

# THE HUMBLE MONGRELS

## SCOURING THE UNIVERSE FOR TOMORROW'S MEGASTARS

THE CHARACTERISTICS THAT MAKE SMALL-CAP FUND MANAGERS GOOD AT WHAT THEY DO INCLUDE TENACITY, A WILLINGNESS TO ADMIT MISTAKES, AND A DISCIPLINED VIEW ON WHAT DRIVES LONG-TERM VALUE CREATION.

WORDS  
SIMON HOYLE



There are certain characteristics that make a small-cap equity manager good at what they do, says Colonial First State Global Asset

Management's small companies senior portfolio manager Dawn Kanelleas.

"You've got to have, I suppose, a characteristic that is probably mongrel," she says. "You're constantly, constantly looking at your investments, rethinking them; and you're prepared to acknowledge that you make mistakes."

Kanelleas says the worst thing a fund manager can do is to stick with an investment after it becomes apparent that a company's strategy has changed or that "the delivery on the strategy that you thought was going to be delivered has changed".

"That's part of the ability to preserve capital," she says. "So you need individuals who can be humble as well. Mongrel and tenacity, a constant searching, and I have to say, a pretty high intellect."

"The two young men who work in my team have very modest origins but they were both duxes of their schools and they are highly driven to be successful and competitive. They want to deliver excellence to the people who we feel privileged to invest their money, and respect their capital, in the way we respect our own capital and our own money."

Kanelleas has been a fund manager for about 20 years, is a scientist by training, a former post-doctoral research fellow in physical chemistry who spent time "bouncing neutrons off surfaces".

### THE ANALYTICAL AND PROBLEM-SOLVING SIDE

It was the "analytical and the problem-solving side" of funds management that attracted her. She runs a team of three, which she believes is "ideal for the breadth of what we're doing, our ability to communicate and to understand what each of us is doing, and to allow a sufficient amount of diversity in thinking and approaches to investing".

"We're often thought of as being in the grubbier end of the market, which is kind of true, but we're looking for future Top 100 companies," she says.

"We're always looking to see where we're going to find the next Microsoft or the next Apple."

Some of the companies that Kanelleas' team invested in even before they were in the small-cap index, let alone before they graduated as large-caps, include REA, Magellan and TPG.

Kanelleas and her team manage about \$650 million, and do so with an eye on first preserving investors' capital.

"When you think about it, what are our investors looking at? They're looking at absolute returns," she says.

"They want to preserve capital. We don't have to have every winner in the index. As it happens, we've owned Blackmores from \$20 to \$200, but we don't always have to have every winner, we only have to have a couple of winners like that, and avoid the companies that go out the back door."

Kanelleas says statistics show that in the small-cap sector over the course of a particular 12-month period about 15 stocks more than doubled in value, while 23 increased by more than 50 per cent. But at the same time 75 stocks lost more than half their value.

## AVOID THE LOSERS

Sometimes, simply avoiding the losers is a big part of what drives small-cap fund performance, and in its latest review of the sector Zenith Investment Partners says the outlook for actively managed small-cap funds is bright.

“Overall, we believe the current environment provides more scope for active managers to outperform by leveraging their strengths in stock selection,” says Zenith’s lead analyst on the Australian small cap sector, Quan Nguyen.

Nguyen says 2015 was “another strong year” for small-cap funds and the actively managed funds on Zenith’s approved product list outperformed the S&P/ASX Small Ordinaries Accumulation Index by an average of 5.7 percentage points, net of fees.

Nguyen says this is a robust performance, but remains a far cry from 2012 and 2013 when the outperformance reached about 16 percentage points, when outperformance in 2012–13 was driven by funds being overweight industrials and underweight resources.

“However, with the resources sector having bottomed post this period, the trade for this excess-return driver has largely played out,” Nguyen says. Managers have now deployed capital into high-quality industrial companies that offer more certain cash flow and earnings.

