FOCUS ON DIVIDENDS, AVOID CYCLICALS

Matco's Anil Tahiliani hangs in with portfolio selections despite severe market correction

By Michael Ryval, *Morningstar*

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Despite a severe market correction brought on by fears of a global pandemic around the coronavirus, or COVID-19, Anil Tahiliani, a portfolio manager and vice-president at Calgary-based Matco Financial Inc., is hanging in with his portfolio selections and has in fact added to some existing holdings on price weakness.

"I think the correction is overdone. In the last couple of weeks, it's been running on sentiment, and this time it's fear," says Tahiliani, manager of the 3-star rated $48.4 million silver-rated Matco Small Cap Series F. "Typically, markets are driven by corporate earnings, interest rate expectations, and sentiment. In the last few weeks, the market has switched focus strictly to sentiment and negative news about the virus. It's pricing in a global recession."

Tahiliani expects there will be some type of bail-out program for industries that are affected by the virus. "It will be no different than in 2008-09, when the U.S. government backstopped the auto companies and certain sectors to make sure that jobs were protected and to make sure that if we did go into a recession it would limit the depth of the recession. This time, it may be the airline industry, since it employs so many people."

The Federal Reserve has stepped in with two interest rate cuts and a US$1.5 trillion quantitative easing package through the purchase of U.S. government debt, much like the action taken in the 2008-09 financial crisis. "But we need a combination of further tax cuts and increased fiscal spending. The Trump administration will try to push the infrastructure spending through Congress and get the Democrats to approve it as an economic stimulus spending package worth about US$1-$2 trillion to offset a slowdown because of the virus. The package may happen in the next couple of weeks," says Tahiliani, a native of India who has lived in Canada since the age of one and who joined Matco in 2018, after working for 16 years as a portfolio manager at Calgary-based McLean & Partners Wealth Partners. Tahiliani has also had stints at Bissett & Associates Investment Management and the Alberta Treasury Department.

"Interest rate cuts are good, but they alone cannot support economies. The market is looking for massive fiscal stimulus."

While the Bank of Canada has also dropped rates to prop up the Canadian economy, and the market braces itself for further volatility, there is no doubt that the small cap sector has taken a major hit. The benchmark S&P/TSX Small Cap Index is down 38.86% year-to-date (as of March 17). Much of that is due to sharp double-digit declines in the energy and materials sectors.

In contrast, Matco Small Cap Series F is down 31.34% year-to-date. The relative out-performance of the fund, which was launched in March 2010, is due to Tahiliani's strategy of avoiding resource and commodity names. Over the past five years the fund averaged -2.89%, compared to -3.36 for the median fund in the Canadian Small/Mid Cap Equity category. Over 10 years, the fund averaged 2.94%, compared to 2.75% for the category.

Not surprisingly, valuations are now much lower than before the correction. The benchmark index is trading at 10 times trailing earnings, largely because about one-third of the index consists of resource stocks.

From a strategic viewpoint, Tahiliani has been defensive since late 2019. "Our process has been adding defensive stocks to the portfolio. In January we sold all our energy stocks when there was a rally. We have had no base metals stocks, so we have had no material cyclical exposure. We also started adding real estate names," says Tahiliani, who is a growth-at-a-reasonable-price investor and running about 3% cash. "We have been adding to existing top ten holdings and not buying new positions. We pro-rate the cash as it comes in."

It's all about the process

In selecting companies, Tahiliani looks for three key metrics: high return on equity, attractive trailing price-earnings ratio, and high dividend yield. He also likes firms that have significant exposure outside of Canada, largely to benefit from faster growth rates and better diversification in jurisdictions such as the U.S.

The average ROE for the fund is 18.6%, versus 5.8% for the benchmark. The trailing p/e is 10.7, compared to 21.1 for the benchmark. The fund's dividend yield is 6.3% versus 3.6% for the benchmark. "We focus on ROE because we want to make sure the company is generating excess return on invested capital. If they do this, they have four options: grow the company through mergers and acquisitions (M&A), or they can reinvest in the company for the future, or they can increase dividends, or they can buy back shares on market weakness. Typically, small companies don't take the last option because they rather reinvest in the business or use M&A to grow their business. But a number of our companies have been increasing their dividends."

Running a high conviction portfolio with only 30 names, Tahiliani likes companies such as Calian Group (CGY), an Ottawa-based mini-conglomerate with four business segments: healthcare, advanced technologies, learning and information technology. "They do a lot of business with the federal and provincial governments. About 60% of their revenues are recurring because of long-term government contracts."

The company, which has a market cap of $365 million, has been a consistent grower over the last decade and has a conservative management team, says Tahiliani, adding that the firm has little debt. The firm has a 18.4% ROE, trades at 17.2 times trailing earnings and pays a 2.51% dividend yield. "We see this as a long-term holding, because of the high ROE. It's a company that is focused on a growth path. We are comfortable with the management team's strategy going forward," says Tahiliani, adding that he does not give out target price ranges.

Another favorite name is Alaris Royalty (AD), a Calgary-based alternative lender to small private companies. “They take a royalty and equity and warrants in return for offering loans to private businesses that want to grow quickly,” says Tahiliani. Alaris does the bulk of its business in the U.S., with a concentration on industrials and business services. The firm, which has a market capitalization of $500 million, has a ROE of 12.5%, trades at 6.5 times trailing earnings and generates a 12% yield. “The dividend is safe, and the payout ratio is 93%. We feel comfortable with the management team and it has a vested interest in the company.”

Looking ahead, Tahiliani argues that his focus on dividend-paying names and avoiding cyclical stocks will be vindicated. “We know that once every five years we will underperform the peer group because we are out of style with the market,” says Tahiliani, referring to 2019 when the fund underperformed its peers.

“So far, we have been right to be defensive. Now we are out-performing in a down market. Once we have a recovery we will do well because I don’t believe that commodities will recover to the same degree that they have dropped,” says Tahiliani, who argues that global growth is expected to slow and the oil price war between Russia and Saudi Arabia may last longer than many expect. “But the other sectors will.”

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