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Interview with the SMID Cap Portfolio Manager

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Interviewer: Can you give us an elevator pitch for the Crawford SMID strategy?

Doug Asiello, CFA: The Crawford SMID Cap strategy pitch can be broken down into a few differentiated principles.

First, the strategy offers exposure to a secular, recurring trend we have found that favors dividend payers within the small-to-mid cap investment universe. To be more specific, we have found that dividend payers within the strategy's benchmark, the Russell 2500 Value Index, consistently outperform non-dividend payers over long periods of time while offering strong downside protection and lower volatility. The small-to-mid cap space is a real sweet spot for this phenomenon because there are many companies that are mature enough to pay a dividend, but there is an overall neglect of higher-quality, smaller company stocks. The Crawford SMID Cap strategy benefits from this behavioral anomaly we have discovered.

Our research team does in-depth fundamental, bottom up research across this dividend paying universe within all eleven economic sectors to identify businesses with clear, sustainable competitive advantages. Our team members each cover an economic sector and have vast experience within their assigned sectors, so the result is a portfolio with strong return characteristics, greater downside protection, and lower volatility. Consequently, the strategy offers a great way to gain exposure to an area of the stock market that is leveraged to nominal GDP growth and can keep pace with inflation.

Lastly, we believe the strategy currently possesses a relative valuation advantage unlike anything we have seen over the past few decades. Large caps have recently demonstrated dramatic outperformance over small and mid caps, and we do not believe this outperformance is sustainable. In turn, we believe a reversion to the mean is likely. We believe this should result in outperformance of small and mid cap stocks, hence strong performance, at least on a relative basis, for the Crawford SMID Cap strategy moving forward.

It sounds like folks who invest in the Crawford SMID Cap strategy today should benefit from a number of positive trends over the next few years. To be a bit more specific, what investor objectives does the SMID Cap strategy satisfy?

TThe strategy provides competitive returns over a full market cycle with lower risk. We deliberately seek out undervalued stocks that have competent management teams who prudently allocate free cash flow, have lower debt profiles, and possess advantaged business models. As a result, the Crawford SMID Cap portfolio is inherently lower risk than its benchmark and even the dividend paying subset of the index. Consequently, the strategy smooths the ride in times of market distress. That said, we believe SMID has a place in many client portfolios, existing and prospective, and we believe it pairs well with many other Crawford equity strategies. We believe clients invested in the strategy should benefit from attractive, long-term returns and a relatively low degree of risk.

Please discuss your personal investment philosophy/approach?

Many seasoned investors say that stock prices follow the direction of earnings. We agree with this generally, but our investment philosophy is price-sensitive and more focused on two other important metrics: Free Cash Flow (FCF) and Return on Invested Capital (ROIC). Within our equity investment team at Crawford, we have a high degree of philosophical consistency and integrity, so I am speaking not just for myself but for the team here.

We follow the magnitude, direction, and growth of FCF. I've already noted that we are looking for companies that have sustainable competitive advantages. But more specifically, we are looking at the sustainability and growth of the FCF stream that the competitive advantage throws off. We seek to identify this when other investors may not realize it, utilizing our information advantage in the process.

Secondarily, and importantly, we look for management teams that can take that FCF and, while paying a dividend, reinvest that FCF into ROIC accretive endeavors. Sometimes that happens through M&A, or acquiring a company that expands the business's competitive advantage or gets them into an adjacent business line. Other times, this could include expanding a manufacturing facility to meet excess demand. Or it could mean repurchasing the company's own shares outstanding at a discount to the company's assessment of its own Intrinsic Value. In sum, we carefully analyze a company's historical ROIC and then attempt to forecast that going forward.

I know management team strength is a key component that you look for when you're exploring new ideas. Can you talk a bit more about this?

I would underscore the principle that our eight member equity research team has been at this game for over 20 years each, which means our collective experience is nearly 200 years. So, we all have experience with management teams that have performed very well over many years and those who have not done as well. So we have our antenna up for red and green flags. For example, a lot of change in the C-suite, CFO departures, or change of auditors – these are the kinds of things that get our attention with respect to management and corporate governance. Our new idea vetting process includes a rigorous assessment of management and corporate governance. We look at incentivization structures, history, and what C-suite executives have done previously in their careers. Essentially, we are looking for long-term-oriented team players who realize that valuation creation is a heavy task. We insist on management teams that are shareholder aligned.

Secondarily, and to bring it back to the point I mentioned before, we spend quite a bit of time looking at historical capital allocation with the existing management team, so we can assess the collective management team's prowess at driving ROIC and creating good outcomes for our SMID investors. We think our thorough analysis of management teams at Crawford is a differentiator for the firm and our investment approach.

In conclusion, could you discuss what company/quality attributes are particularly important in the current environment?

In addition to those attributes I have discussed, we like to buy companies that employ relatively low leverage. We are really looking for companies whose debt load provides financial flexibility and doesn't preclude them from engaging in ROIC accretive endeavors. We are generally uninterested in companies that must use all excess FCF, after the dividend, to address debt loads or debt fears in the market. At the moment, we have our antenna up with respect to lingering inflation. Consequently, we are looking for companies that can pass on inflationary costs, or that have strong pricing power for their products. In our assessment of a company's competitive advantage, we are thinking carefully about whether or not a SMID candidate will be able to wield enough pricing power to offset lingering and potentially higher-than-expected inflation. We believe our investors will benefit from our attention to these attributes as we move forward.

Do you have any final thoughts?

To conclude, we believe the Crawford SMID strategy is attractive today for several key reasons: overall quality and earnings consistency, attractive valuation, and above-average growth prospects. The combination of these should lead to attractive total shareholder returns and we are optimistic about our ability to continue to add value in this area of the stock market.

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