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INTERNATIONAL SMALL CAP STRATEGY

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ABOUT OUR STRATEGY

The GW&K International Small Cap Strategy leverages our proprietary fundamental research process to identify small cap companies that have the ability to generate consistent and sustainable earnings growth. We seek to identify quality companies trading at attractive prices, that are often under-researched or under-owned by other institutional investors, and that possess characteristics of one or more of our targeted growth categories. Applying our strong valuation discipline helps us to discern which companies have the potential to grow earnings or recognize value over the long term. We view our investment universe as including all developed markets excluding the U.S., but we may invest in companies located in emerging markets if we identify opportunities that meet our quality and risk management standards.

REID GALAS, CFA

The global market has been hit hard since the first of the year and there seems to be widespread speculation among financial news pundits that we're in a global market rout. That said, there must be some opportunity out there for small cap international. So where are you seeing opportunity?

Mr. Galas: I think there's always opportunity. Part of the beauty of the international small cap markets is that there are thousands of companies out there working day-to-day to make money whether the markets go up or down. Of course, when you see a sell-off like what we've seen since the beginning of the year, it gives pause. You have to bear in mind that in highly correlated markets, it's not unusual for good companies to go on sale in the face of fears relating to the global macroeconomic environment. Most stocks will drop with the market, but that doesn't mean their businesses suddenly got worse.

So there's no reason to panic. We are, for instance, still positioned much the way we were last year, with a sharp focus on quality businesses with strong balance sheets. We make sure that the companies we're invested in have the financial wherewithal to handle the ups and downs of various market and economic cycles.

Then we look for areas of secular demand. There are elements of demand that happen regardless of the overall global economic cycle. We find a lot of these opportunities in what people often think of as the slower growing, developed markets: Continental Europe, especially in some of the periphery nations like Portugal or Italy. Or in places like Japan. People often think of Japan as an exporting nation, but it actually has an export profile that is very similar to the United States. It's very much a domestic demand market and there are a lot of opportunities in places like that.

It used to be that the more illiquid a stock was, the more it would move when the broader market sold off. For the past couple of years, the reverse has been happening. This tells me that these sell-offs now seem to be driven more by macro flows – people buying or selling futures, for example, or indexes or ETFs, providing us the opportunity to acquire good companies caught up in the indiscriminate selling.

We're also seeing a lot of niche companies that aren't represented in portfolios of the big ETFs and they don't move quite as much, which is actually the opposite of what used to happen. So there's opportunity for us there as well.

Is it safe to say you see the glass as half full as opposed to half empty?

Mr. Galas: We do, but I would also point out that we remain very underexposed to areas where we think there are secular headwinds. For example, we don't have any exposure to iron or copper or base metals. Our Materials exposure is to things like flavors and fragrances and cork and fertilizers. And our Energy exposure is relatively limited, so we don't make bets on commodity prices themselves.

Where we're exposed to areas that may have secular headwinds, it is on companies that are somehow adding value to the supply chain around the commodity, but not dependent on the price of the commodity itself.

A perennial question is how much of an investor's portfolio should be allocated to international. I know it will depend on the risk profile of the investor, whether institutional or individual, but is there any rule of thumb?

Mr. Galas: You normally hear people saying international should account for maybe 5-20% of a diversified portfolio. My view is a bit different. If you are a U.S. investor, almost all of your current and future net worth – your salary, your pension, your house – is already tied to the U.S. economy. So, why not diversify? If you look at investing holistically, it makes perfect sense to increase the amount of one's discretionary exposure to foreign stocks a bit more than what might be conventionally recommended.

For most investors, the core component of a portfolio should probably be U.S. large cap and fixed income investments. For those who have the discretionary ability to increase their market exposure, they should look at including an international allocation. And when they do that, I think they should look at small cap stocks, rather than large cap.

Here's why: Whether you own Unilever versus Kraft, or Apple versus Samsung, or British Petroleum versus Exxon, the difference between them is limited because they're exposed to the same global markets. But if you own a small cap pharmacy stock in Japan, for instance, you're not only getting direct exposure to that market in Japan, it's also going to be something that doesn't overlap with exposure you might already have in the rest of your portfolio.

So, if you make the decision to go international with a goal to diversify, I think it makes more sense to look holistically and up the percentage a bit more than what some people might typically recommend. But I'm an international portfolio manager, so I am probably biased.

What do you see as the biggest risks to your portfolio these days?

Mr. Galas: We look at risk in two different ways. One view is the operational business risk to our underlying companies. We're diversified right now across 18 countries in roughly 74 positions. What we spend most of our time on is trying to figure out how the underlying business works, how it is faring now, and if it is getting better or worse. From that perspective, we want to make sure that the companies we invest in have strong balance sheets so that they can weather any sort of slowdown in demand or any sort of financial crisis, and, if there is an unanticipated issue, they can handle it.

From a macro point of view, we want to make sure that we're "barbelled" to both market and economic headwinds and tailwinds. For example, Japan is a large part of our portfolio at about 25%. And the exchange rates in Japan are pretty important. So the yen drives the markets as well as impacts the underlying company.

And since we're not going to predict what could happen with the yen, we want to make sure that we have some companies that will benefit from a strong yen and some from a weak yen.

Personally, I worry that some of the very large trends are reversing. Over the past decade or so you had countries, especially in emerging markets, that were doing well because of commodities. That growth allowed them to borrow a lot of money, often in foreign currencies. Now they are seeing demand for commodities fall, hurting their own currencies just as they need to pay back the debt in an appreciated currency. And so that's kind of a triple whammy. You have to be careful that all of those things are going wrong for those countries and companies at the same time.

