Architect Manager Spotlight
Barrantagh Investment Management

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The Manager Spotlight showcases managers in the BMO Nesbitt Burns Architect Program® ("Architect") and provides them with the opportunity to share their views on recent market events and strategies specific to their portfolios.

BARRANTAGH
Investment Management

Established in 1995, Barrantagh Investment Management Inc. provides disciplined portfolio management to individual and institutional investors. Barrantagh seeks to generate growth through the consistent application of their quality, value-based, fundamental investment philosophy to deliver above-average investment returns, while incurring below-average levels of investment risk.

To gain further insight into the **Barrantagh Canadian Small-/Mid-Cap Equity Portfolio**, the BMO Private Wealth Investment Manager Research team recently spoke to **Sean Wetmore**, **Portfolio Manager, Barrantagh Investment Management Inc.**

Briefly describe the investment philosophy and process for the Barrantagh Canadian Small-/Mid-Cap Equity Portfolio?

Barrantagh Investment Management ("Barrantagh") employs a disciplined, fundamental, value investment approach. Simply put, we look for companies that are superior businesses managed by capable management and trading at attractive prices. Our fundamental research process controls risk from the bottom-up by focusing on quality value. This is a combination of a bias to full cycle profitability, low capital intensity, strong balance sheets, management assessment, and entry points when companies demonstrate value versus their peers and their own valuation history.

The Barrantagh Canadian Small-/Mid-Cap Equity Portfolio is a focused "Best Idea" portfolio holding 20 to 40 stocks (typically 25 to 30 holdings). We generally target companies that are less than $2 billion in market capitalization with a dividend yield of 1% or greater. Our quality, value focus delivers a lower risk profile by avoiding "concept stocks" (stocks that may benefit from popular momentum and are valued beyond their net worth) in favour of measurable cash-flow-based profitability, proven management and limited cyclical exposure. Portfolio candidates are assessed using our disciplined investment decision-making process which consists of preliminary screening, qualitative analysis including a company's Environmental, Social, and Governance ("ESG") profile, and a thorough management assessment; followed by financial modelling, including discounted cash-flow analysis of each company, to help determine those companies that we believe have a 40% return potential over three years. Price targets are set for each company, reviewed on an ongoing basis, and sold upon full valuation unless targets are re-priced due to earnings updates and/or company news that provides upside opportunities.

Historically, the Portfolio has demonstrated strong downside protection relative to the S&P/TSX SmallCap Index. What has been a major contributing factor?

The S&P/TSX SmallCap Index has been an index with high volatility of returns, largely attributable to its large weighting in cyclical sectors, such as Materials and Energy. It is important to note there are considerable differences between the Barrantagh Canadian Small-/Mid-Cap Equity Portfolio and the S&P/TSX SmallCap benchmark. Our conservative approach to this asset class has provided far more stable returns with much less volatility than the Index. The Portfolio has historically underweighted

Materials and overweighted Industrials, which have been key contributors to moderating portfolio volatility and downmarket risk. Focusing on quality companies that pay dividends is another important contributor to limiting our downmarket risk as these companies benefit from demand as more defensive investments in a down market. Since the inception of the strategy in January 2008, we have produced a Beta of 0.53, indicating that the risk in the Portfolio represents almost half that of the Index. The strategy has demonstrated very low risk metrics while outperforming the Index by more than 10% per annum.

Why does an investment in Canadian small-cap companies makes sense at this time?

