PORTFOLIO MANAGER Q&A | NOVEMBER 2023

# KNOW YOUR C-SUITE: THE IMPORTANCE OF SMALL CAP MANAGEMENT TEAMS

Active small cap managers can help create meaningful opportunities for investors through rigorous company research. We believe a crucial component of this research is evaluating a company's management team — an integral part of the company's overall success.

We spoke with GW&K's Equity Portfolio Manager Joe Craigen about how important it is for his team to really get to know the management teams at the small cap companies they invest in, and what he's learned to look for in a team during his tenure as a portfolio manager.


**JOE CRAIGEN, CFA**

*Partner*
*Equity Portfolio Manager*


### Q: How much of a factor is leadership when you're evaluating small cap companies?

**Joe Craigen:** It's critical. Before we ever invest with the company, we always talk to the management team — typically face to face, multiple times — to really get to know them and what their strengths and weaknesses are.

We're looking to invest with really good management teams running really good businesses that are trading at reasonable valuations. There's a reason we put management first in that framework: Good management is absolutely critical.

### Q: When you talk about management teams, are you speaking specifically about the C-suite, or are you including the head of investor relations or other roles as well?

**Joe:** We consider all members of management in our assessment. But above all else, we put a tremendous emphasis on evaluating the CEO. It's the CEO who is ultimately responsible for the strategy, the capital allocation, and the culture of an organization — all of which are critical to long-term success.

In addition to the individuals reporting to the CEO, our team puts a lot of importance on the people above the CEO as well. Unfortunately, investors rarely have the opportunity to interact with members of the board of directors. But the board is certainly something that we consider in our analysis. Aside from ensuring there are independent directors and a good amount of diversity on the board, we're also focused on the types of experience that are represented on the board. We really like to see directors with CEO experience, either current or in the past — primarily for two reasons: first because those people are probably best positioned to give advice and counsel to an existing CEO about the challenges that person is facing. And second, those board members are most likely to be in a position in their careers where they can push back on a CEO when necessary.

## Q: What qualities do you look for when evaluating CEOs and their management teams?

**Joe:** We're looking for people who have a lot of experience and intelligence, as you'd expect, but beyond that, we're also looking for leaders with integrity who are passionate about their business and have the strategic vision and long-term focus required to help the company flourish over a multi-year period.

At GW&K, we are in a great position to make those assessments of corporate managers because of the experience of our investment team. Every member of our investment team has been doing this for well over a decade. Anyone on our team can sit across the table from a senior executive and make both professional and personal judgements about whether or not they're speaking with someone we'd want running one of our portfolio companies.

There's also a quantitative piece to the analysis, evaluating each person's track record — both in their current role and in previous roles and companies, to the degree it's possible or relevant. In small caps, we also like to see a high level of insider ownership, so we know their incentives align with ours as shareholders.

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## Q: What happens when members of your team disagree when evaluating management?

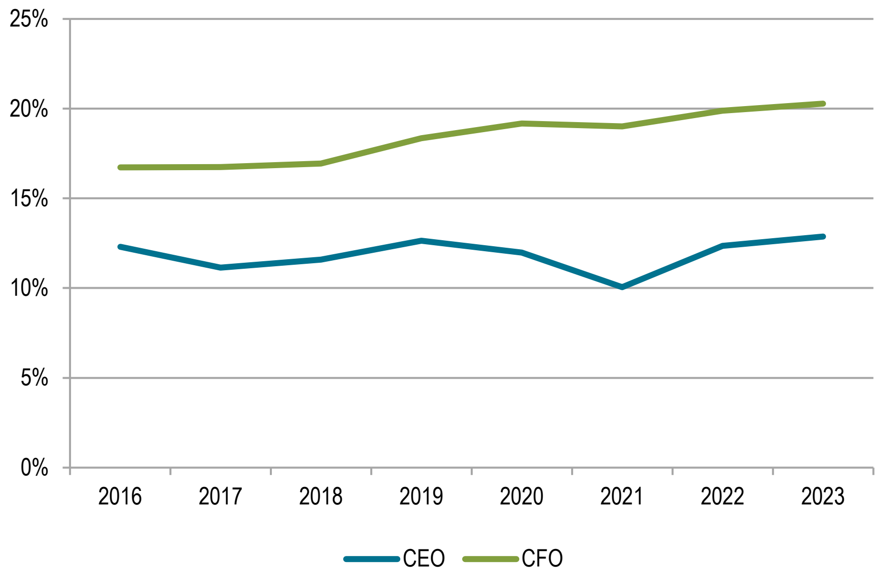
**Joe:** One of the benefits of our rigorous hiring process and the continuity of our team is that we all feel comfortable sharing our ideas, concerns, and feedback with each other, and know our input will be valued. I've been at GW&K for 15 years and during that time we have had only two stock pickers leave our team, which I think speaks volumes about the culture of our organization. We can freely share our perspectives with each other, and ensure all points of view are heard. When vetting a company, we often have multiple people meet with the management team to ensure we have different interpretations of all the factors we use to evaluate management.

