Silver Linings – Episode 7

Hello and welcome to the next episode of Conversations. As always, we aim to bring you lively discussion with a range of investment specialists. Today's expert is Simon Brown, portfolio manager of the Tribeca Australian Smaller Companies Fund.

In conversation with GSFM's CEO Damien McIntyre, Simon will share his insights about Aussie small and mid-cap stocks and sectors and explain how they've been coping with inflation, rate increases and volatility. We've been talking about silver linings and Simon will let us know whether the recent reporting season showed signs of silver linings amid our small and mid-cap companies.

Before I hand over, I need to read this important notice:

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Damien McIntyre

Welcome everyone to Silver Linings. The purpose of these podcasts is to share information with our portfolio managers and you. Our portfolio managers are working in financial markets every day. They're looking at companies every day. They're analysing lots of information, and, hopefully, the idea is that they'll provide you with, even if it's only one insight that's helpful for you in your discussions with clients, or even the way you're framing your thoughts about markets, it's been a useful exercise.

So, this episode of Silver Linings, as Tracey outlined, is with Simon Brown. Simon is a veteran at Tribeca. I first met Simon in the middle of 2008 which was right in the storm of the Global Financial Crisis, and Simon was the Australian equity's team dealer at that point in time.

So, Simon, firstly, welcome, and secondly, if I might just start with a question, how did you get into funds management and how did you find your way to Tribeca?

Simon Brown

Thanks very much, Damien. It's great to be here today. Just to shed a little bit of light on my career trajectory, I was at university doing some reasonably widespread topics of study, and it wasn't until I came across owning some shares myself which were bequeathed to me, a small amount, which I immediately looked to liquidate to fund my lifestyle at university but that wasn't going to wash with my parents.

So I took an active interest in these shares that I had in the share market and made a little bit of money. Through some friends at university, realised that there was an opportunity within an area called funds management where you could manage the portfolios of stocks and get paid to do it, and instantly, I was hooked with the idea. I'm a bit of a competitive person. It is a very competitive space. Lots of investors out there trying to make money for themselves or make money for others and being rewarded for doing so.

So, I set about my path of learning how to educate myself and get a foot in the door in the funds management industry, and luckily, that came at Tribeca, which was Jenkins Investment Management way back then. David Aylward had started that business and he was running the small cap fund, which was a foundation fund of Tribeca 25 years ago, and he took a bit of a punt by giving me a shot at being a dealer. Now, thankfully there wasn't a huge amount of experience required to be the dealer and they were going to train me up. As I sit here today, that was 17, 18 years ago, and I always had the intention, and I think I told Dave at the time too, that I wanted to do his job which he scoffed at, but now I'm working alongside him on the small cap fund, which has been rewarding to the process, I guess.

Damien McIntyre

So, what was it like during the '08 crisis? Small caps are at the more liquid end. There was moments of really extreme volatility as information was downloaded from the state, the solvency of various banks, and other corporations. It must have been a baptism of fire on the dealing desk on some of those days.

Simon Brown

Yeah. Look, I think, Damien, that was probably the cliche that I was going to use to describe it. My own personal investing journey, I had been through that relatively favourable period up until 2008 and investing, trading for the fund. But the volatility was quite incredible, and, obviously, for a relatively junior person, it was definitely nothing I'd experienced before, and have experienced within periods of volatility since.

But it certainly taught me that shares can go down and markets can go down for a lot longer than you think, and I think you've just got to respect that because a lot of the time the markets do go up, and over time, they provide fairly generous returns. But there is, probably instilled in me by trading through that period and seeing how volatile markets could get, a real respect for markets. They can go down and they can go down quite violently and destroy a lot of value along the way.

Damien McIntyre

Yeah, each and every period of volatility or correction, or however you want to describe it, it's for a different reason but more often than not, big market corrections or big changes in direction are quite often linked to interest rates. So, if we go back to, of course, the share market crash of '87, that was on the back of inflation and rising US bond markets. You go through to the financial crisis itself when those structured products or those mortgage funds blew up, and that sent tremors through rates markets everywhere.

And here we are today, where inflation sprinted ahead and central banks all around the world were very quick to jack rates, and jack rates high. So, with that as the recent action and the recent cause of volatility, what are the impacts that you can see on the broader market, and also, more particularly, within the small cap sector?

