

# THE WALL STREET TRANSCRIPT

Connecting Market Leaders with Investors

## Small Cap Investing



**JASON KOTIK** is an investment manager on the U.S. equity team at Aberdeen Asset Management, Inc.. Jason joined Aberdeen in 2007 following the acquisition of Nationwide Financial Services' equity investment management team, where he had served as an assistant portfolio manager and senior equity research analyst since November 2000. Jason previously was a financial analyst with Allied Investment Advisors. Prior to that, he was a trading systems administrator with T. Rowe Price Associates. Jason is a graduate of the University of Delaware, and has earned an MBA degree from Johns Hopkins University. He is a CFA Charterholder.



**MICHAEL J. MANZO** is an investment manager on the U.S. equity team at Aberdeen Asset Management, Inc. Michael joined Aberdeen in 2007 following the acquisition of Nationwide Financial Services' equity investment management team he served as a research analyst providing fundamental research coverage to the value team since September 2005. Michael was an analyst covering the machinery multi-industry/electrical equipment sectors at JP Morgan Chase and Company from July 2000 through August 2005. Prior to that, he was an equity analyst intern at Lepercq, DeNeuflyze & Company. Michael graduated with a BS degree in business administration with a specialization in finance/economics from Fordham University. He is a CFA Charterholder.

### SECTOR – GENERAL INVESTING

**TWST:** Please tell us about Aberdeen Asset Management and your Small Cap Fund.

**Mr. Kotik:** Aberdeen is a large global investment manager, and we work on the U.S. Equity Team. We've been with Aberdeen for over two years, but with that being said, both Mike and I came from the predecessor firm that was acquired.

**TWST:** Introduce our readers to the Aberdeen Small Cap Fund.

**Mr. Manzo:** Our Small Cap Fund is roughly \$200 million in assets as of Sept. 30. It's a blended fund and invests primarily in small-cap companies, which we define as roughly \$3 billion in market cap or less. We are bottom-up investors undergoing a very intensive, proprietary research process with

emphases on buying businesses, buying companies and becoming stakeholders in companies.

**TWST:** What exactly are you looking for in potential holdings? Would you take us through your investment decision-making process and the criteria that you look for?

**Mr. Kotik:** Our investment process is basically something that's consistent across the world. We have a bottom-up process, as Mike alluded to, where we meet with the companies that we invest in at least once or twice per year and put together models and estimates in comprehensive stock reports. We seek out stocks with what we feel are good long-term fundamentals, and that's what we do. We only buy our best ideas. It's a diversified fund but with concentrated positions. We try to take large-size positions in companies, as we are their stakeholders and our job is to look at

the quality of the business. And we look at the industry structure, the strategy of the firm, execution of management, focus a lot on the financials, balance sheet especially.

Then after we determine that it's a quality company that we want to invest in, we then look at the valuation or the price. Our job is to make sure that the price is fairly reasonable and the valuation is reasonable, where we don't have a potential for surprises without us being prepared.

**TWST:** Earlier this year, there were a lot of low valuations. Did you find that a time of plentiful opportunities? Tell us how you have been doing so far this year.

**Mr. Manzo:** Yes, we did find a wonderful buying opportunity in the early spring. We felt like the valuations in small-cap stocks largely reflected, or more than reflected, all of the weakness in the overall economy, and we were finding very high-quality companies at very inexpensive prices. During that time we found our best ideas in the economically sensitive sectors, including industrials, energy, consumer discretionary. These early purchases have worked out quite well for us for the past six to nine months or so.

**TWST:** What is the market like at this time for the small-cap arena, now that we've just topped 10,000 and valuations aren't as low as they were?

**Mr. Manzo:** Certainly small-cap stocks and the financial markets in general have moved up quickly and quite forcefully. It

**TWST:** Do you do sector work? What are your exposures and weightings at this time?

**Mr. Kotik:** Like we said earlier, we take a predominant fundamental approach from the bottom-up. We don't tend to make a call on sectors, so to speak. Our names come from the bottom, and they develop out. One thing I want to mention is that we're benchmark aware, but we run our portfolio as an absolute performance product. At this point, we are overweight in industrials and energy predominantly, and underweight in utilities and health care.

**TWST:** How would you say that your portfolio has shifted in emphasis over the last 12 months?

**Mr. Kotik:** We don't have dramatic turnover, so the portfolio will not move on a dime based on the economic environment. Our idea in the long-term investments that we started to find had significantly inexpensive valuations with high-quality companies. We have somewhat shifted a little bit because during the downturn, leverage became a significant issue to focus on.