But this is not a repeat of 2008, and the U.S. financial system is not at risk.

Speaking of impact, how about oil? Its drop has been precipitous and in some regards relatively unanticipated. Is your portfolio insulated from declining oil prices?

Mr. Galas: Generally, yes. I think in most cases, developed markets benefit from declining oil prices. But the benefit may come with a lag. In the United States, the first thing that gets cut, of course, is capital expenditures, around energy spending, and that hurts. We're seeing that now in Texas and North Dakota. The slowdown there impacts companies right away.

The benefit of lower gasoline prices, lower input prices to things like plastics or anything that's energy intensive, that takes a while to come through, partially because some of those companies hedged. They were probably paying a little bit higher than spot price for a while and the lower prices have to work through the inventory and the supply chain before you see a benefit.

But if you're in a developed market, say Japan or the United States or Europe, lower energy prices are an absolute benefit. Think about it. If you asked, "Would we be better or worse off if oil prices were zero?", of course, we'd all be better off if energy was free.

Not so if you are in the Middle East or Russia or in certain areas of South America. Then there's obviously a risk. And then, of course, things get more complex when you go from energy to the other commodities.

Are you investing in China?

Mr. Galas: We have some investments in companies that do business in China. We own two companies listed in Hong Kong that are technically Chinese, however one of them doesn't sell anything in China. So the answer is yes, but we are relatively insulated on a direct basis.

Right now, I would say our views are more negative than positive on China and so we've structured the portfolio to make sure our exposures are quite limited.

Are you doing anything in South or Central America? How does the portfolio break out regionally globally?

Mr. Galas: We look at the portfolio in terms of four key regions. We have about half the portfolio in Western Europe, and about 40% of the portfolio is in Asia Pacific, which includes Australia and Japan. The rest of our investments are in either North America, which is mostly Canada, or in the Middle East/Africa region, which is mostly Israel. At the moment, we do not have any direct exposure to Latin America and we don't have any direct exposure to Eastern Europe or Middle Eastern markets outside of Israel. However, we have the ability to invest anywhere outside the U.S. and look to invest opportunistically in emerging markets but only when a company meets our standards for quality, growth, and valuation.

What do you use as a benchmark?

Mr. Galas: We use the MSCI World ex-U.S. Small Cap Index. Essentially, it's the developed markets (excluding the United States) small cap index.

Where do you get your best ideas?

Mr. Galas: We focus on finding companies that aren't well-covered or well-known, so our ideas come from a lot of different sources. We seldom buy stocks that are pitched to us by the investment banks. We do our own research.

As a team, we sort through hundreds and hundreds of companies to come up with a couple of gems that may look attractive.

What tends to happen to us a lot is that we'll find a company that might look interesting, and in the course of analyzing it, we'll come to realize that there's a different company in the supply chain that's even more interesting. Maybe it's a supplier or a competitor or a customer. And then we'll shift our focus to the more attractive company.

We're constantly looking places where we think there are long-term secular growth tailwinds, for example in growing consumption and healthcare spending. By sorting through companies in those sectors, we find ideas. Finally, we read a lot.

We also keep track of what has worked well in the past and if we find something that looks similar we will do the research. I want to know which companies are doing well, especially if I've never heard of them before. I want to understand why they're doing well. Then, if they are attractively valued, well managed and have a strong business, we'll take an in-depth look. That has tended to work for us.

Ultimately we are looking to find companies that have the ability to generate consistent, sustainable earnings growth which will then drive their stock price performance over time.

How often do you turn over positions in your portfolio? Is there a lot of turnover?

Mr. Galas: There's not. We launched the Strategy a year ago and in that first year we had about 30% turnover. If we own a stock an average of three years, that's a pretty good timeframe for us. That means that we had the ability to find a stock that wasn't too expensive and maybe the catalyst hadn't hit yet. As a business generates good results, people will become interested, the stock price increases, and we sell the stock when it falls within the parameters of our buy and sell disciplines.

Naturally, if we think a business is deteriorating or that we made a mistake in our analysis, we want to catch it as soon as possible so we can put the capital to work somewhere else.

As a small cap international manager are there things that keep you awake at night?

Mr. Galas: The way I look at it is that in a universe of thousands of companies we should always be able to find 75 attractive companies in any market environment. We want to make sure that we don't have too big a position in any one company. What would make me worry is if we took too large a position. That's also why we focus so closely on balance sheets. I'm very firm about making sure that our companies aren't over levered.

One way a company with a good business can really get hurt is when they don't have time working for them. In other words, they have too much leverage. Then they are at the mercy of the market's sentiment at a point in time when they may need to be financed. A company with a strong balance sheet can wait out tough markets or, even better, opportunistically take advantage of those times.

Other than that, we are diversified in almost every factor you can think of so we minimize the chances of getting hurt by an individual issue.

What are you hearing from clients these days?

Mr. Galas: When we talk to clients they are concerned with a lot of the same things that other people are. There is a lot of geopolitical worry, whether it is the unrest in the Middle East, the impact of oil prices, or the slowdown in China. I think those are all legitimate concerns.

However, as long as people go to see movies in the U.K. and buy pharmaceutical drugs in Japan and eat sandwiches at Starbucks or have kids that like to watch cartoons, then our companies are going to be fine. So, even though the moves that we've seen recently in the markets are certainly of some concern in the short-term, it is that volatility that gives us the opportunity for outperformance later on.

Disclosures

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Small cap stocks may be subject to a higher degree of risk than more established companies' securities, including higher volatility. Foreign investments may be subject to a greater risk than U.S. investments due to non-U.S. economic, political and legal developments, including favorable or unfavorable changes in currency.