow market share or the ability to take costs out of the business.

Conn highlights Pact as an example of a company that has grown successfully through value accretive, sensible acquisitions since its inception over a decade ago. Through these acquisitions Pact has now become the largest rigid plastic packaging manufacturer in Australia and NZ. This has helped its competitive advantage as it has enabled the company to get the benefits of scale in its operations. In the last few years, the company has also branched into contract manufacturing and pallet pooling, sectors which have the scope to help the company continue to grow its earnings and dividends further over the long term.

## 2. Back a management team you can trust

In the past 20 years, the IML team has seen various company managers create or destroy wealth through well implemented or poorly implemented

strategies. Identifying strong, reliable management has always been an important part of IML's investment process.

Apart from seeing booms come and go, IML's experience and analysis has enabled us to get to know many management teams well over time. IML has developed a keen eye for "who is a good manager and who is a lousy one".

"Before we buy into any stock, we are looking for honest, prudent and experienced managers. We like to back managers who make it a habit of under-promising and over-delivering – as opposed to people who know how to put a good spin on things – and there are plenty of those around! We also like to see Boards of Directors with a diverse skill set that mentors their managers and asks the right questions" adds Simon.

As an example, Mayne Pharma's managing director's vast experience in the pharmaceutical industry has helped create a leading US generic pharmaceuticals company through a series of astute acquisitions which we believe will help the company do well over the long term.

## 3. Undervalued quality companies often become attractive takeover targets

Many of the stocks IML has owned in its small cap funds in the past have been subject to takeover bids. "When you invest in a good quality company with the attributes we look for, the company is also potentially attractive to a competitor or a new entrant into that market segment" he says. "This can not only lead to some great wins for our investors but it also provides downside protection if the

stockmarket falls or the stock falls out of favour.”

In the past “There have been a number of companies which we bought as we felt they were good quality companies trading at undervalued prices and we received takeover bids for our stakes at fantastic prices compared to our entry prices.” Simon adds.

Good examples of this included Vision Systems, Adsteam Marine, George Weston and the Sydney Futures Exchange. More recently investors in IML’s Funds have benefited from takeovers at wonderful prices for stocks held in the past like Energy Developments and Duet. “At the moment Fairfax, which we hold in all our Funds, looks like it is also a contested takeover candidate and appears to be another good result for investors in our Funds.”

#### **4. Stand aside from the bubbles and don’t listen to the noise**

One of the benefits of investing with a disciplined manager such as IML since 1998 has been the firm’s ability to stand aside from market manias. Over the past 20 years we have seen a number of market bubbles swell and pop, including the technology boom, LPT boom and resources boom.

Simon says: “Being a country boy who was originally brought up on a farm, I experienced first hand the boom and bust nature of agriculture and the volatility and unpredictability of commodity markets. Commodity producers have no control over the price of their outputs and by their nature these companies – like all agricultural or Resource companies - are high risk and

do not make good long term investments.

The other lesson I learnt from my early life on the land is to respect the cycle and to not make the mistake of thinking that just because a market has gone up it will keep running. When sectors in the stockmarket become over-hyped and share prices run well ahead of their fundamentals, experience has taught us that it pays to be very wary. It does not pay to get caught up in the hype of the latest fad or theme.

I started at IML in 1998 as part of IML’s investment team working closely with Anton, and we have always employed a philosophy of focusing on good quality industrial companies with a competitive advantage – and this philosophy has always sat very well with me given my boyhood experiences.”

Our cautious approach has served our investors well as bubbles inevitably pop. Bellamy’s listed in August 2014 and a market cap of \$100 million. We bought shares in the float initially as we thought it looked like a good company but we sold out as the market cap of the company surged to an insane \$1.3 billion only months later. Bellamy’s captured many investors’ imagination and was a direct beneficiary of investors’ hunger to invest in the China ‘soft commodity theme’. The bubble has since popped and Bellamy’s now trades at a valuation significantly below its peak. It’s been a roller coaster ride for its investors and it’s one that we have been happy to have sold out of when we did.

### Continuing to hold steady in a short sighted market

"We are now in an environment where most investors have become much more short term in nature than when IML began back in 1998. Rates are low and it appears that people are looking for short-term sugar hits in terms of returns" says Simon. "There is much more volatility and the market is very fixated on themes and short-term momentum - the advent of computer trading is also adding to the volatility in my view."

Companies with forecast strong EPS growth like Dominos Pizza, Corporate Travel and a2 Milk are trading on steep

multiples and in our view are pricing in excessively good news. "We do not own any of these companies. While they may have attractive growth prospects, they appear over valued to us and we are always very disciplined around valuation."

As in the past, the IML team remains focussed on finding quality industrial companies at reasonable prices that we are happy to hold for the long term. This strategy has enabled IML's small cap portfolios to not only significantly outperform the market, but to also generate consistent and reliable returns for near on 20 years.

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