Going through the financials, we paid very close attention to some of those issues

that could trip up companies, whether it be debt covenants, where they had to refinance or they needed to issue equity, etc. So our portfolio has gotten a little bit more economically sensitive, I would say, a little more debt. We look for high-quality companies, so we're not going to be in highly leveraged businesses that have

## HIGHLIGHTS

*Jason B. Kotik and Michael J. Manzo manage a blended small cap fund. They undergo an intensive proprietary research process with emphasis on buying businesses, buying companies and becoming stakeholders in companies. They meet with the companies that they invest in at least once or twice a year and assemble models and estimates in comprehensive stock reports. It is a diversified fund but with concentrated positions. They like to take large-size positions in companies they favor and examine their industry structure, strategy, balance sheet and financials, as well as execution of management. Earlier this year, they found their best ideas in the economically sensitive sectors, including industrials, energy and consumer discretionary. Today it is more difficult to find the higher quality names at such bargain basement prices, but they take a long term view and are still able to find new names. Currently, they remain overweight in energy and industrials and are underweight in utilities and health care. Companies include: Compass Minerals (CMP); Drew Industries (DW); Kennametal (KMT); Phillips-Van Heusen (PVH); Tellabs (TLAB).*

*Kotik: Compass Minerals has a multitude of businesses predominantly made up of highway deicing salt and sulfate of potash. Basically, they have strong pricing power in their businesses. It's mostly North American-centric, but they also have a position in the marketplace in the Great Lakes region in salt, where there is tight capacity for highway deicing salt.*

is more difficult to find the higher-quality names at such bargain-basement prices. But if we take a longer-term investment horizon and keep in mind that we do want to own these companies for three to five years, we are still able to find new names. We're buying businesses, we're buying companies and taking a little bit of a longer-term view; we are still finding value although it is getting more difficult.

taken themselves into a bad position. We focus on those companies that have strong management execution and typically will be ahead of, if not in advance of, any issues that might come about.

**TWST:** You said that you have a blended portfolio. Would you say the value stocks are generally outperforming growth stocks or vice versa at this time?

**Mr. Manzo:** Yes, the more traditionally value-orientated sectors of industrials and energy have outperformed. These companies were severely impacted by economic weakness and their stock price valuations got incredibly cheap on a relative basis in early 2009, and we felt like that we could buy great companies at very reasonable prices. So all those traditional value sectors got very inexpensive, and they've all again risen pretty forcefully since the markets bottomed.

*Manzo: Drew Industries manufactures components for the RV and manufactured housing sectors. The company holds a dominant position, is run by a very high-quality, experienced management team and over the course of the cycle routinely captures market share by outgrowing their competitors by increasing product penetration and making small bolt-on acquisitions.*

**TWST:** Would you talk about some of the companies you have found attractive in recent months and the reasons why you selected them?

**Mr. Kotik:** One of the names that has been a recent purchase of ours is **Compass Minerals (CMP)**. **Compass Minerals** has a multitude of businesses predominantly made up of highway deicing salt and sulfate of potash. So it's one of those specialty materials companies that is very well run. We've met with the company multiple times over many years, understand their asset base, and the stock had basically not done anything in the downturn. In the downturn it did come down, but the stock had not rallied significantly in this rebound that we discussed in the markets. Basically, they have strong pricing power in their

**1-Year Daily Chart of Compass Minerals**



Chart provided by [www.BigCharts.com](http://www.BigCharts.com)

businesses. It's mostly North American-centric, but they also have a position in the marketplace in the Great Lakes region in salt, where there is tight capacity for highway deicing salt. And they're able to achieve pricing power a few percentage points a year. And because of that tight capacity, they've actually been able to take advantage of their assets — their mine in Ontario, where they are able to expand that capacity. One, we like that pricing power, we like their ability to be able to increase capacity and the fact that they've produced very strong cash flows. We took advantage of that, and that's been a recent purchase.

