Investment Team Corner

In conversation with Small-Cap Investment Committee member Mark Costa, CFA

Investment Team Corner: Mark Costa, CFA (Member of Brandes' Small-Cap Investment Committee)

The last few years have been a rollercoaster ride for stock markets around the world, including the small-cap space. We sat with Mark Costa, a member of our Small-Cap Investment Committee, to discuss how COVID-19 has changed the investing landscape for small caps, specifically for Brandes portfolios, and what opportunities the team sees in today's markets. Mark has 23 years of investment experience under his belt and has been with Brandes since 2000.

Mark, how has the opportunity set for Brandes' small-cap portfolios evolved in the last few years?

It's been an interesting few years. If you go back to 2019, Brandes' small-cap portfolios had above average cash levels, their weighted average margins of safety (the discount of market price to our estimate of intrinsic value) were at the low end of the historical ranges, turnover was minimal as few opportunities were attractive, and correlations in the market were very high, making it difficult for stock pickers. Additionally, leverage was rising on corporate balance sheets with interest rates near zero, and after a decade since the Global Financial Crisis, corporate earnings were near cyclical peaks. With cyclical risk at elevated levels, there were a lot of land mines that we were trying to avoid. We were in capital preservation mode, seeking to maximize downside protection.

And then the pandemic happened. March 2020 was marked with an immediate meltdown in the financial markets and the biggest liquidity event I've seen (fourth of such event since the dot-com era). This gave us an opportunity to deploy capital. Amid a major valuation compression and indiscriminate selling in the market, some of the companies that we were buying were former large caps that fell in the small-cap territory. It was a very active period for our small-cap portfolios as we divested positions that had helped preserve capital prior to the pandemic and replaced them with more cyclical and economically sensitive businesses that sold off.

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Can you give us an example of a large-cap company that fell into the small-cap category due to the pandemic? How is the investment team able to capture such opportunities?

I think one of the biggest strengths of Brandes' research infrastructure is that our analysts look at investment opportunities with a global purview, regardless of market cap or where the companies are located. For instance, an analyst who researches companies within the energy sector will look at oil and gas firms in all market-cap categories, both in the United States or outside.

An example was when we purchased Halliburton. Pre-pandemic, Halliburton's market cap was north of $30 billion. The pandemic-triggered selloff caused its market cap to drop to the $5 billion territory, a level we had not seen since the mid-1980s. Our oil and gas analysts had already done the fundamental work on the company as it was on the monitoring list for our larger-cap portfolios, although it was not a candidate for our small-cap portfolios due to the market cap. Thanks to this pre-existing analysis, the small-cap investment team was able to swiftly estimate the company's intrinsic value and take advantage of the steep share-price decline to initiate a position.

There have been other recent examples as well, including Textron, Scotts Miracle Gro, William Morrison, and Mohawk.

Many of these businesses are complex and require deep, fundamental analysis to understand, and the dislocation between market prices and intrinsic value estimates often happens suddenly and sometimes within a very short window. As such, having our analysts' sector specialization, especially combined with their average tenure covering those sectors, has proven valuable to us. Our analysts have a wholistic view of their sectors; they understand how the small players fit within the industry and the global economy, and what kind of dynamics they have with the larger participants in the market. If our analysts only focused on certain market-cap categories or had a generalist approach, it would have been more difficult for us to act quickly on these short-term market inefficiencies.

You mentioned that Brandes' small-cap portfolios have had a very active period, especially early in the pandemic. How has the positioning of these portfolios changed?

Throughout the pandemic, portfolio activity remained elevated, and we continue to find pockets of opportunity after the value's "comeback" that started in the fourth quarter of 2020.

In 2021, we saw strong performance from companies tied to post-pandemic economic reopening, and we shifted exposure from companies in those areas to businesses that had not done as well, such as those in aerospace, defense, and energy. In early 2022, Russia's invasion of Ukraine and inflation's emergence brought further volatility, creating opportunity to rotate away from some of our defensive positions, such as Japanese net/nets and food companies, to those that we believe offer greater upside potential.

