TD Global Investment Solutions

Spotlight 10 Minutes
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A Conversation With

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Finding Value in U.S. Small Cap Stocks

The name of the strategy you co-manage is Small Cap Quality Value. Can you explain what you mean by Quality?

There are a lot of different definitions of Quality. Quality indexes, for example, tend to use a collection of factors to define quality, such as high return on equity, low debt to equity and low earnings volatility. These factors may help to indicate that a company is a quality company but they can also be manipulated within the rules of accounting. We look at things a little differently and took the time to identify 6 key fundamental factors we believe drive long term shareholder value. Our fundamental analysts evaluate these factors during their research process. We even require the analyst to score the companies they evaluate on each factor and roll that up into an overall quality score for each company. The fundamental factors include management and board quality, capital allocation, competitive position, industry quality and cyclicality, free cash flow, as well as other potential company specific catalysts.

Can you explain what you mean by value?

What we are trying to do is buy a company for less than it's truly worth. We agree with a common phrase in investing that says — *Price is what you pay. Value is what you get*. It's a broadly accepted financial principle that the fair price, or intrinsic value, of a business is simply based on the present value of future cash flows. Through a detailed and disciplined fundamental research process, our analysts forecast a normalized level of free cash flow over the next several years and discount that back to present value. We then evaluate that present value vs. where the shares trade today. Of course, we're also very focused on the terminal value of the business where we analyze competition, obsolescence risk, and other long-term factors. If you wanted to use currently available multiples, we would highlight free cash flow to enterprise value (FCF/EV) and free cash flow yield

(FCF Yield) as the two key metrics that can be used to measure value. We are agnostic to the book value or price to book ratios.

Why not use Price to Book, like most Value managers?

While book value does tend to be very stable, which is a positive, we believe book value has been losing relevance over time and that might even get worse. This is because corporate America continues to shift their mix of investment from tangible assets towards intangible assets. Tangible investments are physical goods, things you can touch and feel. Think about things like factories, all the machines and tooling inside those factories, retail stores, inventory, trucks and construction equipment. Intangible investments include those things you can't really touch and feel. Think about software code, all the patents and formulas across the medical and pharma industry, name brands, ecommerce technology. While we still need tangible assets in our lives, even these tangible assets are filled with intangible investments. Think about all the technology in your car and home and how that compares to a few decades ago. With the growth in Artificial Intelligence, it's possible this trend accelerates further from here. So, it shouldn't be that surprising to know that over the last 40 years, the mix has flipped and the majority of capital investment is now going towards intangible investments. This is where the accounting comes in and the distortions arise. In general, tangible assets are depreciated over their useful life while intangible investments are expensed up front. To avoid these distortions and stay relevant with the modern and future economy, we focus on FCF based valuation metrics and not Price to Book.

Is there any data that supports FCF based valuations being a better indicator of company success?

Absolutely. Bloomberg does a great job analyzing 20 different valuation metrics. Over longer time periods, such as 10 and 15 years, price to book is one of the worst performing value metrics. This is probably why it's become common for people to say things like "value investing is dead" or "value investing only works one out of every five years." On the flip side, FCF/EV and FCF yield are some of the top performing metrics over 10 and 15 years, according to Bloomberg. So, value investing is *not* dead, it is alive and well, as long as you look to buy companies attractively valued based on their *free cash flow*, rather than companies with cheap price to book ratios.

How has this focus shaped the U.S. Small Cap Quality Value Strategy?

Our portfolio's metrics over the last 5 years prove that we do what we say we do. Again, our goal is to buy high quality companies at a discount to their FCF-based valuation. When you compare our portfolio to its benchmark, the Russell 2000 Value Index, our portfolio is *cheaper* on a Price to FCF basis. It also has superior operating margins and returns on equity. Lastly, it has been able to do this with balance sheets similar to, or better than, the benchmark on a net debt to EBITDA basis. This is not easy to do. It is only possible thanks to our dedicated team of fundamental analysts' adherence to our rigorous and disciplined investment process, which is laser focused on finding quality companies with strong cash generating enterprises.

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