GW&K INVESTMENT MANAGEMENT

PORTFOLIO MANAGER Q&A | JULY 2021

INTERNATIONAL SMALL CAP STRATEGY

REID T. GALAS, CFA

Partner
Portfolio Manager

Investment Professional Since 2008
Joined GW&K 2014
BS, Cornell University
MBA, University of Michigan

ABOUT OUR STRATEGY

The International Small Cap Strategy seeks long-term capital appreciation by investing primarily in a portfolio of equity securities issued by foreign, small market capitalization companies that we believe have the ability to generate consistent and sustainable earnings growth. We aim to discover well-managed businesses that are unrecognized or undervalued by the market and that can grow earnings and recognize value over the long term.

- **Strategy Assets: $220 MM**
- **GW&K Global Equity Assets: $2,778 MM**

Assets as of 6/30/21

REID T. GALAS, CFA

As countries around the world reopen, inflation jitters are attracting the attention of the Fed and other Central Banks. How well is the International Small Cap Strategy likely to perform in an inflationary period?

Mr. Galas: When people talk about inflation and its impact on investing, I think what they most often mean is finding companies that have the ability to have some pricing power. To take whatever cost inputs they receive and pass them through to their customers.

I don't think that's necessarily the right way to look at it. It focuses on the wrong part of the income statement. During inflation, most companies will be able to raise prices, that's the definition of inflation. What we want to do is find companies that have the ability to keep their costs under control in the first place. These companies will benefit from higher margins if they pass through the higher prices, or they can take market share from higher priced competitors without hurting their own margins. Because of this, we believe our Strategy would hold up well during an inflationary period.

Consider countries that have had very low inflation or even deflation for long periods. Companies that are thriving in those locations most likely have that cost-cutting mentality. Japan, which is the largest country weight in our Strategy, is a classic example since they've been dealing with a deflationary, or disinflationary, environment for approximately the past 30 years. If these companies find they suddenly have the ability to pass on price increases that would be an incredible tailwind to their performance.

How is the international small cap stock market different than the U.S. small cap stock market? What is most compelling and challenging about investing there?

Mr. Galas: Right now, the clearest difference is valuation. The U.S. markets have outperformed for about a decade. Most of that outperformance has come through multiple expansion rather than stronger fundamentals, although U.S. fundamentals have been quite good. Despite what people think, the U.S. has not always traded at a premium to non-U.S. markets, and there is nothing to say that the valuation difference, or valuation gap, won't shrink and then reverse over time. The net result is that you can find very attractive valuations outside the U.S. with favorable fundamentals.

Another difference is that the international small cap market is very large, but with a lot less analyst coverage, which creates opportunities for active managers. As we like to say, there's a lot less people fishing and there's a lot more fish. We believe the international small cap space is currently an attractive place to invest.

Over the past several months, we've seen a shift from growth stocks to value stocks. How has this rotation impacted your portfolio?

Mr. Galas: We've seen the same shift globally. Clearly the valuation spreads between high growth stocks and deep value stocks got out of hand, so there's bound to be some reversion to the mean. We're seeing strong economic growth – this year will probably have the best global GDP growth that we'll see for quite some time.

Economically sensitive or cyclical stocks should do very well in this environment. When you get these big, cyclical economic upturns in the economy, growth becomes something that you don't want to pay for because you can find it everywhere.

Because we tend to be less exposed to those companies, particularly in the commodity space, we could lag the Index on a relative basis. But that is normally a relatively short-term phenomenon. Our focus remains on high-quality, growing businesses that should do quite well through a market cycle and over the longer term.

When we think about equity investing, small cap stocks are more volatile, but potentially higher reward. Aren't international small cap stocks even more volatile or risky?

Mr. Galas: People often conflate volatility with risk. They're not the same thing. Academics use volatility because it's easily quantifiable, but that's not what I think most investors are actually thinking about when they're thinking about risk.

