Finding quality, value and growth with Chris Prunty

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Disciplined, focused and humble are three words that spring to mind when describing smallcap specialist Chris Prunty. He's unlikely to tell you about the cricketing prowess that earned him a scholarship to study at Australian National University. He's even less likely to let on that he was 'peer reviewed' and rated as one of the best 14 analysts in the world by US investment website SumZero.

Livewire readers have been fortunate enough to receive contributions from Chris, covering his views on the under-researched small companies sector. In this exclusive Q&A, readers will get a more in depth look at his core investment disciplines, where he is seeing excessive exuberance, and the stocks that are catching his eye right now.

Picture: *Tony Waters and Chris Prunty of QVG Capital*

Chris, how did you get started in investing?

It started with beer. I remember as a child that there was a page in the newspaper that was only numbers and the numbers moved up and down every day and it was explained to me those numbers represented companies. The stock I chose to follow most closely was Foster's. I remember adults seemed to like beer so 12 year old logic suggested Fosters would do well. As a kid I thought it was a cool thing that you could potentially make money off your ideas and that seemed like a more attractive job than going out and digging a ditch or something.

And who gave you your first break in the professional world?

I was very fortunate to be recruited as a graduate right out of University to come up from the ANU in Canberra to Sydney to work at AMP Capital. It was a bit like an episode of Survivor. They had 100 graduates in the room and then next week, I'd fly back up and 50 had been voted off the island and the week after we'd be down to 20. By the end of it all they'd gone from a few thousand applications to four of us in the room, so I was pretty lucky in hindsight. Ironically, one of the other 4 is also a Small Cap Portfolio Manager, *Atchu Maheswaran at IFM; so there must have been something in the water.*

And then how did you transition across to becoming a fund manager?

After a year at AMP, I went from a firm with thousands of people to a 20-person institutional stockbroker in CCZ Equities. I joined there essentially as a research assistant, helping a couple of senior guys; one of whom was Tony Waters. In a 20 person firm there's nowhere to hide and pretty quickly I was covering stocks.

And that's where you met your current business partner Tony?

Yeah I met Tony Waters there, he's been a very positive influence on how I think about markets.

How would you describe your strategy, Chris, and what gives you the edge?

85% of what we do is trying to find good companies getting better and 15% is bad companies becoming less bad or turn around situations. I think if deep value manager was here, they would say their edge is the fact that markets tend to over react on the downside and they make their money when things revert to the mean. We're a similar in the sense that markets can also under-react. There are times when share prices under-react to good news or it takes time for markets to appreciate the positive things that smaller companies are doing. If we can get on to those companies earlier than the next person or better understand those companies as they're getting better and stay on the journey for longer, our investors should do well.

What are some of the signals that you look for?

We're looking for positive change. That can be a number of things. Usually, the most obvious is an earnings upgrade but it doesn't have to be earnings related, it can be around the product, competitive landscape, management, board or a change in the balance sheet or cash generation of a company.

I know you look at management teams pretty closely and that's obviously a really important part of evaluating smaller companies. What really gets you excited about a management team?

I get excited when I understand the motivations of the management team and when they are not purely associated with their remuneration. Emotional drivers can be more powerful than financial ones. The financial motivations for why people do things are fairly obvious, you can see it in the numbers. But there are other motivations. Family legacy is an interesting one, I can think of a specific example, where we've done quite well was Andrew Hansen, from Hansen Technologies (HSN:ASX), it's actually his father's name on the door, not his name, but he was the eldest of six siblings and everyone wants their parents to be proud of them and I think his father would've been very proud, given what he's done taking a breakeven software business global. It's a very high-quality business and he's done a great job allocating capital for Hansen, so in that case, I think even though Andrew and the family own around 20 percent of the company, there's more than just financial driver at work there. That's quite a powerful motivator. It's also something you can look at and say, the probability of a guy like that taking too much risk or blowing that company up by taking risk is very, very low.

Often what you see with older CEO's is this might be their 2nd or 3rd time around, they know exactly what they need to do; part of it is just fun. Part is just proving to the world that they can do it – so ego – and they know the industry and they're just gonna go out there and create something really special to show others they can.