Simon Brown

Look, I think as we've seen over the last about 10 to 15 years of relatively unconventional monetary policy that followed the 2008 Financial Crisis, there has been very much, I guess, the expectation that the reserve banks will be there in times of extreme market volatility with the ability to use monetary policy as a bit of a lever to save the share market to some extent.

I think this time, for the first time in quite a while, we saw an inflationary burst that wasn't necessarily going to dissipate by itself and given the relatively robust measures that were taken out during the pandemic and provided to the people with a lot of stimulus and money in their account…and consume they did. So, I think if I was going to start somewhere, it probably unwound some of the excesses that might have built up over that long period of very favourable monetary policy and quantitative easing, and the most obvious area of that was companies that had existed for a long time, the very embryonic or early stage business models with no revenues and earnings or had a very long runway to any type of proper cash flows.

We saw those names get de-rated materially, and in the subsequent rebound we've had here in 2023, we haven't really seen those names come back. The cohort, that higher valuation end that have good cash flows, perversely remained relatively resilient through that period and have gone on to make new highs now. So, I think that's one area that was fascinating and that, potentially, always was going to be an opportunity where the rug got pulled out there in terms of some of those business models.

I think if we look at the last 12 months, the obvious impact has been lower valuations via higher interest rates and through high risk-free rate. That's pretty much all of them to be honest because it went across such a large range of inputs, whether it be raw materials or you were very exposed to labour, they both have gone up materially. Electricity or rents have done the same, and so has the cost of funding in terms of debt. Yeah, management has had a challenging task passing these onto consumers, and they've had varying levels of success.

Growth has been probably the other one, where higher rates and looking to dampening demand and restrict liquidity and lending, has been very much in the forefront of investors' minds, and they're trying to determine how much growth or how much of the decline in growth might impact company's earnings.

Then lastly, you've obviously got to capitalise. What level of earnings do you need to capitalise and what's the appropriate level to capitalise those at? So, I think it has been quite challenging on that front, and it always has been as we've seen during those periods of volatility.

I guess if we drill down a little bit into the market, some areas have ridden that better than others, and if we look across smaller sectors or small and large cap companies in particular, small caps have a tendency to perform poorly in periods of rising rates, and it was definitely no exception this time. They tend to be more volatile. It's pretty much a fact, and that's due to the fact that business models can be less mature and generally, reliant on domestic demand in more competitive marketplaces with little offshore earning streams to provide you that currency protection.

On the other side of the coin, that mid-cap and large-cap names have fared relatively better. They tend to be a bit more mature with oligopolistic characteristics in the marketplaces they operate in, and that's enabled them to push through those higher costs in the form of higher prices with less elasticity in terms of customer demand, I guess. So, that's how I sum up the last 12 months.

Damien McIntyre

Initially, there was a lot of talk about recession and then, as the numbers unfolded, the economy showed some pretty reasonable resilience, and now, the focus is on a soft landing. So, if we are tracking into a soft landing or that's our anticipation, are there sectors that you think will do particularly well, and are there sectors that you would avoid?

Simon Brown

Yeah, look, that's a great question. I guess if you're looking for sectors that might outperform, you always tend to look across the sectors that have underperformed the journey to where we currently are. If you look at some of those, and they've been sectors that have been pretty familiar with previous downturns and tightening periods such as building materials. Discretionary has been another area that's underperformed. Rates have done particularly poorly this time on much higher rates. However, there has been a couple of other areas such as healthcare, which you would've imagined being relatively defensive, and media has traditionally been an area where it's exerted defensive characteristics but it's underperformed.

On the other side of that, you have energy, which has been a big outperformer, and look, there has been extraneous factors there in the structure of the oil markets and Ukraine, while telcos and staples, as you would imagine, have been pretty defensive.

At the smaller end, it's less well-defined because it tends to be a lot more diverse in terms of the makeup of that market but look, it has carried larger weightings to discretionary. Materials, resources, non-bank financials, and rates as well, which they've, obviously, helped get to the point where the small cap market is, in terms of the recent underperformance that we've experienced in the last 12 months and one of the worst periods in the last 20 years for underperformance versus large cap.

So, we're probably looking towards the other side and to the earnings forecast for the market to bottom, and then look to take advantage of some of the beaten-up areas across some of those consumer spaces. Housing's an area where we've been a bit earlier on and reasonably positive, and a number of other stock-specific opportunities, and probably, steering clear of the supermarkets and the telcos and the banks which we don't necessarily invest in its small caps, and alongside Agri where we think they'd struggle to keep up with a more positive view of the outlook for the market.