As a result of our buys and sells in the past few years, the small-cap portfolios now have a balanced positioning, in our opinion. While we still have some defensively oriented holdings, we have also increased our exposure to more cyclical or economically sensitive areas that have experienced tough down cycles but possess what we consider significant recovery potential and trade at attractive valuations, such as the commercial aerospace industry and the energy sector. Conversely, we have been avoiding economically sensitive areas for which the market seems to have been underpricing the risk of a downward reversion from peak cycle demand. These encompass areas of the market where demand was temporarily boosted by consumer optimism, easy credit, and low interest rates, such as leisure vehicles, home remodeling, and specialty retail. Of course, we could uncover opportunities in these industries in the future, but it will require fundamentals to normalize and asset prices to become more appealing.

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Can you give us examples of recent opportunities?

Generally, we have been able to find businesses with strong compounding characteristics.

For example, Millicom is a Luxembourg-headquartered wireless and fixed-line telecom firm that services nearly 50 million customers in Latin America (LatAm). Millicom differs from its LatAm peers in its focus on smaller countries, either by early entry or by acquisition, a strategy that has helped it gain top market share positions in most of the countries in which it operates. Given the low adoption rates of wireless data services across a population of nearly 120 million, meaningful growth opportunities persist across Millicom's geographic markets. Although we had followed Millicom for more than 15 years, this was the first time we purchased its shares. The company underwent a large rights offering in 2022 that increased its shares outstanding by 70%. This, combined with general market malaise, has put Millicom's shares under significant pressure lately. In our view, Millicom is among the most attractively valued LatAm telecommunications services providers. Its operations are concentrated in countries that have relatively low competition (many are duopolies), lenient regulation and manageable foreign-exchange risk, while offering a favorable macroeconomic outlook.

What about the small-cap space within the U.S. equity market? How has the pandemic changed the investing landscape?

In general, U.S. small caps are more appealing to us today than they had been over the previous number of years. Leading into the pandemic, U.S. small caps (using the Russell 2000 Index as a proxy) were broadly expensive, both on absolute and relative terms (compared to their non-U.S. counterparts). Many companies in this space had high financial leverage and were not profitable. While the overall asset class was not all that attractive, we believed the Brandes U.S. Small Cap Equity Strategy provided strong risk-adjusted return potential and diversification benefits for those needing and wanting exposure.

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Today, valuations for the asset class are more sensible, in our opinion, with pockets of significant value potential. We’re excited that the holdings of our U.S. Small Cap portfolio exhibit the best balance sheet quality that we've seen in in many years. To put some context around that, when you look at our holdings, many of them have net cash positions, including five of the portfolio’s top ten holdings. For some of these holdings, the net cash positions account for more than a third of their market cap. At first glance, these companies, which operate predominately in the industrials sector, look cyclical and potentially risky. However, upon investigating the underlying businesses further, these firms not only have what we consider solid market positions, but also are well capitalized and have significant post-COVID recovery potential in their end markets. Additionally, many appear under-researched by the sell side, with little to no coverage, which means the potential for market inefficiencies is higher.

Relative to international small caps, the opportunity set for U.S. small caps is not as large. Our U.S. Small Cap portfolio is more concentrated than our International Small Cap (45 positions vs. 69 – as of 12/31/22), and the underweight to the U.S. is still prevalent in our Global Small Cap portfolio. That said, we believe all of our small-cap portfolios are very well positioned. They look different than their respective benchmarks and many of their peers, and can provide a compelling alternative to index-tracking or passively managed strategies. Their average margins of safety have improved greatly in recent years and we are optimistic about possible catalysts for future returns, including the potential for a continued value-led performance cycle and the potential for small caps to outperform large caps.

How would you summarize the current environment for small-cap investing?

In my opinion, this environment - where we have the ability to buy what we consider good, resilient businesses that also have attractive return potential - is like a boxer being able to punch with both fists. It’s the sweet spot for our value-oriented, bottom-up investment approach, seeking the absolute return potential that our clients are looking for while also seeking to preserve capital. *It’s refreshing.*

Net-Net: A company that trades for less than current assets minus all liabilities.

Net Cash: Total cash minus total debt.

The Russell 2000 Index with gross dividends measures the performance of the small cap segment of the U.S. equity universe.

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