Welcome to Conversations with Ken–a podcast where we discuss relevant topics in investing. I'm Ken Crawford, Portfolio Manager with Argent Capital Management.

Ken: With me today I have Peter Roy. Peter, welcome!

Peter: Ken, great to be here.

Ken: Peter is our Small Cap Portfolio Manager. Peter, how long have you been at Argent?

Peter: So I joined Argent, back in the spring of 2019. That's right. And the current team took over managing the Small Cap strategy at the end of June 2020.

Ken: So a couple years plus or minus.

Peter: That’s right.

Ken: And already, you're a portfolio manager. How did that come about?

Peter: That's right. Well, I've been in the industry for close to 25 years. And before coming to Argent, I worked as a portfolio manager and analyst on a successful small cap strategy for almost 17 years. And we're applying the same approach to investing in the small cap market here at Argent that our team effectively utilized prior.

Ken: So considerable amount of history coming in.

Peter: That’s right.

Ken: Okay, well, why don't you tell our listeners, what is your investment process and philosophy?

Peter: Sure, I'd be happy to. So we are searching for high quality businesses that are priced at attractive valuations and that we can own for many years. Quality can mean different things to different people. So I think it's probably important that I explain how our investment team here at Argent defines a quality business. To us, a quality business is one that is profitable, generates growing cash flow, one that has plenty of opportunities to allocate capital in a value creating manner, and has a conservatively financed balance sheet. That might sound simple, but you'd be amazed at how many small companies don't check any of those boxes. We also believe that the management teams running these small companies are very important to an eventual successful investment. So we like to see management teams with a track record of effective capital allocation at the helms of the companies we invest in.

Ken: Great. So with that in mind, and correct me if I'm wrong, but as I recall last year, there were some companies that didn't have profits that were doing quite well. How did you guys do in that environment? And what did you do to react to that environment?

Peter: Sure that that is correct Ken. Last year in 2020 and in early parts of this year, it was really difficult from that perspective. A little known fact is that around 1/3 of the companies in the Russell 2000, don't make any money at all. And that percentage has been growing for the past half-decade or so. In 2020, that group of unprofitable companies generated returns north of 50%. While the group of profitable companies within the Russell 2000 returned just under 10%. So that 40 point spread is enormous, and provided a severe headwind for small cap managers that focus on investing in high quality businesses such as ourselves. Now those trends did begin to reverse this past spring and this reversal really helped our strategy here at Argent. Through the end of August this year, the small cap market was up around 16%, and the Argent Small Cap strategy was up close to 18%.

Ken: Well, congratulations. So do you guys hold any stocks that are unprofitable?

Peter: We own one small investment position in a company that is on the cusp of turning profitable. They're growing revenue very quickly and about to grow into their cost structure. So the other 47 companies we own in our portfolio, which make up 98% of the portfolio, are all profitable growing businesses.

Ken: So one in 50, plus or minus. Okay, so we talked about some of the things that you don't own and how that has affected your portfolio. Tell me about some of the stocks that you do own and why you like them and what they do?

Peter: Sure, I'd be happy to. One area of the market that's getting a lot of press these days is the cyber security space. You can't open the newspaper or an internet browser without reading about the latest company or agency that's been hacked. One of the more well-known examples this year was the Colonial Pipeline ransomware attack. That negatively impacted computerized equipment responsible for managing the actual pipeline. As more and more companies conduct business digitally, and that's a trend that we've seen accelerate since the onset of COVID-19, the need for cyber security products and solutions will continue to grow, in our opinion. A company that we own in that space is called Telos. They sell software and they sell it to the federal government, as well as commercial customers, such as Microsoft and Amazon. That's a new business forum. And we think that as the company shifts to more commercial customers, they have a real chance to improve their margin profile and grow their earnings and cash flow. So that's one of the companies we like.

Ken: Oh, that sounds interesting. A company, obviously in a growth area, adding new businesses to its mix to grow further.

Peter: That's right.

Ken: So you talked about quality. And when I think of quality, good companies, as you mentioned, one of the things that people talk about is downside protection. Is that something that you focus on? And if so, how do you implement that?

Peter: Yeah, we think quality really gives us a buffer against downside for downside protection. And for those that aren't familiar with that term, it's basically a measure of how an investment manager performs during down markets. If a manager goes down the same amount as their benchmark does, their downside capture is 100%. If a manager goes down less than the benchmark, their downside capture will be under 100%. So a hypothetical example, say the benchmark goes down 5% and Argent Small Cap portfolio goes down 4%. That results in a downside capture of 80%. And so another way to think of that is we want to protect our client’s capital and we strive to outperform in down markets by going down less than the market.

And we believe that a focus on high quality companies can help us do that. The reason we've seen that play out over time is fairly intuitive we think. In markets that are declining, investors tend to shy away from the riskier, lower quality companies and shift their focus to the stalwarts, those higher quality companies that tend to weather the storm better. That's where we invest and where we benefit.

Ken: So it sounds like you mentioned “all weather” and “an all weather strategy” is kind of where you're throwing your dart.

Peter: That's right Ken. Our goal running the Argent Small Cap strategy is to protect on the downside, while participating in the upside, when markets are driven by a focus on a company's fundamental operating results.

Ken: So if you find those companies and you gather 50-ish in your portfolio, it sounds like you could own a stock for a long, long time.

Peter: That's our goal, our turnover is very low. For the peer group of small cap managers this year, it's in the mid 20s. And I would expect something similar moving forward likely between 20 and 30%. We like to own companies we invest in for three to five years. And then the best case longer, forever. It's really hard to find good small cap companies that are executing. And once we find one of those companies, it's tough to let them go.

Ken: Well, our listeners might remember Kirk McDonald, who was on the podcast last talking about mid cap. He talked about downside protection. He talked about concentrated portfolios. He talked about quality. Sounds like a recurring theme throughout Argent. Is that kind of how you think about it Peter?

Peter: I think that's fair to say, Ken. That's the theme across all of our strategies here at Argent.

Ken: Okay, well, with that, I will say goodbye on our fourth podcast. Thank you very much, Peter.

Peter: Thanks for having me, Ken.

Thank you for listening to Conversations with Ken. For now, stay safe, stay well and thank you for investing your time with us.