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EP 153 | Moody Mr. Market: Finding opportunities in the Canadian small-cap space amid changing market psychology

[00:00:00] Kevin Minas: This is Kevin Minas, and in this episode, I sit down with Samir Taghiyev, Portfolio Manager on our Canadian small-cap strategy. Samir shares with me some key themes that drove markets in 2023. We also discuss the importance of being aware of the pervasive narratives of the so-called "Mr. Market" without getting caught up in them. And we finish with a portfolio example that highlights how diligence can be the mother of good luck.

[00:00:46] Kevin Minas: Samir, nice to see you today. So, it's been about a year since we last discussed the Canadian small-cap strategy on the podcast. It'd be great if we could start the conversation with a recap of what's been going on in the Canadian small-cap space.

[00:01:01] Samir Taghiyev: Last year was a really good year to remind us that markets are a very manic-depressive beast that can change its thoughts about the environment, the economy, or particular companies. Warren Buffett has a very interesting quote, I think he took it from Ben Graham, of looking at the Mr. Market perspective as someone who is very moody and changes their opinion all the time. But they knock on your door and offer you opportunities to either sell or buy specific companies or specific stocks from you.

I think 2023 was good on that because the year started off with—more or less—high optimism. Then, toward the middle of the year, the moods of the market shifted, as the markets started to doubt whether the so-called scenario of a soft landing was possible at all. And toward the end of the year, the moods got back. There were increased signs of the economy doing better than anticipated, but also the mood of the market changed.

So that's all on the external side. I think it's very important to be mindful of that; not to be too hung up on that but be mindful of that and be mindful of the mood of the market and take that as an opportunity and not get too carried away with the same moods of the market. As I look back, we were cognizant internally of those moods throughout the year. Thankfully, we took advantage of some of the opportunities that the market presented us in the middle of the year.

[00:02:42] Kevin Minas: To start there, as you said, some concerns around whether we'd have the soft landing. Things ended on a pretty positive note. Given that backdrop, can we move to some of those internal observations, things that the team did? You mentioned a few opportunistic moves that the team made. Can you give us some more details on that?

[00:03:01] Samir Taghiyev: One of my favorite quotes from Ben Franklin is, "Diligence is the mother of good luck." So that's why we have the process and philosophy. Sticking to that philosophy and process and not getting carried away with the moves of the external world is very important. Otherwise, we will make the same mistakes that the rest of the market is doing.

One example of that would be Converge Technology Solutions. There was one company where the opinions of the market have shifted a lot for this particular company, from years back to 2023 and even until now. In the middle of the year, especially, the valuations have gotten to such extremes that we saw this as an opportunity. The reason why we saw this as an opportunity is because we did our work. We did our diligence, understanding the company over the years; talking to management often—at least once in this case—multiple times throughout the year to understand the changes happening in the business. Very importantly, we did our validation work, which is DCF work, and understanding what the market implies about the future of the company.

It was really evident at that point that the market was implying a continued decline of the business, which was happening right then. In the summer of 2023, there was a lot of pessimism in the business world to take a step back, and Converge provides technology solutions for businesses out there. Because of the lower moods of the market participants, the businesses themselves had cut back on their technology investments. As a result, it became a self-fulfilling prophecy being reflected in converges. But as we looked at what the company was doing, what the management was doing, compared to the environment out there, it was evident that there were a lot of improvements internally in the business. So that's one.

Second, the cutbacks in the investment by their customers were very tempered. As you know, we're using technology now. It is evident that businesses will continue using more technology over time. And there were increasing green shoots that Converge may, in fact, be benefiting from the tailwinds of artificial intelligence (AI)—helping companies figure out how to deploy AI and supplying them with all the necessary tools and equipment for that, which was very much not reflected in the valuation by the market.

But what was reflected is the decline in the business, which we didn't think would be a secularly happening, so that was a great opportunity to increase our position. I don't want to be short-term patting us on the back, but I want to show this as a change in the moods of the market. The shares are more than twice the levels we saw just last summer, recognizing some of the things that we did just by doing our diligence. Again, diligence is the mother of good luck—looking at the business, management, and valuation.

[00:06:12] Kevin Minas: So it sounds like the fundamentals had deteriorated at the margin, but the broader market reacted quite strongly that this was a structural issue in the business as opposed to a temporary headwind. At least so far, the way it seems to have played out, it was a temporary headwind. So then, opportunistically, leaning into that position has been helpful so far.

[00:06:31] Samir Taghiyev: Exactly. And we see that a lot. There is very delayed feedback happening in the markets. Something happens; for example, the mood in the markets has changed. The businesses start to cut back on their investments. It takes a while for that to get reflected in the financials and for the investors to see those financials. By that time, the reality might have changed, but the market reacts to that information at that specific point in time and a lot of times extrapolates that indefinitely. That creates a phenomenon of this very moody Mr. Market dynamic, and that creates opportunities.

There's also a very interesting dynamic related to that: "Just in the crowd, sentiments are contagious." One of my favorite books that I read in 2023 was by Gustave Le Bon, a psychologist/sociologist in the 19th century who was fascinated by the shifting moods of crowds of people. He framed it as collective hallucinations. If we apply that to the markets, markets also go through these collective hallucinations, some kind of a hype that excites everyone, and they reflect it as a crowd. Then, a collective hallucination to the depressive side that the recession is coming. It's undeniably imminent, which was the story in 2023, that the recession is going to come. It's only a matter of time in the next three or six months, and we're yet to see it. Given that the best place to be is to be very balanced and emotional, not just intellectual.

[00:08:16] Kevin Minas: So this more psychological aspect to investing that you're mentioning – the question would be presumably that applies across all investment types but perhaps to varying degrees. Do you think there's any unique aspect to this in the small-cap space? Are there any unique implications to some of these things you're mentioning?

[00:08:33] Samir Taghiyev: I think that applies quite generally to the markets overall because all of the markets are primarily driven by humans, even though there's increasing use of automation and bots out there. But in the small caps in particular, for some of the smaller companies, there might be more retail investors involved, and their involvement in the markets is especially lagged, meaning that they get into the markets when the mood is very euphoric, and they give up on the companies when the mood is very depressing. So they exacerbate the dynamic, which in the small caps is more easily seen. But we've seen that recently in the larger caps as well, this concentration of the Magnificent Seven. The reason why that's happening is because of the retail investors' involvement in the ETFs, which has resulted in this concentrated behaviour in a few stocks, and their stock charts, at least, behave like very much small-cap investments, even though they're one of the largest companies in the world.

[00:09:42] Kevin Minas: Awesome. I love all these mental models. I find them fascinating. It's always really helpful also to hear how they're applied, how you guys think through when you're evaluating companies and management, and ultimately how stocks end up in the portfolio. It's nice to get some colour on a lot of these frameworks that we have. Thanks a lot for speaking with me today, Samir. I really enjoyed it.

[00:10:00] Samir Taghiyev: Thanks a lot. Good. I enjoyed it very much as well.

[00:10:03] Kevin Minas: Hey everyone! Kevin here again. To subscribe to the Art of Boring Podcast, go to mawer.com. That's m a w e r dot com forward slash podcast, or wherever you download your podcasts.

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