Historically, small-cap Canadian stocks have outperformed large-cap Canadian stocks as markets recover from a sell-off, a pattern that can persist for several years. We again observed this outcome following the Q1 2020 market sell-off as the COVID-19 pandemic took hold. As we progress into 2021 and the re-opening of the global economy, we expect government fiscal stimulus and a recovery in consumer spending to continue to be a supportive environment for small caps. We do encourage investors to approach this asset class strategically, as a long-term allocation, as opposed to market timing a short-term position. Diversifying by market cap in Canada can deliver superior diversification benefits compared to diversifying by large-cap style (i.e., growth versus value). Given our conservative dividend approach to the small-cap market, our research tells us that the Portfolio has a low correlation (0.60) with large-cap managers, which provides better risk-return outcomes than combinations of large-cap managers who are highly correlated. Since inception of the Portfolio in January 2008, it has enhanced overall return with either no additional risk or, in many cases, lowering overall risk when complemented with a large-cap Canadian manager. With a strategic weight to small caps over the long term, portfolios are more diversified and have been rewarded with enhanced returns, lower volatility and low correlation offsets as part of a broad portfolio.

The Energy sector represents a decent weighting within the benchmark. What are your views on the sector and what type of energy-related companies are held in the Portfolio?

After several years of under-performance, Canadian energy stocks have seen some renewed interest in the current environment. We see longer-term secular challenges for Canadian oil as egress roadblocks and a decarbonization push in the developed world will prioritize lower emission power and fuel. With that said, we do see opportunities in the space. We see a stronger structural backdrop for natural gas as a transition fuel with a cleaner environmental footprint. As with all our holdings, we look for leaders along all three legs of the ESG stool, recognizing the extremely important role these companies can play in their communities and the positive contributions they bring. We recently added ARC Resources, a pure play Montney liquids-rich natural gas producer, which is benefitting from increased scale and improving commodity prices. As well, we have holdings in the midstream and downstream segments of the energy market and exposure to renewable energy.

Could you provide insights on one of your high conviction names in the Portfolio?

Trisura (“TSU”), was added to the Portfolio in Q4 2019 at a cost of $40 per share. Our initial analysis outlined an attractive risk/reward opportunity for this steady, core Canadian business with a history of profitable underwriting. Trisura’s management team is highly capable with an ”under-promise and over-deliver” mentality.

As Trisura delivered on their strategic plan, seeing strong growth in the U.S. business with their nimble and tech-enabled offering, we note the following has taken place in just over a year:

- **Trailing return on equity** from 2% to 13%, trailing **Earnings per share growth** ~9X, and **Forward earnings expectations** up ~100%;
- **U.S. gross premiums** increased from $70 million per quarter to $210 million, more than tripling the fronting fee income;
- **Market capitalization** increased by ~4x with an ~10x increase in **trading liquidity**; and
- **Total shareholder return** ~215%.

On a go-forward basis, our forecast for this stock remains very positive. We anticipate continued strong underwriting and stable execution in Canada. We see further growth from their large U.S. opportunity, given they're still growing off a relatively small base. Recent entrance into the admitted insurance market grows the total addressable market ~5x. We anticipate multiple expansions as the capital-light, fee-based fronting income grows in significance. With a 5-year growth in earnings of ~15% annually, the share price target would be $225 to $250. Accretive M&A and/or a potential takeout could further accelerate shareholder returns, and with the scarcity of quality, value, small-cap Financials, we expect Trisura's profile to continue to grow.

Though these observations represent our current constructive view, we'll be monitoring closely for any new information that will impact our expectations, either positively or negatively.

About the Manager

Sean Wetmore, B. Comm., CPA, CA, CFA
Portfolio Manager

Sean Wetmore has 12 years of experience in the financial services industry. Sean is responsible for managing the Barrantagh Small-/Mid-Cap Canadian Equity strategy and contributes valuable research expertise to the Canadian Equity team, with an emphasis on mid-capitalization and small-capitalization companies.

Prior to joining Barrantagh, Sean developed his research skills as an Associate Analyst at National Bank Financial where he gained considerable experience as an analyst, attaining primary coverage responsibility for a growing portfolio of companies. Previously, Sean spent over four years in the public accounting practice of KPMG where he received invaluable experience in several key industries.

Sean is a CFA Charterholder, a Chartered Professional Accountant with a Bachelor of Commerce degree from Queen's University

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