THE GLOBE AND MAIL

Little-known smaller stocks that a $2.3-billion fund manager is buying and selling

BRENDA BOUW

SPECIAL TO THE GLOBE AND MAIL

PUBLISHED JULY 23, 2022

While many money managers shy away from buying small cap and microcap companies, Alex Etsell seeks them out – believing some of these lower-profile names can provide the greatest growth potential.

Mr. Etsell, a senior portfolio manager and partner at Hillsdale Investment Management Inc. in Toronto, also believes these smaller-sized stocks should be part of the mix in most investor portfolios.

“There’s a tremendous diversifying effect with these names,” says Mr. Etsell, who oversees about $2.3-billion of his firm’s $3.8-billion in assets.

He defines microcap stocks as those with a market valuation of about $100-million to $300-million, while small-cap stocks are anywhere from about $300-million to $4-billion.

And while these stocks tend to be risker because the companies are smaller and their stocks less liquid (meaning they trade less), Mr. Etsell has outperformed the broader markets by selecting the ones he considers to be high quality with strong growth potential.

His Canadian small-cap fund is down 7.2 per cent over the past 12 months, as of June 30, while his microcap fund is down 0.7 per cent. These results compare with a loss of 6.5 per cent for the S&P/TSX Composite Index over the same period.

The annualized return for Mr. Etsell’s small-cap fund over the past three years is 10.4 per cent, as of June 30, while his microcap fund’s annualized return over three years is 18.9 per cent. The S&P/TSX Composite Index’s annualized return over the same three-year period is 4.8 per cent. These products of Mr. Etsell’s are pooled funds that are available to accredited investors only.

“What makes the microcap space such a great opportunity for us in Canada is that we have the TSX Venture Exchange, which is a sophisticated junior exchange … and has been a proving ground of sorts for many small companies,” he says.

The Globe and Mail recently spoke to Mr. Etsell about his strategy, including companies he’s been buying and selling.

Describe your investing style.

We take a quantitative, data-driven approach. We score stocks on a wide variety of investment factors against their peers. We don’t favour any specific investment style, such as growth or value. Instead, we use what’s known as an ensemble approach that captures those different styles. We rank stocks on a few different styles and we look for agreement between those styles. We believe the approach allows us to achieve more consistent returns. We are also active traders, which is the nature of the quantitative approach. That said, there are many names we hold for many years.

What’s your take on the current market environment?

As most investors know, there’s quite a bit of uncertainty in the market today. A lot of people who came to the market for the first time during the pandemic got very comfortable with an oversimplified ‘buy the dip’ mentality, which is an easier proposition when central banks are doing everything they can to prop up markets.

It’s more nuanced today in a rising rate environment. There’s been a fair amount of pain, and I don’t know if we’re at the end of it yet, but there is quite a bit of value in the market if you know where to look.

What have you been buying or adding?

We’re always looking to hold high-quality names, which in this market environment are companies that are growing and still showing profitability and have very strong margins. These factors are especially important in a high-inflation environment. One name we recently added is Taiga Building Products Ltd., which provides decking products, railings and accessories. Other names we own include envelope and paper company Supremex Inc., as well as Hammond Power Solutions Ltd., which makes transformers used in electrical equipment and systems. These have been very profitable names for us, and we’ve increased our positions in them recently. We have also been adding some restaurant operators, a sector where we still see some upside coming out of the pandemic, such as Keg Royalties Income Fund and SIR Royalty Income Fund. Both have dividend yields of about 8 per cent.

What have you been selling or trimming?

We have sold a few names that are still good companies but we see them as being higher risk. One is industrial valve company Velan Inc., while another is Stampede Drilling Inc. We will also sell architecture and engineering firm IBI Group Inc. soon, after its recent takeover news. [IBI Group announced on July 18 that it's being bought by Amsterdam-based design and consultancy firm Arcadis for $19.50 a share – a 30-per-cent premium to its share price before the deal was announced.]

Name a couple of stocks you bought as microcaps that have since grown into larger caps.

Some recent examples of our top microcap holdings over the last couple of years that have outgrown the portfolio and gone on to join the S&P/TSX Composite Index include Converge Technology Solutions Corp. (CTS), which we sold in the first quarter of 2021, and Headwater Exploration Inc. (HWX), which we sold in the second quarter of 2021. With HWX we saw a return of 140 per cent, while CTS gave us a return of 290 per cent.

Our ideal microcap holding is a name that picks up some analyst coverage, graduates from the TSX Venture Exchange to the TSX, and then is eventually added to the major equity indices, like the S&P/TSX Composite. Those are often great holdings for us. Also, it's not uncommon for names to leave our funds through acquisition; we get five to 10 of those a year.

This interview has been edited and condensed.

Follow Brenda Bouw on Twitter: @BrendaBouw

https://www.theglobeandmail.com/investing/markets/inside-the-market/article-invest-in-these-microcap-stocks/