

A Top Global Small-Cap Investor's Stock Picks

By Lewis Braham • June 7, 2018 3:15 p.m. ET



PHOTO: COLE WILSON

If you go to ABC-MART's Japanese website, mostly what you'll see is a bland assortment of shoes: Nike, Converse, Puma, Skechers—all the usual brand names. "ABC sells quite ordinary everyday shoes," says Magnus Larsson, lead manager of the AMG TimesSquare International Small Cap fund. "But they [sell] almost four times as many shoes in their retail space as the competition. How do they do that?"

It's Larsson's job to figure out how, and he's good at it. His \$1.2 billion fund (ticker: TCMPX) has delivered a 13.6% five-year annualized return, beating 94% of its peers in Morningstar's foreign small-cap growth fund category and the Vanguard FTSE All-World ex-US Small-Cap exchange-traded fund's (VSS) 8.3% return. He's done this using old-fashioned stock-picking, with analysts doing on-the-ground research at specific companies.

International small-mid-capitalization stocks are one of the few market sectors where active management can consistently add value. They are poorly covered by financial analysts, and thousands of them aren't even included in benchmark indexes, so managers who find good undiscovered companies can beat passive funds. In fact, a 2013 study by Radford University finance professor Abhay Kaushik found that the average foreign small-mid-cap growth fund beat its benchmark by 3.18 percentage points a year, after fees, over a 20-year period from 1992 through 2011.

"Two key things that differentiate us are we have one of the most experienced foreign small-cap teams, and we are all from overseas," Larsson says. "I am Swedish, and we have a Frenchman, a Taiwanese, a Turk, and a Dane. We actually come from the regions where the companies we invest in are located." The five-member team averages 23 years of experience each. "I've been in small-caps my whole [professional] life," says the 47-year-old Larsson.

A deep understanding of the local business culture in specific countries is vital to Larsson's strategy. He spends two to three months a year on the road. To understand ABC-MART (2670.Japan), he went to its Japanese stores. "The company has a very highly trained sales force, but also something a bit un-Japanese—every local store manager has a high degree of say over what shoes that particular store can sell," he says. That means a store manager in a blue-collar neighborhood can sell different shoes from a manager in a wealthy white-collar one.

AMG TimesSquare International Small Cap

	Total Return		
	1-Yr	3-Yr	5-Yr
TCMPX	14.1%	13.7%	13.6%
Foreign Small/Mid Cap Growth Category Avg.	17.2	10.3	10.5

Top Ten Holdings* Company / Ticker	% of Portfolio
Horiba / 6856.Japan	3.3%
Altran Technologies / ALT.France	2.9
Amplifon / AMP.Italy	2.8
Samsonite International / 1910.HK	2.7
CIE Automotive / CIE.Spain	2.7
Sugi Holdings / 7649.Japan	2.7
ABC-MART / 2670.Japan	2.5
Prosegur Cia de Seguridad / PSG.Spain	2.4
Izumi / 8273.Japan	2.4
RPC Group / RPC.UK	2.3
Total	26.7

*Holdings as of 4/30. All returns as of 6/5; three- and five-year returns are annualized. Sources: Morningstar; AMG Funds

"The typical competition at the other national chains sells the same shoes in every store everywhere, and a local manager would never dare question senior management on what kind of shoes to sell," Larsson says. "That's a cultural thing in Japan." Because of its more customized strategy, ABC has a sales advantage.

Larsson says management matters more at small companies, so meeting CEOs is important. "If you look at a company like Siemens [SIE.Germany], which has nearly 400,000 employees, how much difference does the CEO really make; whereas a smaller company's management has a much stronger and more direct impact on the success of the business," he says.

Significant insider ownership is another plus: "If management has a stake in real equity, they will act as owners and not only try to cash in a yearly bonus," Larsson says. So in the case of ABC-MART, the company's founders own 37% of its shares, worth \$2 billion, and the CEO owns about \$4 million in equity.

His favorite companies have steady cash flow growth and are the dominant players in industry niches. The fund's largest holding is Horiba (6856.Japan), a Japanese manufacturer of air-quality and emissions testing equipment, among other things. "In car and truck emissions testing equipment, Horiba has a 60% to 70% market share in most markets globally," he says. "It also has a strong market share in equipment that measures air quality for the semiconductor industry."

Microchips are made from refined silicon in what are called "clean rooms" that must have pristine air quality. "You're not going to buy cheaper air-quality testing equipment just to save a couple of thousand dollars when you've invested a billion dollars in a big semiconductor plant," Larsson says. "We love those kinds of situations when our companies have a very small part of a much bigger value chain, but they're mission-critical and hence the customer would not want

to save money on such a small thing and risk everything." Being dominant in such a niche gives Horiba sustainable profit margins.

One of the problems with growth funds in general is they're often volatile, as highflying market darlings can crash. But Larsson has managed to limit downside risk. In the past five years the fund has had an upside/downside capture ratio of 105/56—with 105% of the market's upside with only 56% of its downside, according to Morningstar.

