PROFESSIONAL BUYER CITYWIRE

A closer look at small cap star Bill Hench's new First Eagle fund

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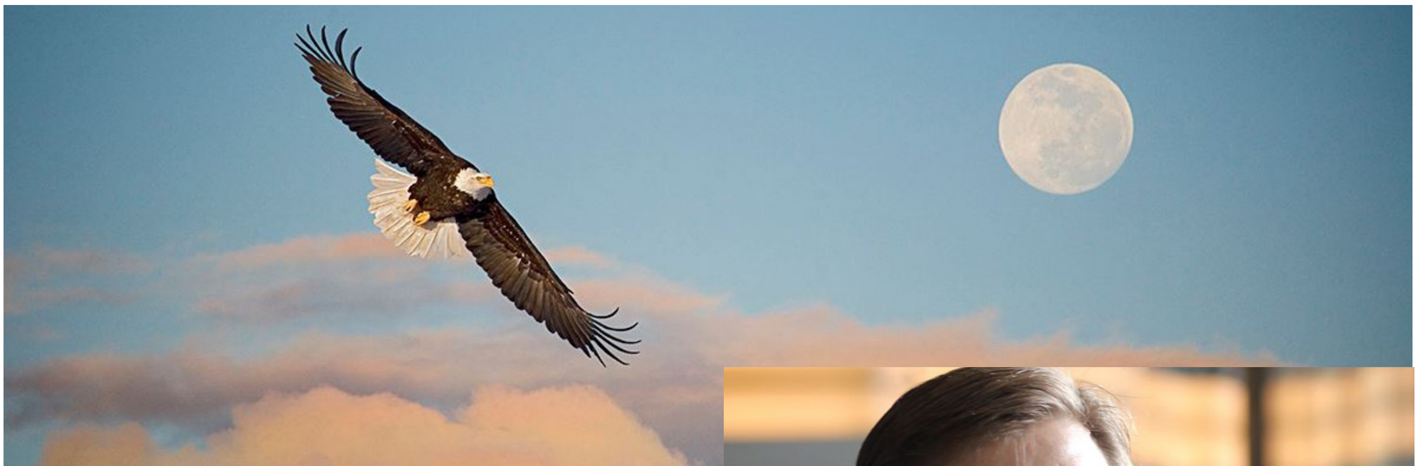

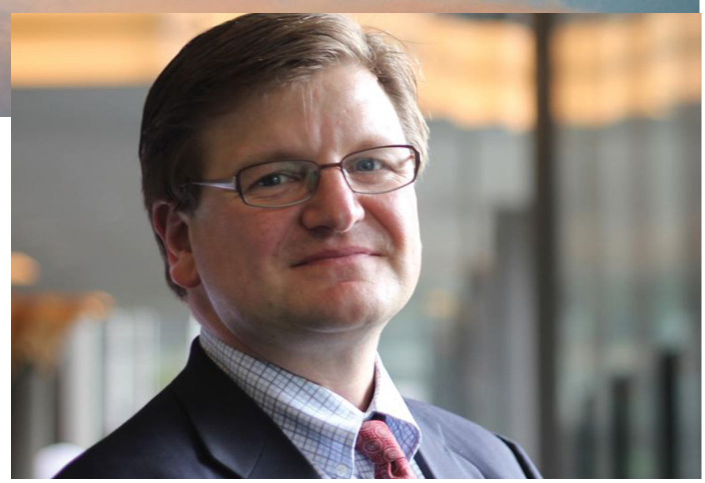

First Eagle swooped for Bill Hench and his team. Here's what kind of fund he plans to run for his new firm.

One of the most notable manager moves of the year came in April, when the highly rated small-cap manager Bill Hench and his team left Royce Investment Partners and joined First Eagle Investment Management.

Hench along with his co-managers Suzanne Franks and Rob Kosowsky, and senior research analyst Adam Mielnik, had previously run the then $2.1bn Royce Opportunity fund.

Hench is now head of small cap investments at First Eagle, reporting to the firm's president and chief executive Mehdi Mahmud, and he runs the First Eagle Small Cap Opportunity fund, alongside Franks and Kosowsky, which launched on July 1.

The below an is interview, conducted via email, with Hench, which has been edited for clarity and length.