**TWST:** Any others you want to talk about?

**Mr. Manzo:** We also purchased and hold a good sized position in **Drew Industries (DW)**. **Drew** manufactures components for the RV and manufactured housing sectors. The company holds a dominant position, is run by a very high-quality, experienced management team and over the course of the cycle routinely captures market share by outgrowing their competitors by increasing product penetration and making small bolt-on

acquisitions. **Drew** has remained free cash-flow positive for the past four quarters, despite a significant decline in volumes. The company has very little debt on the balance sheet and a reasonable-sized cash position. So we are comfortable with the balance sheet. Management is a good steward of capital. They did make accretive acquisitions in the more difficult times, and we felt that the price of the stock more than reflected the precipitous declines in the industry. We just couldn't find an industry with

**1-Year Daily Chart of Drew Industries**



Chart provided by [www.BigCharts.com](http://www.BigCharts.com)

a more depressed fundamentals than the RV and manufactured housing space, and **Drew** is a very high-quality player in both those spaces. You're starting to see a little bit of a turn in the recreational vehicle business, and we feel like it's well positioned for the next two or three years or so.

**TWST:** What about a name in the energy industrials area that you are favoring at this time?

**Mr. Manzo:** We also own a company called **Kennametal (KMT)**. **Kennametal** is a machine tool manufacturer, mostly industrial production-led, and end markets include auto, general industrial, energy, mining. **Kennametal** is a nice combination of early-cycle businesses with automotive and industrial production, with a pretty decent exposure of late-cycle businesses with some of the energy markets. **Kennametal** is a very high-quality company run by a solid management team, throws off a lot of free cash,

which we love, and has a reasonably clean balance sheet. Their competitive position is pretty dominant in most of the markets that they play in. Again, we purchased the stock at valuations that we felt were very attractive and a stock that we feel like we could own for the next two or three years.

**TWST:** That's a well-known, well-established company. Is that on the larger size of your small-cap arena?

**Mr. Kotik:** It is. I think it's \$1.5 billion to \$2 billion.

**TWST:** What is the range of capitalization in your portfolio?

**Mr. Kotik:** Our average market cap ends up to be about \$1.5 billion. Kennametal kind of fits in there pretty well. Because of the significant market moves in some of our stocks, we do have a few names over \$3 billion. We don't look to add new positions typically at that level. We have to hold a significant percent to make sure that they are small cap, and I think the bottom end of our range is typically \$200 million to \$300 million in market cap.

*Manzo: Kennametal is a nice combination of early-cycle businesses with automotive and industrial production, with a pretty decent exposure of late-cycle businesses with some of the energy markets. Kennametal is a very high-quality company run by a solid management team, throws off a lot of free cash, which we love, and has a reasonably clean balance sheet.*

1-Year Daily Chart of Kennametal



Chart provided by [www.BigCharts.com](http://www.BigCharts.com)

A lot of times, you'll find those small companies, a lot of small-cap biotechs with no revenues and hope for some sort of drug approval that will fall in there, and due to our quality criteria, probably would not be part of the investable universe.

**TWST:** What are some of the core holdings, some of your top holdings that you've held onto the longest in your fund?

**Mr. Kotik:** I would say two of our core holdings have been Phillips-Van Heusen (PVH) and Tellabs (TLAB). I think as of our last report of holdings, those were two of our larger positions.

**TWST:** Mergers and acquisition activity looks like it might be on the rise again. How does M&A impact your investing?

**Mr. Manzo:** I think it indirectly impacts it. Certainly if we're finding these kind of high-quality businesses attractive, other larger companies will as well. I think you are starting to see the onset of another time period of reasonable M&A activity, as some of the cash from the big companies gets put to work. Interest rates are low enough where holding cash in the balance sheet just isn't attractive. Fortunately, we have had two of our companies recently being taken out — Omniture, Inc. (OMTR) taken out by Adobe (ADB), Perot Systems (PER) being taken out by Dell (DELL).

**Mr. Kotik:** Part of our process, like Mike said, is to find these businesses that have a significant value in the long term and I agree. Because the cash on corporate balance sheets is still large, they were waiting to see that there would be some sort of financial markets environment from the banks being able to be there as a backstop. But our philosophy is not to buy companies only because they could be acquired.

**TWST:** Two of the sectors that have been doing really badly but have shown opportunities recently are the financials and the consumer discretionary. How are these sectors faring in the small-cap arena?

**Mr. Kotik:** Yes, consumer discretionary in the small-cap sector has probably been, if not one of the top-performing segments of the market. During the winter/spring of 2008-2009, they were very good values in the economically sensitive consumer discretionary space. One of the things that's been happening over the past couple of years, as you know, is the deflation of the housing bubble, number one. And then two, the decline in consumer sentiment and increased unemployment. What that has done is caused valuations to become rather inexpensive. Those high-quality names that had a potential for forward growth and increased margins were trading at levels that you don't often see. We did take advantage of that in the consumer side. On the financial side, we have a very diversified portfolio of financials. We've been very skeptical of the system, and we've been very focused on our financial services holdings, looking for those that, one, either trade below book value where we don't think there's deterioration in the book; two, companies that have very strong execution; and three, those with capital that they can actually take advantage of and thrive in the downturn. We did take advantage of those particular stocks that would meet those criteria.

