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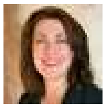

Kate Stalter, Contributor

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4 Picks from a Small-Cap Growth Manager

*Sustainable growth and a differentiated business model are among criteria that fund manager **Patrick Gundlach** uses to pick stocks for his small-cap fund, as he explains here. He also discusses his approach to IPO investing.*

Listen to the complete interview here.

Kate Stalter: Today, I'm on the phone with Patrick Gundlach. He's the co-manager of the BMO Small Cap Growth Fund. So, Patrick, tell us a little bit about your funds' objectives.

Patrick Gundlach: The objective of the BMO Small Cap Growth Fund is first and foremost going to own a diversified portfolio of small-cap stocks, ones that we deem to be growth companies.

But more specifically, what we're looking for are growth companies that exhibit three distinct characteristics. First is that they're demonstrating improving growth, secondly that they demonstrate explainable growth, and finally that they are showing sustainable growth.

One of the big differentiators for us and our process, and part of why we've been able to put up such consistent results over the last few years, is that focus on direction of growth rates, as opposed to being fixated on what the absolute level of growth is.

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Kate Stalter: Say a little bit more about that, what that means.

Patrick Gundlach: Well, what we see in them is, more often than not, earnings and/or revenue growth rates. There are other metrics that we'll look at that are good indicators of the health of an underlying business—like backlog for industrial companies or production rates of oil and gas for oil and gas companies.

We've found that what really is a better indicator of how a stock is going to do is not necessarily how fast they're growing in an absolute sense, but rather, is that growth improving? So, we key in on companies showing improvements in growth.

We then dig in to understand why this improvement is happening. It could be a product cycle, for example, or an acquisition that's driving improving results.

And then, through our research, we have to see if we can get comfortable. Is this trend we've identified as sustainable going forward? And if we determine that it is sustainable going forward, more often than not, the market tends to underestimate just how long and to what degree these positive changes can occur. So those stocks tend to outperform.

Kate Stalter: I want to ask you about some of these specific holdings that you have. But first, just to address a couple of the concerns that investors often have when they go into a mutual fund: This is a four-star rated fund from Morningstar, but I do notice there have been some concerns over time about the expense ratio. What would you say to people who might be worried about that?

Patrick Gundlach: Well, with regard to the expense ratio, one thing that I want to make sure that people are completely aware of is that the returns that are reported are after expense ratio returns.

So if you look at the historical track record and the fact that over a three-year basis, a five-year basis, a ten-year basis, the BMO Small Cap Growth Fund has put up fairly substantial excess returns vs. the Russell 2000 Growth index. That's after deducting those expenses.

So, our expense ratio, I believe—we have a couple of different share classes—but a bit under 1.5% for the main share class. We do have an institutional share class that I believe is at 1.19%. That is certainly a fee, but we put up very strong results for our investors, even after taking that into account. In our experience, the fees that we have are fairly standard for the small-cap growth mutual fund space.

Kate Stalter: Let me just touch on one more thing in the small-cap space. Obviously, that's an area where stocks could get beaten up a whole lot more than larger companies in poor market conditions. What would you say to investors who might get impatient with having to sit through a drawdown in some poor markets?

Patrick Gundlach: Yeah, small caps definitely have the potential to be a bit more volatile, particularly on an individual stock basis.

Now, one advantage of a mutual fund such as ours is that it offers a diversified portfolio of small-cap stocks, so a lot of that volatility is really counteracted and smoothed out by the fact that we are pretty heavily diversified. So you can still get that excess return potential by being exposed to small-cap companies, but reduce that risk profile.

That being said, we certainly would recommend that investors look across various asset classes and figure out what the best mix is for them. But we strongly feel that small-cap exposure is certainly a good thing to have, at least as a percentage of pretty much anyone's diversified portfolios.

Kate Stalter: Now, let's talk a little bit now about some of the stocks that you like. I notice that energy is an area where you are heavily invested at the moment. Can you say something about some of the holdings there?