Citywire: Please talk about your approach to small-cap value investing within the new fund. How does the hunt for value differ (if at all) in the small cap universe? Is it as easy, for example, to find companies with similar competitive advantages to those in the large cap space?

Bill Hench: We first identify names with good value statistics (like low price-to-sales or low price-to-book ratios) and then work out whether those metrics can be improved upon. Put another way, we look to buy companies currently selling at low valuations that we believe can get back to producing normalized returns.

Low valuations are a key starting point, but you can wait a long time to get acceptable returns if there isn't a reason for investors to get excited about a company. Therefore, it is imperative we have confidence that each company we invest in is either actively pursuing ways to better their performance or are in a position to take advantage of market conditions that will help them do so. These 'catalysts' can include new management, a more favorable business cycle, product innovation and margin improvement. While they may or may not be obvious when we establish our position, catalysts are key to avoiding the dreaded 'value trap.'

For an active, fundamental manager, finding value in small stocks is sometimes easier than in larger stocks, as coverage and patience are two features generally lacking in the world of small-stock investing. As with big caps, small names with true competitive advantages will sell for a premium. Getting in early or before a turn in performance is the most important factor.

We consider ourselves true small cap investors, and we tend to focus closely on keeping our portfolio from drifting into the mid cap range. The weighted average market cap of our portfolio is typically 40–50% smaller than many of our peers, and often includes microcap stocks with capitalizations below $1bn. Being at the lower end of the capitalization range has tended to increase the portfolio's volatility given the lower liquidity of these stocks, but we believe security- and market-level volatility also hold the potential to enhance our long-term results. Navigating the difficult market periods successfully can provide above-market returns when conditions improve.

CW: There are around half the number of publicly traded companies in the US now compared to 25 years ago. How much harder does it make your job?

BH: There are still over 3,000 names in our investment universe. The reduced size of the small cap market might be a bigger factor if not for the fact that the number of people managing money in our space has appeared to shrink along with it. The cycle of new companies coming into the public markets clearly has not been that robust in the small cap space, but that can change quickly.

CW: First Eagle's family of funds are known for holding cash and gold. Will you do the same?

BH: Cash is a residual of our investment process and typically will represent less than 5% of the portfolio. Our universe is large and although it may sometimes appear that 'everything is expensive' or there aren't any 'great opportunities,' the fact of the matter is that even in the best of times there are companies and/or sectors going through a rough patch that may represent an attractive entry point. Sometimes these conditions may be self-inflicted and sometimes it may just be a tough end market, as illustrated by some energy companies in recent years.

We generally stay as fully invested as is feasible for a number of reasons. First and foremost is that our clients invest with us for the exposure to the differentiated universe we traffic in. Secondly, liquidity plays a particularly important role in the small cap universe. We think it would be impossible to correctly time pullbacks or opportunities without being whipsawed or constantly chasing the right time to get involved.

CW: Where are you finding value currently?

BH: We search for value on a name-by-name basis, but sometimes we are fortunate to find a group of companies that share attractive valuations and also have the potential to benefit from the same secular changes. For example, there are a number of semiconductor capital equipment stocks we are excited about, as we believe a buildout in North American and Asian semiconductor manufacturing capacity will have a great and long-lasting impact on a relatively small number of companies that largely operate with extremely high market shares and engineering and product knowledge that is not easily replicated.

Another example is homebuilders, an industry that enjoys what many would love to have: high demand and low capacity. We believe the low interest rate environment, historically high savings rate and improving employment data have provided well positioned builders with the potential for a longer-than-expected cycle of good fortune.

Finally, we have started to add positions in aerospace companies. The aerospace supply chain is populated by a relatively small amount of players, and regulatory hurdles make new entrants to the space very rare. We believe the global trends that were a tailwind for the industry prior to Covid-19 should return, to the potential benefit of earnings in this industry.

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There are risks associated with investing in foreign investments (including depositary receipts). Foreign investments, which can be denominated in foreign currencies, are susceptible to less politically, economically and socially stable environments, fluctuations in the value of foreign currency and exchange rates, and adverse changes to government regulations.

A principal risk of investing in value stocks is that the price of the security may not approach its anticipated value or may decline in value. “Value” investments, as a category, or entire industries or sectors associated with such investments, may lose favor with investors as compared to those that are more “growth” oriented.

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