CIBC Asset Management

Market Insight

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The Canadian Small-Cap Effect

We recently sat down with Jennifer Law to learn why she believes the current environment is favourable for Canadian Small Cap stocks.

Jennifer Law, CFA
Vice-President, Small and Mid-Cap Equities

Jennifer Law is a member of the equity team with lead management responsibility for the Canadian Equity Small Cap Growth at a Reasonable Price (GARP) strategy.

Q: Why is now a good time for small cap stocks?

We are currently amidst a regime change in the market with resource companies rebounding strongly year-to-date. This bodes well for Canadian small caps as they have greater exposure to commodities relative to Canadian large caps and global small cap peers. With oil prices rebounding 80% from February's bottom and gold bullion up 17% year-to date, Canadian small caps have outperformed strongly both in Canada as well as on a global basis. Mining stocks, after going through a downturn in the last four years, have rebounded, with a year-to-date return of 60% for gold equities and 39% for base metals stocks while energy equities are up 18%, on average.

While the associated volatility with this regime change presents challenges to institutional investors, it also creates opportunities. Historically, the type of rebound we are witnessing today has tended to last longer than initially anticipated by investors. Having managed small cap portfolios through several of these cycles, I believe it is important for investors to be aware of this. With the upward move in the underlying commodities, the economics for resource companies changes. Understanding this change, we identify companies that will benefit or thrive in a stronger commodity environment. Although resource companies tend to be highly correlated during these rallies, our emphasis will continue to focus on quality companies with an improving earnings profile.

Q: Why should institutional investors consider Canadian small cap vs. global small cap?

While smaller companies within Canada have large exposure to different commodities, such as oil and natural gas, gold, copper, zinc, diamonds and lithium, its' non-commodity companies are quite diverse, many with revenue generated outside Canada – really making them North American or global businesses.

We believe that investors can build a diversified portfolio of smaller, but growing businesses with companies that are listed on Canadian exchanges. One of the important tenets of our investment process is assessing company management and monitoring changes in strategy. We believe that this is critical with small companies since management teams possess outsized influence over the success of the business over time.

Often, CEOs of smaller companies are entrepreneurs who are effective at creating something out of nothing. They are creative individuals willing to take the necessary risks to build the company. This type of management style may not be what is needed to build the company into a larger, more efficient, cash generating company.

By staying a bit closer to home and investing primarily with Canadian-listed companies, we can effectively monitor changes with management and their strategy by frequently meeting with them.

Q: What are the opportunities of investing in Small Cap Stocks that are not available in the Large-Cap space?

Relative to large caps, there is much greater diversification in the small and mid-cap portion of the Canadian market simply due to the number of companies in the universe. This added diversification allows us access to more unique ideas that are less followed or covered by other investors. The additional degree of diversification can also be used to complement large-cap strategies within a full portfolio context.

Another benefit of focusing on smaller, less followed companies, is that these companies are often mispriced. With less attention from sophisticated investors, the market is less efficient. We see this inefficiency manifest in many ways often driven by fear, greed and naïve optimism. These over/under-reactions to fundamental changes creates opportunities.

Smaller companies also have the opportunity to grow and become larger more established global businesses. We have the opportunity to identify these companies early and take advantage of the long runway of growth compared to larger cap companies that can find it difficult to grow at the same rate simply due to their size. Smaller firms are often the target of larger companies that need to buy their growth, creating another avenue for the small cap investor to generate strong returns.

As mentioned earlier, the non-commodity companies in Canada are quite diverse with revenue generated outside of Canada, in effect making these smaller companies North American or global businesses. We believe that institutional investors can build greater diversification in their equity portfolio by including these smaller, higher-growth companies that have very different business models compared to those included in the S&P/TSX 60.

Q: Describe your investment philosophy

CIBC Asset Management has a strong history and depth of knowledge in small cap portfolio management. This expertise leads to familiarity with a large number of Canadian small cap companies and their management teams–this allow us to more deeply assess risks and expertise represented by a management team or board of directors. For small companies, the management team is critical to the fortunes of a company, particularly if the company is at the early stages of its lifecycle. As such, our heritage and skill in the small-cap space has served our clients well.

We believe that market inefficiencies are often exaggerated in the small-cap space creating opportunities for investment outperformance within a diverse universe of reasonably valued growth and commodity-related companies. A diversified portfolio that balances the growth opportunities, particularly in the resource space, with companies with positive cash flow and dividends leads to positive long-term risk adjusted returns.

Q: What is your approach to investing in Canadian small cap stocks?

Our team follows a bottom-up approach that combines quantitative and qualitative analysis that results in portfolios with approximately 60 to 80 securities. We buy growth stocks at a reasonable price and focus on management teams that have demonstrated a track record of success, differentiated products that lead to sustainable competitive advantage, and near-term catalytic events. The portfolio construction process includes determining a balance between resource and non-resource sectors. The resource sector weighting (the high growth portion of the portfolio), will vary according to commodity price outlooks and bottom-up individual opportunities. The commodity price outlook is developed by CIBC Asset Management's mining and energy analysts in conjunction with the firm's Asset Allocation team. The non-resource portion of the portfolio provides stability and dividend growth for the entire portfolio. This includes stable, high quality, positive cash flowing and dividend paying names.

Stock selection and idea generation are supported by the Research team which provides valuation and growth statistics, as well as stress-testing and dividend/capital metrics. All members of the firm's investment team, including portfolio managers, contribute to research. Additional macro inputs are also generated from discussions with the Fixed Income team and Asset Allocation team. Working in an open "arena", equity and fixed income portfolio managers and research analysts are situated around trading desks – this allows for a free flow of information and critical thinking.

Q: What differentiates your team's stock-picking process?

With the market fairly short-term focused, one differentiation of the small cap team is our willingness to take a longer view, say 3+ years, on our target company. We invest in the 'people', its management team, and we invest in strong business models that compete effectively in attractive industries. By taking a longer view, we pay a reasonable price for these businesses, oftentimes before the market starts to pay full price or overpay for their growth prospects.

Another area that differentiates our team is our participation in commodity investments whereas a large number of our competitors have opted out of the commodity square citing volatility. We believe that by understanding a commodity's supply and demand dynamics, we can reduce the risk profile of investing in resource stocks.

For further information, please contact:
Sean Wagner - Vice-President, Consultant Relations
sean.wagner@cibc.com