Risk to them is the chance they fall short on their investment goals or outright lose money. It's very specific to their experience and outcome. When you look at small caps versus large caps historically though, the data is telling. Looking at U.S. data going back to May 1930, small cap stocks are more volatile, and for short investment horizons this means they are more likely than large caps to experience negative returns. However, for investors with longer-term horizons, say greater than five years, the higher returns from small caps have outweighed the volatility, and so there are actually fewer periods where small caps lost money. When you get to an investment period of ten years, in fact, small cap stocks have never lost money. This is not true for large cap stocks. Another way of interpreting this is that over a long enough time period small cap stocks have shown lower risk than large caps stocks when you define risk as the chance of losing money.

We do not have the same data for non-U.S. stocks, but we would expect them to behave similarly.

How do you find good investment ideas? What sectors are you presently finding the best investment opportunity?

Mr. Galas: I wish there was an easy answer to this question. We spend much of our time looking for new ideas. We read research, we analyze industries and supply chains to make sure we understand what is changing, which markets are growing, and who has pricing power and who is managing costs effectively. We are constantly asking ourselves, are we invested in the right areas or should we be looking elsewhere?

It's by no means glamorous work. We speak with over 400 management teams a year. And that number actually accelerated during COVID. We see investing as a cumulative process where time spent and work done add up over time. Our process is iterative and we spend a lot of time looking for well-run companies with good business models, but they are just not that common. When we look for a company to add to our portfolio, we don't want an average company, we're looking for the exceptions.

The markets have come roaring back, but at the moment, it's a pretty challenging marketplace. Because so much positive expectation is already built into stock prices, it's not easy to find good companies at attractive prices. Currently, we are looking at companies which have lagged in the recovery, but have a secular tailwind. For example, we know that Japan has a demographic shortage, so they will need more labor supply. We believe that companies that provide that labor supply should do well over the long term even if they are currently struggling due to COVID lockdowns.

Another example would be video gaming companies. They did extremely well in 2020 and we benefited from having heavy exposure. We continue to think the industry has a long growth runway and are willing to hold during periods, like now, where people are more focused on cyclical rather than secular growth.

How can you cover such a large market with a team of three?

Mr. Galas: Despite believing our team size is appropriate, we get this question quite a bit. What I tell people is, first, we have a very strong track record that was built using the team that we have in place. Second, we have a proven investment process and have consistently, and significantly, outperformed our benchmark over the long term. Also there are some advantages of having a small, close-knit team in a situation where frank discussions and high levels of trust are important.

Third, our universe is very large, our portfolio is not. There's no team large enough to analyze every company in the universe or even the Index. However, we can focus on what we own. We want to make sure that our portfolio is made up of good businesses, run by honest and capable management teams all trading at attractive valuations.

Lastly, we have what we refer to as an exclusionary mindset. The goal here is to exclude companies from consideration as quickly as possible so that we can use our time more advantageously to find new opportunities.

Over 25% of your portfolio is allocated to Japan. What do you like about this country? What kind of investment opportunity are you seeing there?

Mr. Galas: Japan is the largest country weight in the MSCI World ex USA Small Cap Index, and while it's true that 25% of our portfolio is allocated to Japan, that's actually underweight the Index. That said, we do find Japan very attractive.

As I mentioned previously, Japan has been dealing with deflation for so long that its companies are world class in things like cost control. While we think most people don't appreciate this yet, the key to doing well in an inflationary period will be effective cost control, not pricing power. In addition, Japan is seeing improvements in corporate governance and shareholder returns which could unlock substantial upside opportunities. Of course, the current valuations are very attractive both on an absolute basis and relative to other markets.

Beyond Japan, how is the Strategy positioned geographically?

Mr. Galas: Japan is our largest holding by country, but we are broadly diversified across geographies. Presently, we have investments in 24 countries. After Japan, Sweden is next highest at just under 10%.

We see opportunities all over the world. At the moment, we're currently overweight Asia and underweight Europe. However, we're spending a lot of time looking at Europe where we're finding some attractive investments, so we expect these weights will shift over time.