**TWST:** What is the sell process? What triggers an exit from your portfolio?

**Mr. Kotik:** Yes, that's pretty simple. One is deterioration in the quality of the business, whether that be driven by industry dynamics or a change in management issues with industry players not being rational, things like that, that would change the way we

look at the company. Obviously M&A if a company is taken out, obviously where that is another area. Three would be better ideas — if we find a significantly better idea that meets the portfolio's needs, then we will take out one of those ideas that we have less conviction of.

**Mr. Manzo:** I'll just add, if we feel like the valuation of the stock price does not justify some future level of earnings or future level of cash flow and we just can't get our hands around valuation, we certainly will sell the stock. We emphasize valuation on all that we do, including sell figures.

*Kotik: We build up a database of stock company visits with management teams that is actually a global process that is consistent across our businesses, whether it be in London, Singapore, Sydney, Philadelphia, etc. And so that database is checked across industries and across regions.*

**TWST: What about the average turnover in your portfolio? Is that higher than usual this year?**

**Mr. Kotik:** I would say, if you look at our rolling 12-month turnover, it's about 140%. Over time that figure is likely to be lower. This has been a marketplace that has been very unheard of from a volatility standpoint, going from a pretty booming economy to a significant recession, if not close to depression, with the government having to step in and provide stimulus not just in the U.S. but globally. So when you find opportunities, like Mike said, with valuation of high-quality companies and vice versa with names that have run to a significant level where we can't justify the next, anymore valuation criteria, then we'll have to do that for the shareholders.

**Mr. Manzo:** Our turnover has trended materially lower as the years progressed.

*Kotik: We meet with these companies multiple times a year and build up this database of knowledge, and that we can put it upon the entire team and it's not this star manager approach. We have a team that can look at every piece of data that we've had discussing with that company, and we pay very close attention to valuation.*

**TWST: What is the beta or the alpha when it's compared to your benchmark index?**

**Mr. Kotik:** Our beta is about 1.1. A part of our risk management of the portfolio starts with vetting the company significantly, looking for diversified business models and focusing on the balance sheet. So risk is controlled at that level. Beta basically comes out of the stock-picking itself, and we watch it, but it's not particularly managed to a number.

**TWST: Tell us more about the risk that you mentioned.**

**Mr. Kotik:** As of Sept. 30, the Fund was up 30.66% and the Russell 2000 was up 22.43%. The Lipper Small Cap Core average was up 26.17%, again as of Sept. 30.

**TWST: What about the risk in the portfolio and risk at the individual security level? How do you attempt to control risk?**

**Mr. Manzo:** Our first defense against risk is the significant amount of due diligence that we do on a company before we invest. We always meet with a company at least once before we invest. We write a full company report, which includes work on the balance sheet and work on the management team. So certainly, our first level of defense against risk is the very significant amount of work or due diligence that we do on the company before we

invest. And again, that certainly includes at least one visit with the management team. Also keep in mind that the process permits us to buy companies of very high quality, and we really do take that seriously as investors. Our goal is to buy what we think are best-in-breed companies with strong management teams and very good, solid competitive positions. So again, the first level of risk and certainly the most important level of risk is defended by our significant due diligence process.

**Mr. Kotik:** I would say all that is exactly right. And then we look at them, the business risk by a diversified business model. We don't want to own five railroad companies or five hardware companies. We tend to focus on the business itself. Then behind that, we have a corporate risk department that kind of does a back check of the portfolio. And so that's how that gets played out.

**TWST: What do you think gives your Small Cap Fund**

**its edge? What are the distinctive features of your investment approach that distinguish you from other peer companies' small-cap funds?**

**Mr. Kotik:** I think, one, we're bottom-up stock pickers. We have a very high-conviction portfolio. We build up a database of stock company visits with management teams that is actually a global process that is consistent across our businesses, whether it be in London, Singapore, Sydney, Philadelphia, etc. And so that database is checked across industries and across regions. While we would hope that all investors look and visit with their company management teams, we have this database, number one. Secondly we cross-cover companies. So we put multiple sets of eyes on

each company. We don't have specific sector coverage. We have strong experience in many sectors due to the depth of the team, and that team approach and that cross coverage doesn't allow us to get locked up into certain areas, like you saw in the tech bubble in 2000 where everyone was focused on technology. We have everybody looking at every sector and every company, and vet each decision.