## Q: Have you noticed an uptick in C-suite turnover? Any notable drivers, such as retirements post COVID stress, etc.?

**Joe:** Executive turnover is something we're continuously monitoring, whether it's due to retirement, performance, compensation, or strategic reasons. In the Russell 2500 Index, which is a good measurement of publicly traded small cap companies, turnover for CEOs declined in 2020 and 2021 — likely due to the need for tenured leadership as companies navigated the pandemic and its aftermath. CEO turnover bounced back in 2022, and has ticked up again so far in 2023. The increase in CEO changes last year and this year may just be a matter of some catch up after a Covid-induced dip. Even at this higher level in 2023, CEO turnover is still within the typical range of the past few years **(Figure 1)**.

FIGURE 1

Annual Turnover in CEO and CFO Positions at Small Cap Companies




Data as of September 30, 2023. Source: FactSet. We analyzed turnover for the roles of CEO and CFO at each firm within the Russell 2500 over the last eight years.

For both CEOs and CFOs, YTD 2023, on an annualized basis, had the highest turnover of all periods in the analysis.

CFO turnover has been steady or rising each year through the entire period.

## Q: Is turnover typically a negative factor?

**Joe:** Turnover can be both a red flag and an opportunity. In companies we own, seeing turnover in the executive ranks that we think isn't for the best may cause us to sell our shares. Conversely, if we find situations where a new high-quality management team takes over an underperforming asset, that can be an opportunity for us to invest.

## Q: What about a lack of turnover on a management team — does that give you pause?

**Joe:** Typically, it's the opposite. We like long-tenured management teams. That gets to the quantitative component of our evaluation of management. We put a lot of emphasis on our qualitative assessment of individuals, but we also like to combine that with a demonstrated track record of execution. All else equal, the longer the tenure, the longer the track record and the greater the experience operating in varying economic environments. That's part of the reason why we over index to founder-led organizations: They typically have been in their seats for a long time, in addition to often having a long-term view and significant insider ownership.

Of course, there can be situations where the needs of a company change as it grows, which may require a change in leadership. For example, a CEO who is excellent at leading a small company may not be as good at leading a larger, more complex organization, and the company may benefit from a change at the top.

## Q: What do you consider your team's edge to be in managing small cap stocks?

**Joe:** That emphasis on management is a key differentiator for us. I'd go back to how we started this conversation, our goal is to invest with really good management teams running really good businesses that are trading at reasonable valuations. And we do that with an eye to investing over the long term. Our commitment to that approach can be seen by looking at our low total turnover. I've seen other managers point to low name turnover within their portfolios as proof they are long-term investors, but it's really *total* turnover that determines whether or not you are a long-term investor. If you are really focused on the quality of the business and the quality of the management team, those things shouldn't change much on a day-to-day basis or require trading in and out of stocks.

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Certainly we are sensitive to valuations. When stocks get to the upper limit of what we think is a reasonable valuation, we use that as an opportunity to take profits. When they get towards the lower bound of what we think is appropriate, we'll use that as an opportunity to add to our positions. But our focus is really on picking the long-term winners, hence our low total turnover.

Finally, I'll reiterate that in addition to our emphasis on management, we're in a very good position to evaluate management because of the experience and stability of our investment team. Every one of our stock pickers has been doing this for quite a while.