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JOHCM US Small Mid Cap Equity Fund: A fund targeting the best of the US economy

Vince Rivers, Portfolio Manager at J O Hambro Capital Management, tells Hubbis about the investment philosophy and more behind JOHCM US Small Mid Cap Equity Fund.

According to Rivers, the JOHCM US Small Mid Cap Equity Fund, marketed by London-based asset manager J O Hambro Capital Management (JOHCM), is a concentrated US small and mid-cap fund, which invests in roughly 50 stocks using a sector-based approach.

A number of these small and mid-cap companies have benefited from Donald Trump and his economic policies over the last two years.

Boston-based Rivers says that these are generally companies that will benefit from the recent tax reforms and the increase in infrastructure spending that the current administration has passed in the last year in the US. "We expect better-than-average growth from our companies and believe the valuations are appropriate and make an interesting place for investors to be investing in right now."

Three is better than one

Rivers says that the fund leverages the sector-specific expertise of the team's three portfolio managers.

"Our fund has three portfolio managers (Thorsten Becker and Arun Daniel being the other two) and the way it's structured, each portfolio manager is responsible for a couple of sectors," he says. "My history has been covering healthcare and tech for almost 20 years now, and I focus on those sectors, while one of my other peers (Daniel) covers consumer stocks and industrials, and another (Becker) is responsible for the more cyclical sectors, the financials, energy, materials, utilities."

According to Rivers, the three portfolio managers aim to understand what changes are occurring at the sector level and then use that insight to screen the companies to create an investible list of companies that the fund works on.

"We identify a group of companies we think would be a good investment, a good neighbourhood to look at and move over to fundamental research on those names. Then we are generally creating a model based on the feedback that we get from our research."

Rivers and the other fund managers frequently meet with industry participants and try to identify the real changes that are going on within a sector. "We use that knowledge and focus of our research on what we believe is the best neighbourhood of, say, 15 to 20 companies that we're going to perform bottom-up analysis on to figure out what companies are appropriate for the fund."

These are companies that, according to Rivers, give the fund an opportunity to really directly invest in a trend at a specific level and not have to own a big broad company, which is levered to multiple trends.

The right fit

Asked about the particular characteristics of companies that the fund managers would want to invest in, Rivers says that first and foremost, they want to invest in someone that's doing something different than market expectation.

"The first question you ask yourself as a portfolio manager is where is my view different than the market?" he says.

"So, you want to look across a company's product set, maybe the way they manage it, their approach to the industry, something that over a two to three-year time period is going to yield a difference versus market expectations."

"If you have a company that's very well understood, with products that are very well understood, you're unlikely to find a real differentiated view on it," he explains.

"Sometimes the market will give up on a story long before we will, and we will look at that, and say, wait a minute, they are getting something wrong here," he says. "The growth is there; it's just not showing up in numbers today, the products are working through their sales funnel."

"When it comes out of the sales funnel after another two to four quarters you are going to see significant upside to numbers," Rivers reasons.

Challenge/Opportunity

Rivers is cognizant, however, that investing in small cap companies at an early stage comes with its own set of risks and challenges, especially in the tech sector. These could be anywhere from critical issues like the fraud as in the case of biotech firm Theranos to that of Uber and its reputational issues.

This becomes doubly vital when you know that second and third generation investors in South East Asia and beyond are rapidly turning towards environmental, social and governance (ESG) investing. And some tech companies recently, given also the Facebook-Cambridge Analytica scandal among others, don't climb high up the ESG ranks.

Rivers acknowledges that governance is a crucial factor. "On ESG, the biggest factor we focus on is the 'G', partly because the 'E' and 'S' are sometimes little more esoteric, but governance practices are pretty global," he says. "If you are generally investing in companies with better governance practices, you

generally get better returns over time." Why governance matters, Rivers says, was best seen in the case of Snap, the firm behind social networking app Snapchat, and its IPO, which raised USD3.4 billion from investors.

At that time, prospective investors were told that they would be sold shares with no voting power, that the co-founders Evan Spiegel and Bobby Murphy would retain control even if they stepped down, and that Spiegel's voting power would be diluted only if he cut his stake substantially or nine months after his death. Snap's stock has stumbled since then, and the firm has been called a governance nightmare. "These are companies we just generally don't invest in; our fund tends to have a quality bias to it," he says. That being said, Rivers concedes that the firms that they look are more vulnerable to corporate governance concerns.

"Smaller cap companies tend to have smaller boards, they tend to be more concentrated and less diverse, and so you can't say, we are never going to own a stock that has those characteristics because you eliminate most of the universe," he explains. "But within that universe, you can tell which companies have a board with all their buddies on it, and which have tried to go out and attract real talent to get some good governance on their board."

Looking for wins

On being questioned that being only in small to midcaps is in some ways a more difficult area to get defensive in, Rivers pushes back.

"The last year the US market was negative in was 2015, and our fund was positive for the year," he states. "And it's not that we sat entering 2015, and said, we want to batten down the hatches and change what we do; it's more about putting together 50 companies that are truly changing what's going on in every year."

"Our job is to identify these differentiated stories that are changing things," he says, adding that even though the market could be down or up in a certain year, identifying companies and their products that are truly winning give one a differentiated view of the market, which you eventually get rewarded for.

"We don't make macro views and say, well, I think the market is getting tougher I am going to go buy a bunch of telecom stocks," Rivers notes. "I could tell you what they are and the valuation metrics that will be more defensive, but in a year where that's happening, I could also give you several technology companies that I think are still going to work that are priced on EBIDTA/sales."

Finding those these companies, Rivers says, has the fund take a systemic approach. "The first objective is going to look at the market cap and liquidity of the names," he says. "If you have USD300 million market cap, and it's not liquid at all, or on the other hand a USD30 billion market cap, that's not something we could trade."

Typically, he says, there are five or six names that the fund has targeted based on the fund managers' first view of the industry. "Then within that usually a couple fall out pretty quickly, maybe one that I am not comfortable with either on product or management team," he explains. "When I am maybe down to three names, I start talking to industry participants and taking in what they say."

Eventually, they tend to find a company or a product that's misunderstood in the marketplace. "That stock tends to stick out," he says. "What I end up usually doing though is a full model of at least of the two stocks in that area that I look at and say, relative to expectations and value base, which one offers a better risk-reward." What the fund finally invests in, he says, are companies that are changing their industry, creating new products, or just simply doing things better and different than their large-cap peers. ■