Patrick Gundlach: We have several names we like in the energy space, predominately oil and gas production companies, also known as exploration and production, or E&P companies.

A couple of our favorites at present are **Forest Oil** (FST) and **Unit Corporation** (UNT). What they both have in common is that they are both showing increasing growth rates in production, specifically on the oil and liquids side of their business, which offers much greater economics in this environment.

- **Also read**: Keeping Its Energy Close to Home

Both of these companies have very strong portfolios of acreage and inventories of future drilling locations. Both of them have at present in the midcontinent, Oklahoma and the Texas panhandle, and each of them have some properties that are unique. But the thing that ties them together is that they all offer very attractive returns for investment in this environment.

Kate Stalter: What are you looking at in the tech sector right now?

Patrick Gundlach: In the tech space, we have quite a few names. One in particular that is one of largest holdings in the portfolio as a whole, not to mention just in the tech space, is a company called **Ebix** (EBIX).

Ebix is a company that while not very well known by the Street at all, but has actually been ranked as one of the best growth companies over the last ten years. They put up year in and year out, both earnings growth and revenue growth at very strong rates.

They've built software and services into the insurance industry. They're riding some very powerful tailwinds on the industry level, as the insurance industry moves away from paper and more to a digitized-type process, and this is a company that we feel has years of running room up ahead for it.

Kate Stalter: We had spoken earlier, and I know that you are invested in a recent IPO and I want you to talk about that particular name. But before you do, how do you enter IPOs? Is it on a case-by-case basis?

Patrick Gundlach: IPOs are not a very big portion of our strategy. What we've found, and particularly with a sizable asset base—we have about $600 million in the BMO Small Cap Growth fund and another $300 million in accounts that mirror that, so just under a billion under management—it can often be very difficult to get a meaningful stake in IPOs, particularly the ones that are pretty popular and most likely to act well on the first day.

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So, we found you have sort of the winner's curse of often you put in for an IPO, and you get all you want and more of the ones that act poorly. But the ones that are going to act well, you get very little. It's hard to add to returns that way.

That being said, once in a while we find an opportunity such as a **CaesarStone** (CSTE), is I believe what you referenced, where we are very highly attracted to the business. And for whatever reason it's not a very popular IPO at the time, so we're able to kind of get a sizable stake.

Kate Stalter: Tell us a little bit about that company.

Patrick Gundlach: CaesarStone is a very unique company. They do basically one thing. They manufacture quartz countertops, predominately used for countertops, also used in some other surfaces, but this is a company that was actually the founder of engineered quartz countertops.

And for many years in various parts of the world, Israel, Australia, Italy, for example, engineered quartz has very good market penetration. It has a lot of the advantages of pure stone, in that it is antimicrobial, easy to clean, doesn't stain, but it also has the ability, because it's an engineered material, you can customize colors and it has some very positive characteristics.

CaesarStone has done well internationally, and they are just now making a very strong push in the United States, which is by far the biggest market for countertops in the world. And quartz is showing good signs of taking share from granite. It is still at a very small base, so even just taking a couple of percentage points of share each year could provide powerful growth for CaesarStone.

Kate Stalter: I want to wrap up, but I've got to follow that up with one more question. Given what's going on in the housing market—and I know there's been some conflicting data about whether or not there is a housing recovery—how does a company like CaesarStone fare in that kind of environment?

Patrick Gundlach: For CaesarStone, the nice thing about it is that we don't need the housing market to recover, in our opinion, for this company to do well and for the stock to work. But if it does recover, that would be a great bonus, whereas other companies in the home building space are going to be completely dependent on new home starts increasing from here and to what degree.

CaesarStone is much more critical that they just continue to take share in the category and move from 5% market share to hopefully 10% or 15% in the United States. And if we start putting up a bunch more homes, which hopefully can happen sometime in our lifetime, that would be very nice for them, but not required.

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