Transcript of Interview
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Small Cap Stocks

Brett Harris: We don't often talk as much about small caps, though. They get a lot less attention from analysts on the street and some investors may wonder how to go about evaluating these types of stocks. Well, our next guest takes a quantitative approach to small caps. Sam Wiseman is President and Chief Investment Officer of Wise Capital Management, and he's in our studios. Good to have you here.

Sam Wiseman: Good afternoon, Brett. Thanks for inviting me in.

Brett: Let's just lay the groundwork here a little bit. There are a lot of different ways that people quantify these. When you're talking about small caps, what kind of market cap are we talking about here?

Sam: We're talking about $700 million. That's what the industry uses. And of course, if the market goes up quite a bit, we'll raise that bar.

Brett: Okay, so $700 million. Anything lower we're into the small cap sector. Now, a lot of people think that these stocks mean they're riskier; they're not quite as liquid overall. But you do have some risk controls that you use when you're evaluating these stocks. Can you explain how that works?

Sam: Sure, absolutely. We have a seven step risk control process we use for large and small cap. Particularly for the small cap, at the beginning of the process we're only looking at companies $100 million or more, and we feel that anything lower is a problem in the Canadian market. At $100 million, in almost every case we can get out of the stock in a couple of trading days. Later on in the process, once we have the numbers, we pay a lot of attention to the fundamentals. It's a fundamental overlay process. In the fundamentals, it's very important for a small company to have a clean balance sheet, because, in Canada, a company doesn't have too many options if they get into trouble. The last thing we look at, and what a lot of people in Canada look at first, is the story. Once the numbers, everything is in place, we say "Does this business model make sense?" And, if we're uncomfortable, we throw out the name. So, we'll throw out perhaps half the names that get screened in just on pure numbers alone.

Brett: How much of it is fundamentals, versus quantitative analysis?

Sam: Seventy-five percent quantitative and 25 percent fundamental.

Brett: Okay, now let's talk a little bit about some of the current trends that you're spotting and that you're tracking with the small caps. What would lead the list?

Sam: Well, right now we see that the average name that we're putting in a small cap portfolio is undervalued by about a third. It's not the highest number we've seen. But we think that there's a couple years yet—that small cap over a period of time will outperform the large caps.

Brett: So you think the markets will eventually reward those stocks with fair evaluations?

Sam: Sure. It's not going to happen every day, but over a reasonable period of time, if investors are patient, they'll see good things happen to these small names. And in the last couple of years we've had a tremendous number of takeovers and other pleasant surprises.

Brett: What's a reasonable period of time? How patient do you have to be?

Sam: Well, I won't put anybody in a small cap portfolio that's not willing to look at this over a full market cycle of about 5 years. But I think in the next two years we're going to see superb outperformance over the TSX for small cap.

Brett: You've got some examples that you've brought in for us today. Aecon Group, I think, is one of those. What is it that you like about this stock?

Sam: Our viewers are familiar with Aecon because it's an infrastructure company. It's involved internationally as well. Aecon has a tremendous valuation: a very low price-to-book, and price-to-cash. It has had tremendous growth, which has not been valued into the market. When we talk about growth, we don't talk about future growth. We talk about the success of management being able to grow its revenues, grow its assets, and that hasn't yet been recognized. It had a high of $7 a few months ago. We believe it will get back there.

Brett: What about Canadian Western Bank? Let's take a quick look at that one.

Sam: Canadian Western Bank is interesting. It's moving along very nicely. It's got very nice fundamentals. It has a rate of return to shareholders of 12–13%, and the analysts are saying that's going to continue. We think it's worth at least a quarter more, and that's because we think it's an excellent takeover candidate. And being a smaller bank, it won't have the same political attention as the larger banks.

Brett: And a very quick look at toy company Jakks Pacific.

Sam: Jakks Pacific is a U.S. toy company. It has the full line of toys. It has, again, excellent fundamentals, excellent growth. In a fantastic industry, it has a price earnings ratio—a normalized ratio—of eight times, which is excellent for any U.S. company. It's rare that we find a U.S. stock that is tremendously undervalued against the market. And here we have one we think is worth at least a third more. We see U.S. analysts saying two-thirds more.

Brett: And, for disclosure purposes, these are all in your client portfolios? Personal portfolios as well?

Sam: Absolutely. We hold all the same names that our clients do.

Brett: Okay. Sam Wiseman, great to talk to you.

Sam: Thanks very much.

Brett: Hope you'll come on back. We appreciate it. That's Sam Wiseman, Chief Investment Officer at Wise Capital Management, with a look at the small caps.