Seymour
INVESTMENT MANAGEMENT

April 17th, 2024

Global equity markets continued their strong performance in the first quarter. The S&P TSX Composite Total Return Index saw a 6.6% increase, while the S&P 500 Total Return index rose 13.0% (10.6% in USD).

Economic data continues to exhibit positive trends, signaling reduced inflationary pressures and resilient demand. Investors have responded favourably, as the likelihood of severe economic repercussions from the rapid interest rate hikes since 2022 appears diminished. Although Canada faces more challenges than the US, it seems likely that a significant recession will be averted, and central banks will be considering rate cuts before year-end.

How I learned to stop worrying and love volatility

After a period of underperformance in small-cap stocks, we are often asked about what companies we own and why, and if those companies' share price declines are indicative of their future prospects being troubled or impaired.

We remind investors that while short-term share price fluctuations can make reviewing your quarterly statements a rollercoaster of emotions, it's crucial to maintain a long-term focus. Historically, small and mid-cap companies have exhibited more volatility than their large-cap counterparts, primarily for two reasons:

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1) **More volatile fundamentals –** As smaller businesses, their revenue streams are often less diverse. They may only have operations in one country or rely on a handful of key customers/suppliers. Consequently, their revenues and profits are more likely to fluctuate with the broader economy.

2) **More volatile investor sentiment & ownership** - In Canada, the vast majority of equity assets are managed by large institutions whose performance is measured against benchmark indices such as the S&P/TSX Composite Index ('TSX'). The TSX is comprised of well-established, large-cap companies like Royal Bank, CN Rail, and

Loblaws, which hold a significant weight (3-5% individually). Index-oriented investors will generally own these large-cap companies as core holdings with similar weightings to their respective index weights. Small-cap companies comprise immaterial weights (0.15% or even 0%) in the TSX, and tend to be less widely owned by large institutions as core holdings. The resulting behaviour is that when things are going well for a small cap company, traditional investors take notice and purchase the stock, but at other times may sell all of their small caps or completely ignore them. This cyclicality in sentiment and ownership results in greater changes in small cap valuations and share prices than is justified by the fundamentals.

Point 1 is a real risk, which we strive to understand thoroughly before investing. We conduct significant due diligence and continual monitoring of business fundamentals; the strength of management in charge; and balance sheet so that investments we own can withstand inevitable business bumps and cycles.

Point 2, however, represents an opportunity. The volatility in sentiment that comes with smaller companies is not always fun as a shareholder or in your quarterly statements, but it allows longer term investors to take advantage of temporary disdain/apathy and buy a great business at a bargain price. If we own a great company that continues to grow, eventually others will notice too.

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It's best to illustrate this with an example. Without revealing their names, we'll describe two great companies we own: One you'll have heard of, and one you might not know so well. Hopefully it will illustrate why investments in high quality small cap stocks can generate better long-term risk adjusted returns. Bonus points if you guess the companies before the reveal.

Company A:

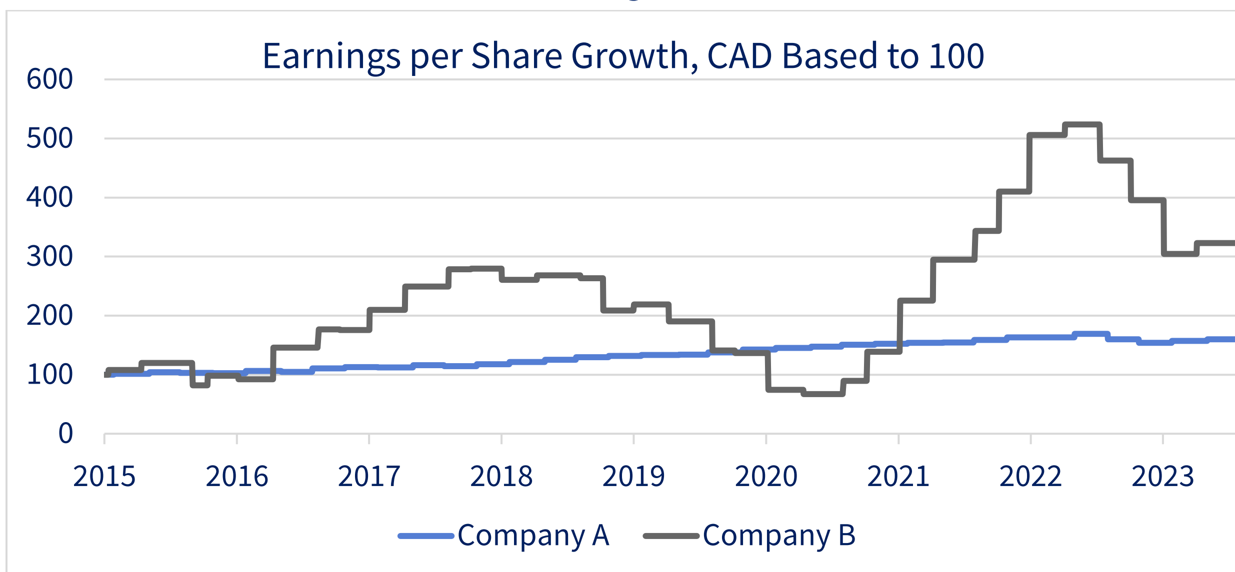
- Is a market share leader in Canada
- Has a track record of growing through acquisitions. While some acquisitions have been successful, others have faced challenges
- Has operations globally, but the majority of the profit still comes from Canada
- Has a strong management team, with a history of successful leadership transitions
- Has brand colors mostly featuring blue and white
- Is government regulated, as per industry norms, Company A uses high amounts of leverage to generate acceptable returns
- Over the 8.5 years, $1 of earnings have grown into $1.60, representing a compound growth rate of 6%

Company B:

- Operates on a global scale, excelling in sophisticated procurement and sourcing, with the majority of revenue coming from the United States & Europe
- Has a long track record of strategic acquisitions, often aimed at expanding into new product lines and geographies
- Has a strong management team who are economically aligned with shareholders as they own about 2/3rds of the company, roughly $2B of their net worth tied to the company's success
- Has brand colors mostly featuring blue and white
- Is very conservative with leverage, has run most of its history debt-free
- Since going public in mid-2015, has compounded $1 of earnings into $3.30 (approximately 15% growth per year)

In the below graph, we've compared the earnings growth over the last 8.5 years of the two companies (since Company B has been public).

Exhibit 1: Two Different Paths to Earnings Growth



Source: LSEG Workspace, Company Reports

As you can see, Company A has shown a more steady and predictable earnings growth rate. Company B was impacted more from the pandemic, first in an immediate slowdown as retail stores were shut down, then a major boom as people looked to entertain themselves and their families at home. Given its market leading position, and great track record of steady earnings growth, Company A shares currently trade at ~12x Forward earnings. In comparison, Company B trades at under 10x earnings with a superior growth profile. Any guesses yet?

The Results

Company A is Royal Bank. Company B is…… Spin Master – the Canadian based toy company who you might know through their properties such as Rubik's Cube, Paw Patrol shows & movies, or Toca Boca & Sago Mini digital games. We've talked about Spin Master in our past fund commentaries. We find the combination of high-quality aligned management, a long runway for future acquisition & internal development, and conservative balance sheet as an example of an excellent small cap investment opportunity that's overlooked & undervalued because of its size.

Exhibit 2: Comparison of RBC and Spin Master

Revenue (FY 2023, $Billions)	$49.1	$1.9
Employees	97,000	3,000
Inside Ownership	0.02%	68%
Historical Earnings Growth Rate (since IPO of TOY)	6%	15%
Forward Price to Consensus Earnings	11.7x	10x

Source: LSEG Workspace, Company Reports

Spin Master is just one example in Seymour's portfolio underscoring the rationale behind our focus on a diverse investment universe that includes small-cap companies. These smaller firms often exhibit superior growth rates and more attractive market valuations. While understandable, investors often mistakenly associate short-term share price volatility with risk. Regardless of a company's size, our approach centers on identifying high quality companies, where the key risk clients should care about, that of permanent capital impairment, is minimized. While it's true that small-cap stocks tend to experience higher volatility in the short term, for long-term investors in high-quality companies, this volatility can be seen as a gift.

Sincerely,

The Seymour Team