Only one small-cap fund currently has the highest-possible Morningstar Analyst Rating of gold. Another 10 have silver ratings and 12 have bronze, including the Colonial First State wholesale small companies strategy, which was up upgraded from “neutral”. Morningstar also upgraded SG Hiscock’s ICE strategy from bronze to silver – both upgrades based on the strength of the managers’ respective portfolio managers, underlining the importance of the individual within a small-cap team.

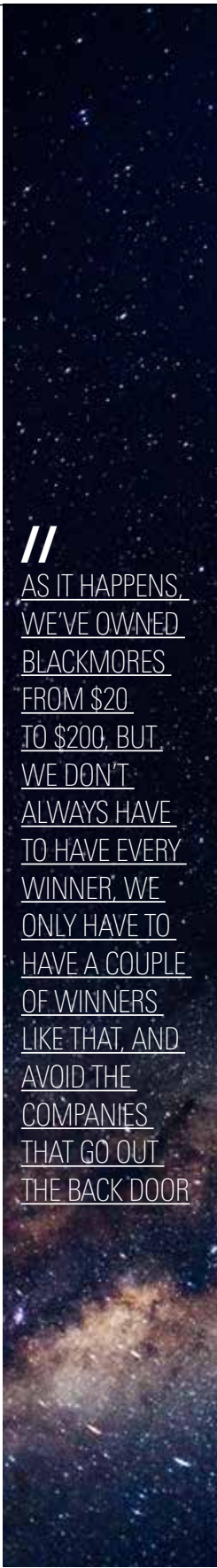
Morningstar’s recent review of the small-cap sector says fund performance is likely to be driven over the next three years primarily by “companies in consumer services, technology, telecommunications, healthcare, agriculture, and financial services”.

And while small-cap funds are active in the initial public offering (IPO) market, this has “limited impact on subsequent performance, and is simply one dynamic among many which a small-cap manager has to deal with”, Morningstar says.

“The key issue for fund managers is to avoid exuberance, particularly when pressure is being applied by stockbrokers for rapid decisions,” it says.

“Investors and advisers should be very wary of small-cap fund managers that suddenly change their process to justify participating in floats and try to take advantage of a buoyant IPO market to artificially fuel near-term returns.

“The greatest chance of investment success comes from selecting a fund manager which maintains a highly disciplined and consistent process throughout the cycle.”



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## VALUE CREATION

Kanelleas says the team has a clear philosophy on long-term value creation, and seeks out companies whose leaders have the same view.

She says management often tries to create value through a strategy known as a roll-up. This involves acquiring a number of companies in the same industry, merging them, and attempting to create value through economies of scale.

“You’ve seen big catastrophes in the roll-up sector, where companies either roll up a lot of stores and extend themselves, or buy other businesses and end up bankrupt,” Kanelleas says.

“Those management teams, you know, are not capable of generating long-term value. So you try to understand what is the strategy? What are they creating in terms of value? Even if there isn’t earnings growth, there is a focus on cash flow generation.”

Kanelleas says CFS Global Asset Management has been looking closely at the separately managed account sector, one that many fund managers – perhaps ironically – are not terribly familiar with.

“They tend to be microcaps – in other words they’re not even in the index,” she says.

“So we’re looking at a growth rate of a HUB24, for example, or a OneVue or a Praemium, and trying to understand what is actually happening in that part of the market, and what are potential returns in that market.”

## BACKING POTENTIAL

Kanelleas says small-cap managers often have to back the perceived potential of the person running or who founded a company, as much as the company’s track record per se.

A good way of explaining what you are looking for [is]: does that management team represent the core values of the business you’re investing in?” she says.

“In other words, is that managing director really interested in building a business for the long term, or are they interested in playing the games you see in the marketplace, which can be successful in the short term, whether they are roll-ups, or people [saying], ‘I’m going to acquire this business’, and you get a short-term reaction in the share price, versus someone creating long-term sustainable value.

“Because we look at businesses when they are very, very small, there’s nowhere for these people to hide.

“That’s really the differentiator. Small-cap CEOs with skin in the game obviously have a very keen focus on shareholder value creation – their drive is aligned with the potential for a small business to become a large business. ■

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