"I think the biggest mistake the average growth investor makes is not being focused enough on valuation," he says. "Investors get swayed by the fantastic growth prospects of companies and forget everything has an intrinsic value." For this reason, Larsson sets valuation-based price targets for every position and sells stocks at their targets even if he still likes them.

Larsson also employs an overlay of macroeconomic analysis to reduce country-specific risks. Since the Brexit vote in 2016, for instance, he has generally kept an underweight position in United Kingdom stocks, which currently account for 11% of his portfolio versus the MSCI EAFE Small Cap Index's 18.1%. "Post-Brexit we saw a significant headwind for the U.K. consumer," he says. "The currency movement caused imports to be a lot more expensive." Still, he says, much of the negativity on Britain is already priced into its stocks today. "We will probably be buyers from here in the U.K. based on valuation."

One recent U.K. purchase is Electrocomponents (ECM.UK). Larsson didn't just buy it because British stocks are cheap; he likes the management. "Three years ago, the company got a new CEO who came with a strong technology background," he says. That CEO digitized the company's entire inventory, which, Larsson says, consists of hundreds of thousands of electrical components, so shoppers can buy them online.

"Still today, the majority of the competition has these big thick telephone-book-sized catalogs where the price is printed once a year," he says. Online catalogues allow for "dynamic pricing" that can adjust daily based on market demand, leading to more efficiency and wider profit margins.

As with every stock he buys, it was his deep detective work that gave Larsson the confidence to invest.

AMG TimesSquare International Small Cap Fund

Investors should carefully consider the Fund's investment objectives, risks, charges and expenses before investing. For this and other information, please call 800.835.3879 or visit amgfunds.com for a free Prospectus. Read it carefully before investing or sending money.

Average Annual Returns (%)¹ (as of 03/31/18)

	QTD	YTD	1 yr	3 yr	Since Incpt.
TCMPX (Class N)	3.59	3.59	28.61	15.02	14.60 ²
TQTX (Class I)	3.63	3.63	28.82	—	31.92 ³
TCMIX (Class Z)	3.69	3.69	28.91	15.29	14.82 ²
MSCI EAFE Small Cap Index	0.24	0.24	23.49	12.25	11.94 ²

TCMPX (Class N) Expense Ratio (Gross/Net): 1.24%/1.24%

TQTX (Class I) Expense Ratio (Gross/Net): 1.04%/1.04%

TCMIX (Class Z) Expense Ratio (Gross/Net): 0.99%/0.99%

The performance data shown represents past performance. Past performance is not a guarantee of future results. Current performance may be lower or higher than the performance data quoted. The investment return and the principal value of an investment will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost. For performance please call 800.835.3879 or visit our website at amgfunds.com.

Mention of a specific security should not be considered a recommendation to buy or a solicitation to sell that security. Holdings are subject to change.

As of March 31, 2018, 10.51% of the Fund's holdings consisted of stocks from the United Kingdom.

A short-term redemption fee of 2% will be charged on shares held for less than 60 days.

Investments in international securities are subject to certain risks of overseas investing including currency fluctuations and changes in political and economic conditions, which could result in significant market fluctuations. The Fund is subject to the risks associated with investments in emerging markets, such as erratic earnings patterns, economic and political instability,

¹ Returns for periods less than one year are not annualized.

² Since the inception of the Fund's Class N and Class Z shares on January 2, 2013.

³ Since the inception of the Fund's Class I shares on February 24, 2017.

changing exchange controls, limitations on repatriation of foreign capital and changes in local governmental attitudes toward private investment, possibly leading to nationalization or confiscation of investor assets.

The Fund is subject to risks associated with investments in small-capitalization companies, such as erratic earnings patterns, competitive conditions, limited operating history and a reliance on one or a limited number of products.

The Fund is subject to currency risk resulting from fluctuations in exchange rates that may affect the total loss or gain on a non-U.S. Dollar investment when converted back to U.S. Dollars.

The Fund may invest in derivatives such as options and futures; the complexity and rapidly changing structure of derivatives markets may increase the possibility of market losses.

The Fund invests in growth stocks, which may be more sensitive to market movements because their prices tend to reflect future investor expectations rather than just current profits.

The MSCI EAFE Small Cap Index is an equity index which captures small cap representation across Developed Markets (DM) countries around the world, excluding the US and Canada. Please go to msci.com for most current list of countries represented by the index.

Unlike the Fund, the MSCI EAFE Small Cap Index is unmanaged, is not available for investment and does not incur expenses.

AMG Funds are distributed by AMG Distributors, Inc., a member of FINRA/SIPC.

Definitions

Downside Capture Ratio: The downside capture ratio measures a manager's performance in down markets relative to a particular benchmark. A down market is one in which the market's quarterly (or monthly) return is less than zero. For example, a ratio of 50% means that the portfolio's value fell half as much as its benchmark index during down markets.

Upside Capture Ratio: The upside capture ratio is a measure of a manager's performance in up markets relative to a particular benchmark. An up market is one in which the market's quarterly (or monthly) return is greater than or equal to zero. For example, a ratio of 50% means that the portfolio's value increased half as much as its benchmark index during up markets.

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