Damien McIntyre

Now, we've just finished reporting season. If it's not finished, we're horribly close to the end. There was speculation that particularly smaller companies, would have trouble with pricing power or passing on the negative impacts of inflation to consumers. Was that a theme? How did that play out?

Simon Brown

Look, I think that was a bit of a theme across the market in general, Damien, because operating margins, if we look across the reporting season, were generally down. However, that was largely consistent across the last 12 months. When you think about it, wages have been a bigger headwind this time. But on the contrary, areas that hurt small caps probably in the first half were rising input prices related to commodities, and everyone's probably heard in anecdotal evidence about how high freight prices went, particularly companies that are importing our product into the domestic economy but these were actually tailwinds this time. So that helped offset some of the other prices that were coming through. Rent and electricity prices have been put up as a result of those supply chain pressures and commodity prices easing.

So yeah, generally, gross profits held up relatively well but I think within small caps and large caps, financing costs are probably the biggest negative that the market failed to factor in appropriately. Despite the fact that interest rates having largely peaked in our view and inflation coming down, there is a fixed level of debt out there, and particularly in the more sophisticated mid to large end of the market where they've got a better ability to fix their debt. The rolling of that fixed debt will mean that there's probably an additional headwind to come across interest costs.

So that will play out over the next one to two years and provide an incremental headwind to APS growth if you like, whereas down in the smaller companies, the balance sheets are in particularly good health with gearing below the average of the last 10 years. We think this provides them with some insulation and the opportunity to deploy those balance sheets into organic and inorganic growth opportunities.

Damien McIntyre

It's a really interesting outcome, considering that the debt was so cheap for so long. Certainly, many companies in the United States took the opportunity on cheap debt, and they are the so-called zombies that exist only because they've had such cheap debt financing. It's interesting to see that that's largely not the case in Australia, that companies' balance sheets are in pretty good shape.

Simon Brown

Yes, it certainly is. Particularly that small cap company that can be a bit of a risk. As I've mentioned before, they do have less access to the capital market's debt funding in particular, and they're forced a lot of the time to go into the equity market to keep funding themselves. So, I think there's that inherent level of conservatism…

Damien McIntyre

And discipline, yeah.

Simon Brown

... across small cap companies and management teams.

Damien McIntyre

Yeah, yeah. So, you're right, it does force boards and chief executives to be prudent with the cash that they've got on their balance sheet, doesn't it?

Simon Brown

Yes, and I think we've probably got a business lending environment where risk-taking is less encouraged to a lot of those larger, when you talk about the big four or five banks, where you have had a whole sector or industry of businesses emerge to cater to that business lending market because it's a market that the larger banks have pulled back from, and I think as opposed to some in the US where that is a more traditional market for them.

Damien McIntyre

Yeah. If you had some additional cash in your portfolio to invest, what are the sectors and maybe some companies that you feel confident about in the medium term?

Simon Brown

I might just start with a quick snapshot of where we were, in terms of, we were probably being a little bit more concerned about the consumer finally coming under a bit of pressure, and that's played out to a degree. So, we've been very positive on travel given that was the reopening play but we're interested in some of the consumer names. I think when you look at reporting season, as I've talked about, an aggregate demand coming into the market by more overseas students and immigration. We could see demand rebound post a reasonably soft period. We saw from about Christmas through to June, July and even into August, where volumes are down and we have some additional population growth to fill up that demand as consumers start to digest interest rate rises that they've seen, particularly those in the mortgage belt across Australia.

So, that's some of the areas that we think are looking particularly cheap with reasonably downbeat expectations priced in, and that's across some of the housing-related exposures and some of the auto-related exposures, where we're seeing some value there.

Travel, we think, has probably priced a lot of the recovery in, but a company-specific name would be Webjet, where we like the fact that they should be able to keep outperforming in this space, post the normalisation we've seen in demand and continue to take share in their hotel bed B2B market, like a relatively defensive salary packaging in the fleet space, where we think investors are still underestimating earnings growth. Names there, we favour Smartgroup and FleetPartners, and it's an area which has garnered a bit more attention recently as the government incentives for novated EBs have become good. We still think they're relatively cheap with better earnings ahead.