On top of that, I would say that we don't manage to a benchmark. You're not going to find us as a closet benchmark fund. Our buy-and-hold approach has low turnover, and we look to consistently outperform over the long term. I think that that significant risk control and process that we follow globally with that team-based approach is what provides a significant differential.

**TWST: What headwinds or challenges in the future should investors in small-cap stocks be aware of now?**

**Mr. Kotik:** I guess from my perspective, typically when we see investors go through cycles of extreme confidence to extreme pessimism, the concern is that you go to one significant direction in that the market's different now. We've had a financial crisis that has been hopefully averted to the most part, at least somewhat stabilized, but we're not going to go back to the leverage that we saw in the past. And so investors in small caps need to pay very close attention to the individual stocks and not chase highly speculative names that may or may not prove to be worthy. Our diversified portfolio is a good example of one that's performed well because it's been diversified and because our due diligence in that time of stress level in the March time frame when the markets bottomed allowed us to be confident enough to buy stocks when most people were panicking and selling stocks.

**Mr. Manzo:** I would say there are certainly headwinds, I think, in the near term would be that stock prices have built in a lot of expectations for a much improved economic environment over the next nine to 12 months or so. They may have gotten them ahead of themselves a bit, I think that's a risk. Generally speaking there's certainly a risk in small-cap investing. It is more difficult. The companies tend to be smaller, less diversified, more susceptible to financing needs and trade liquidity tends to be less. Certainly there are risks for small-cap investing in general.

**TWST: What advice would you give to the small-cap investor about the market right now? Is this a good time to get in or did they leave it a bit late?**

**Mr. Manzo:** No, I don't think so. I certainly don't think so. I think it's a very good time if you have a medium- to longer-term time horizon to invest in small-cap stocks. You're certainly just beginning to see the onset of an economic recovery, both in the United States and globally. While valuations have risen, I think that there is a very good likelihood that in the next three to five years or so, the stock market environment will continue to improve and stocks will do well.

**Mr. Kotik:** I would just say that the small business formation will continue. I think that's one of the big things about

the United States and the best thing in the U.S. is that companies have been able to adjust costs rather quickly, unfortunately to the detriment of employment, but that will come to fruition and actually reverse itself at some point and improve. And the fact that there are secular trends that smaller-cap companies can take significant advantage of and while that's a risk that some of them can be more susceptible to certain sectors or industries, or concentration in certain customers or suppliers, that also provides firms like Aberdeen to find ideas that will be small cap in nature, that hopefully will become large-cap companies. And those investors can invest in a fund of diversified nature that can actually pay close attention to the investment fundamentals.

**Mr. Manzo:** All I'll add is our investment process does not change based on the stock market environment. We're going to continue to search for good high-quality companies run by great management teams, where stocks are selling at reasonable prices despite the market environment.

**TWST: Is there anything else that you'd like to add?**

**Mr. Kotik:** Most of the things we discussed, predominantly that Aberdeen's process is differentiated, but it's a simple process that is global in nature. That's one of our major advantages is this global footprint of investors in different regions that can look across sectors, and we can look at areas where there have been previous problems or bubbles in the past. We have significant-sized teams in Asia who have seen many things before a lot of us have seen in the U.S. And we can build upon that and learn from that.

Our due diligence is very sizable. We meet with these companies multiple times a year and build up this database of knowledge, and that we can put it upon the entire team and it's not this star manager approach. We have a team that can look at every piece of data that we've had discussing with that company, and we pay very close attention to valuation. And hopefully, and not going to say never, but that we won't be surprised when news comes out of a company doing something, making a strategic decision or M&A. We're not caught running or panicking, we know exactly what the thought process is, and we can react at times of potential volatility.

**TWST: Thank you. (PS)**

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Aberdeen Small Cap Fund Holdings information as of Sept. 30, 2009: Kennemetal (2.29%); Phillips-Van Heusen (2.93%); (Tellabs (2.56%); Omniture (2.0%); Adobe (0.0%); Perot Systems (0.0%); Dell (0.0%); Compass Minerals (0.46%); Drew Industries (2.09%)

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The Aberdeen Small Cap Fund has returned -15.52%, -10.56%, and 3.75%, for the one-, three-, and five-year periods respectively, as of Sept. 30, 2009.

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