LWM Consultants Ltd

Meeting the fund manager

Threadneedle American Smaller Companies

We recently attended the Threadneedle Investment Conference, one of the meetings we had was with the US investment team. We were hoping to meet the manager of the Smaller Companies Team however he was not well. We therefore set up a telephone conference with Stéphane Jeannin who is the investment specialist within the US desk. The purpose of the discussion was to talk around the opportunities for small to mid-cap stocks.

What we came away with was an interesting insight as to how many of these companies will benefit from the changing US economy.

Overview

We talked about about why mid to small cap works for the fund. Stéphane explained that large cap businesses tend to be a collection of businesses so if you want to focus on one area then it can be difficult to do. So expanding on this, they have a holding in a refiner; this business is concentrated in a particular area where it can maximize profits. As a result of this its margins are increased whereas investing in a larger diversified refiner would see the business spread geographical and via product line.

Of course small to mid-cap can be harder hit. These businesses tend to have cash on the balance sheets but in the second half of 2012 CEOs held back from making decisions. This was partly due to exposure in Europe and Asia but also at home the Presidential elections and Obama Care. All of which had implications for these types of businesses. As we enter 2013 CEOs feel that some of these issues have alleviated or resolved and they are starting to operate with a normal mindset.

Already this year we have seen increased M&A activity with over 200 deals (in the same period last year it was around 80), the two high profile deals this year are Dell and Heinz.

The main recipients are in the $1 to $5 billion bracket i.e. mid to small caps and this explains the strong performance in this sector.

We touched on the fact that small to mid-cap are hardest hit and more volatile but they do offer the longer term out performance. One area that is a concern is the 1 March deadline, it is likely no deal will be found immediately but the cuts are around the discretionary side (i.e. healthcare, defense and education) but passing the deadline will spur the politicians into action. This delay could have an impact on small to mid-cap stocks.

We talked about investors rotating from bonds to equities, Stéphane explained that investors will buy yield and not look at price. So large caps can be expensive and investors miss this when looking at yield. Investors may therefore turn too small to mid-cap stocks which offer yield, are cheap and offer the potential for growth.

So small to mid-cap offers opportunities but I wanted to see how this would play out in terms of stock selection.

Stéphane gave a number of examples and I wanted to go through these as they show how the fund operates. We know the opportunities in Oil and Gas but much of the infrastructure in the US was put in place in the seventies - it is old and needs replacing. So for example pipelines need to be added or replaced and one company will directly benefit from this, SemGroup provides pipelines, terminals and storage for oil and gas liquids. Every time you use their pipeline they get a fee. With a growth in this area they will continue to grow revenues.

In the housing market, there is a $6 billion market cap business called Fidelity National Financial Mortgage, they provide title insurance for properties and in the US you have to have this insurance. It protects you if someone makes a claim on the title for your property. A lot of the underwriting is done prior to writing the business. As the housing market picks up and re-mortgages and new properties come through they will directly benefit.

Another business to benefit from the housing market is USG which is an industrial firm which supplies building materials. As the housing market improves so demand for their products will increase. This is a relatively new investment for the fund.

Businesses employing more than 50 or more employees have to provide certain benefits and therefore it makes sense for smaller businesses (less than 50 employees) to employ agency workers until they are ready to move forward. One of the companies that is benefiting from this is Robert Half which supplies agency staff.

As mobile communication grows SBA Communication directly benefits from this. It owns telecom towers and rents out space to other telecom operations. The yearly fee has inflation increases written into the contracts so has a growing revenue stream.

In summary although the stocks tend to be more volatile than larger cap the changing economy in terms of a housing market recovery, recapitalised banks and oil and gas means that these types of companies are ideally placed to benefit from this.

Conclusion

Following on from the Threadneedle conference we wanted to to gain a better insight into the small to mid-cap world as this forms a major part of the US holding on the higher risk funds. Clearly the fund is diversified across sectors but also positioned to benefit from the US recovery story.