In addition, we may opportunistically invest in emerging markets up to 20% of the portfolio, although to date we have never been above 10%.

Are ESG factors explicitly integrated into the investment decision–making process? If so, do you engage with companies on ESG matters?

Mr. Galas: ESG is becoming a larger part of our process. The team utilizes Sustainalytics, a Morningstar Company, which provides high-quality, analytical ESG research, ratings and data, as a starting point for our ESG analysis. Our research analysts will use this information to identify and incorporate potential risks into our fundamental research process. Our assessment of an investment is based on a number of considerations. We combine third-party research, company reports, management discussions, and analyst judgement in evaluating the overall impact ESG factors may have on each company's investment thesis.

We then take that information and use it as a point of discussion with management. If we're not comfortable with something, we won't invest. That goes back to the exclusionary principle I talked about before. In areas where we think management has the opportunity to improve, we'll suggest those improvements.

Often when people see ESG they only think about Environmental issues, but don't forget there are Social and Governance components as well. In international small caps, Governance issues are very important. We want to make sure that management incentives are aligned with investors, and investors' interests are taken into account in the corporate strategy.

We want to make sure that we're addressing ALL of the risks that might be out there. We view ESG risk similarly to more traditional financial or business risk. It has become an important component of our investment process.

Can you provide an example of a recent holding that illustrated your investment approach and what you found attractive about it?

Mr. Galas: I alluded to this above, but we recently purchased a position in Fullcast Holdings. Fullcast is a Japanese staffing company that focuses on short-term contracts. They operate several different business models, but all revolve around placing non-standard workers into short-term opportunities. Their core business is placing people such as students, stay at home parents, and the elderly, who may have some time to work during the week, but are not able to work a full schedule. Their customers are also extremely varied, but tend to be businesses and governments that need surge labor, staff for a one-off event, or to temporarily fill a gap. Fullcast benefits when the labor market is tight, so you can imagine this last year has been difficult, but they have major secular tailwinds. The company has a strong shareholder focus with attractive ROE metrics and a focus on shareholder returns. The business itself is very cash generative and management has done well keeping costs under control. Post-pandemic, Fullcast should resume double-digit sales growth, but this recovery is not yet fully reflected in the stock price.

By most accounts, the global supply chain is a “mess.” How has this impacted the profitability of your Industrials holdings?

Mr. Galas: Businesses around the world did an absolutely amazing job of minimizing and dealing with supply-chain shortages.

Although challenges remain, there is now duplication in logistics, second or third sourcing and additional inventory being held at different levels in the supply chain. All of these things are probably good, but they also have a cost, and eventually, it will be passed on to the consumer.

Given time, supply chains will adjust, and most companies should end up doing just fine.

Although the markets seem to be doing reasonably well, how big a threat to international small cap stocks is economic uncertainty around the world?

Mr. Galas: Economic uncertainty, or uncertainty in general, was listed as one of the biggest risks on almost all of our management calls this year. We saw a direct correlation between how well a country was doing with COVID-19, and how much uncertainty management talked about.

It’s our feeling that this uncertainty will dissipate quickly as we emerge from the pandemic. When that happens, we expect to see the economic exuberance that we’re seeing in the U.S., and to some degree in China, repeat itself in other geographies. The question is, how long will it last?

Looking ahead, what do you see as the biggest risks on the horizon?

Mr. Galas: For stocks in general, clearly, the biggest risk is inflation leading to interest-rate increases. The markets are not priced for higher interest rates. Our base case is for higher inflation, but developed market interest rates staying low. That would be a new environment and probably more likely than very high interest rates.

Going into 2020, pre pandemic, the economic cycle was getting old. Now it may have been restarted with the COVID downturn and then subsequent bull market that we’re seeing. Or, we might be late in the cycle and this is the last big hit of stimulus from central banks and governments around the world before a slowdown in 2022 or 2023.

Regardless, there’s always risks, and there’s always opportunity, and the goal is to balance the two.