Damien McIntyre

Now just a general question, and on the same theme, for financial planners who are thinking about changing the shape of their portfolios, do you think it's a good entry point for small caps?

Simon Brown

Of course, we do think it's a great point in time for planners and investors of any type to consider small caps given the amount of underperformance we've seen versus large caps. Now, 2022 was one of the worst years, the second-worst year in 20 years of performance of Australian small caps versus large, and that's continued into 2023. So, I think there's little expectation baked into small caps where they are at the moment.

If we look out from here, it has been a very challenging decade and a bit since the JFE where economic conditions and financial conditions weren't overly positive or helpful for small cap names, whereas the resetting of conditions post the pandemic, we think, provides for a lot more of a stock picking environment.

When you look at small caps, there is a lot of opportunity within the sector. It's a very diverse sector. It very much mimics more of a normal economy than large caps does, and we feel there's lots of opportunities there to find businesses that are growing faster than the market and businesses that are valued lower than the market. And for you to be able to pick up those double benefits of faster growth and a rerating in stocks, which should, we think, bring back the performance of small caps relative to large caps over the next few years.

Damien McIntyre

That really is the beauty about small caps, isn't it? We all accept the volatility at various times in the cycle but over the long-term, investors have always received great alpha from the sector, and particularly, if you can choose your entry point, the alpha can be outstanding. So, it's a great asset class for the long term, but as you said, '22 was a shocker for all market sectors, but small caps, I won't say small caps in particular, they had a particularly rough ride. So, it's great that investors can direct capital to this market sector with some confidence.

I just want to ask you about Tribeca and the way you manage money. The small cap sector is quite often populated with highly experienced investment teams. David Aylward is one, the term veteran or something similar he's banding around, but David really is one of the veterans of the Australian small cap marketplace. It's amazing how quickly time has passed, and you've now been working with him for the best part of 20 years. So, you are approaching veteran status yourself, whether you want to admit to it. So you guys bring all the experience, and the great thing about experience is, of course, context, but over the years, you've had this process that's tried and true. What do you reckon is the best part of the Tribeca process that sets you apart from your peer group?

Simon Brown

Thanks, Damien. I would have to say the risk management and the portfolio characteristics tests that we run consistently across the portfolio. I think if David was here today, talk about the fact that there are a lot of processes out there for identifying good stocks and stocks that are going to grow but it's how you put all those stocks together to achieve an outcome for the customer or for your partner.

I think having the risk overlays that we've got in our portfolio, and it's something David's had there very much from the start, you can be a very successful investor for a period of time, and I think it can be largely about how well you pick stocks. But a lot of the time, there is risks that creep in and risk is insidious. They creep into portfolios that you may not be aware of and then you may have a change in environment, such as interest rates going up and your portfolio can materially underperform.

So, I think David, in setting up the investment process the way he did, he always wanted to create usable alpha for customers, and by usable I mean we've got a target for alpha but consistently trying to achieve that targeted alpha for clients, and not having large drawdowns that mean that people might lose faith with your investment or your small cap philosophy. So, I think the rigorous nature around which we assess the risks that the portfolio emanates, enables us to truly stick to that style-neutral label, which means it doesn't always matter what the macro conditions are like. We're out there, able to adjust and deliver the alpha for the clients that we say we do, what's on the label.

Damien McIntyre

Yeah, that's right. For the best part of two and a half decades now, David's managed and, of course, over the journey, yourself as well, has managed a lot of money for institutional clients. And what institutional clients want, they want the alpha, but they don't necessarily want the volatility, and to have a loyal institutional client base over multi-decades speaks to how well you manage volatility and risk.

I've always believed that retail follows the institutional market. So, where we are today in the journey with Tribeca is to just make it clear to everyone that, sure you can back small cap managers that swing for the fences, but as you say, you may well end up with lots of unintended bets that you weren't necessarily looking for, and you only find it out when you get to 2022 and markets get rugged. So, to blend Tribeca's risk management prudence, along with another manager who sees it differently, really is a great portfolio balancing act and it's one we're encouraging clients to think about.

So, look, thank you very much for your time this morning, Simon. I really enjoyed our conversation, and I look forward to speaking with you and others at Tribeca next time around.

Simon Brown

Very much a pleasure, Damo. Thanks for the time today.