Tony has a saying to "back the high energy CEO". Their enthusiasm and energy is infectious and the most important thing I think for entrepreneurs, especially at the early stages, is grit and determination and the ability to just keep on showing up and keep on persevering and we're fortunate to see that quality in some managers. One of the best examples of the high energy CEO is Jamie Pherous from Corporate Travel Management (ASX:CTD). That was a stock where my colleague Tony met him and just thought this is the most amazing guy and he's consistently high energy and he's done great things for that company.

And now you're launching your own fund, once again with Tony Waters. What are your plans?

The company's name is QVG Capital. Tony and I will launch the 'QVG Opportunities Fund' in September. QVG, Quality Value and Growth captures some of what Tony and I look for in stocks. Plus, all the good names were taken! The fund will be focused on the smaller end of the market and some micro-cap companies but we are trying to get away from the micro-cap name as it really hints at very early stage companies. We've never been about venture capital or sub-hundred million market

cap companies. We're much more comfortable in the 'sweet spot' where the business has already proved its model and its about to hit an inflexion point in terms of its growth.

Good luck with the new venture Chris. At the moment, there's a lot of talk about markets being fully valued. What's your view and how do you go about trying to manage risk in this sort of situation?

The cute answer around risk management is that you hold cash or short something. But our experience has been, when we've cashed up in the past we've been a contrary indicator. It's easy to get nervous at the wrong point. I don't think the market is fully valued relative to a lot of other alternatives. With the US ten year back under 2.2% equity markets will be supportive, you really need to see a strong spike in interest rates to worry about valuations. What else are you going to do with your money? Equity is still the best house on the worst street.

Okay. What do you think the market's gone wrong at the moment?

What's perhaps most exciting right now is that we've had a solid correction in the small cap industrial space, given the number or redemptions out of certain funds. But even before that, there was a meaningful amount of money coming out of small cap equities as people rotated back into the banks with the Trump trade in second half of last calendar year. So, I'm not as pessimistic about the market and the opportunities in the market as some. Having said that the consumer stocks and retail, in particular, is clearly under the pump.

What do you like the look of in that space?

Baby Bunting's is the least mature of the specialty retailers and probably has the strongest competitive position as well, and it's down almost half from its peak. So, that's the baby with the bathwater. Sorry, that's a bit cheesy!

Are you able to tell me some more about your thesis on Baby Bunting?

Tony taught me there are two ways to make money in retail stocks. Turnarounds or roll outs. Roll-outs include Harvey Norman of the 80s, Flight Centre in the 90s or JB Hi Fi of the 2000s. What they had in common is they're have a proven but immature model and category dominance. Baby Bunting is less than half penetrated in terms of store numbers so gives you long runway for growth, which we like in smaller companies. They're also quite dominant in their segment and, given their gross margin structure, it's quite hard for competitors to build to their scale.

What would you be avoiding at the moment?

I'd be avoiding what I call the 'consumer derivatives'. Consumer derivatives are those stocks that are priced for their defensive characteristics but actually have a consumer discretionary element purchase decision. Examples would be something like child care, private health insurance, or IVF, where the

mother can take the child from four days a week to three days a week, or you can push having that second or third child into the future, or private health insurance, you just downspec your policy. Some of these stocks are priced like they're defensives but have 'at risk' earnings streams and we all know the consumer is under serious pressure right now.

Interesting. So what are the most important lessons that you've learned over the years?

Cut your losses. We make plenty of mistakes. It's ok to be wrong, it's not ok to stay wrong. This is especially true in small companies, because they don't have the balance sheets or the revenue diversity to survive shocks as well as larger companies. Cutting your losses is best advice I can give anyone who's playing in the small cap space. Psychologically that can be very difficult to do because you bought the stock in the first place, you've got some presumably emotional attachment to it or an intelligent reason why you were there. But if the stock's down meaningfully, then the market's telling you something.

And how do you know when it's time to sell?

That's tough! We look for a combination of fundamental and share price weakness as a signal. Another reason to sell is what some people call "thesis shift". We often find that we bought a company, we had a reason to do so and the story changes and we sort of shift our thesis to marry to the new facts. As soon as you do that, experience suggests you should at least sell some but probably all of it.

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