The Price Must Be Right

Queens Road Small Cap Value won't risk buying overvalued names.

UNDISCOVERED MANAGER

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In every issue, Undiscovered Manager profiles a manager on the Morningstar Prospects list compiled by Morningstar Research Services' manager research group.

For Queens Road Small Cap Value QRSVX, the watchwords are patience and process, even if it means falling out of step with the market.

Morningstar magazine first profiled the fund (along with large-cap sibling Queens Road Value QRVLX) back in 2009. The nearly 15-year-old strategy has remained largely undiscovered since—but it is still worthy of notice. In 2016, Small Cap Value earned a place on the Morningstar Prospects list of new or under-the-radar fund strategies.

Portfolio manager Steve Scruggs runs the $155 million portfolio with a disciplined, Graham & Dodd-style of intrinsic value investing. But that includes a willingness to hold cash in the portfolio—and lots of it—if Scruggs and his team of analysts at the small, family-run firm in Charlotte, N.C., can't find enough stocks that they believe are truly cheap. That characteristic may cause strict asset allocators to pass the strategy by.

At the end of 2016, after a tremendous run for small-cap value stocks, the fund held 23% of its assets in cash, one of the highest stakes in the small-value Morningstar Category. That is a reflection of a rally that Scruggs believes is being fueled by momentum rather than underlying corporate fundamentals.

"It's not a market call," Scruggs says. "Right now, we just don't see individual securities that meet our valuation criteria, and we haven't for quite a while. As for the companies we do own, we don't want to have larger positions because of their valuations as well."

As small-value funds rallied ahead of all other U.S. diversified-equity categories in 2016 and early this year, the fund was left behind: For the trailing 12 months through February, the fund gained 15.3%, compared with 34.6% for its average peer and 41.3% for its benchmark, the Russell 2000 Value.

Recent underperformance has been a drag on the fund's longer-term rankings, but Greg Carlson, a senior analyst who heads up Morningstar Prospects selection in the United States, isn't giving up on it. "The fund is still strong over the long term on a risk-adjusted basis, and 2016 was the kind of big value rally when this strategy might be expected to lag badly. The same portfolio manager has been in place since the beginning, and fees are average despite the small asset base."

Scruggs hopes investors will look at the fund the same way his firm looks at the potential for stocks: over a full market cycle. That time frame is at the core of how the firm operates. "There are times when the fund looks fantastic and times when the market has really rallied, and we don't look good at all. But through all of that, what's consistent is our ability to be patient and stick to the discipline."

Taking a Long View

The fund's 10-year returns are in the top half of the category, even after its recent slump. However, risk-adjusted performance is where it stands out: Its Morningstar risk-adjusted return over that time frame lands in the top decile.

Even though the fund's five-year rankings are not as strong, it kept volatility in check with a standard deviation of 9.9 over that time, compared with 13.2 for the average small-value fund, and 14 for the Russell 2000 Value Index. While the fund has captured only 69% of the benchmark's upside over the past five years, it also has only suffered 65% of the downside. The average small-value fund, meanwhile, captured 93% of the benchmark's upside, but 94% of the downside.

The fund's low-risk profile comes into plain view in choppy markets and especially when stocks take a dive. It was nearly in the black for 2015, for example, beating 97% of peers in the small-value category. Similarly, its 2008 23.8% loss was large in absolute terms, but relatively limited; the fund also landed in the top 3% of the category that year.

The fund's returns may diverge significantly from its benchmark and category averages at times, but Scruggs can stick to his long-term focus because he has the support of a firm that is inclined to stick with him. Indeed, he is part of the family.

Queens Road Funds is an outgrowth of Bragg Financial Advisors, founded by J. Frank Bragg in 1962. Today, three of Bragg's children are actively involved in the business. Benton is chair of the Queens Road investment committee and works as an analyst on the funds. John directs fund communication and distribution, and Phillips heads up the advisory firm's tax-planning group for private clients. As for Scruggs, he is married to Frank's daughter Katie. All five parts of the family live in homes on the same 400-acre plot of farmland where to this day the adults and kids pitch in together on chores.

"That core of family provides a core of trust that permits us to think about the long term," Benton Bragg says.

The team benefits from the loyalty of investors who understand the process. Kuhn Advisors, based in Durham, N.C., has had client money in Queens

Road Small Cap Value since 2011. Scott Ranby, an advisor in Kuhn's Colorado office, says they employ the fund as a defensive holding in their small-cap value sleeve, pairing it with one that tends to stay fully invested and hew more closely to the benchmark. Queens Road "is very upfront about their discipline," Ranby says. "Their use of cash is interesting. It dampens the volatility, and it hasn't hurt their long-term returns."

Ranby says that Kuhn, which focuses on investing with boutique value managers, also appreciates the accessibility they get with Queens Road. "When we can talk to the manager, and say, 'Give us your top three holdings and why you have conviction in them,' we can relay that to our clients and give them perspective."

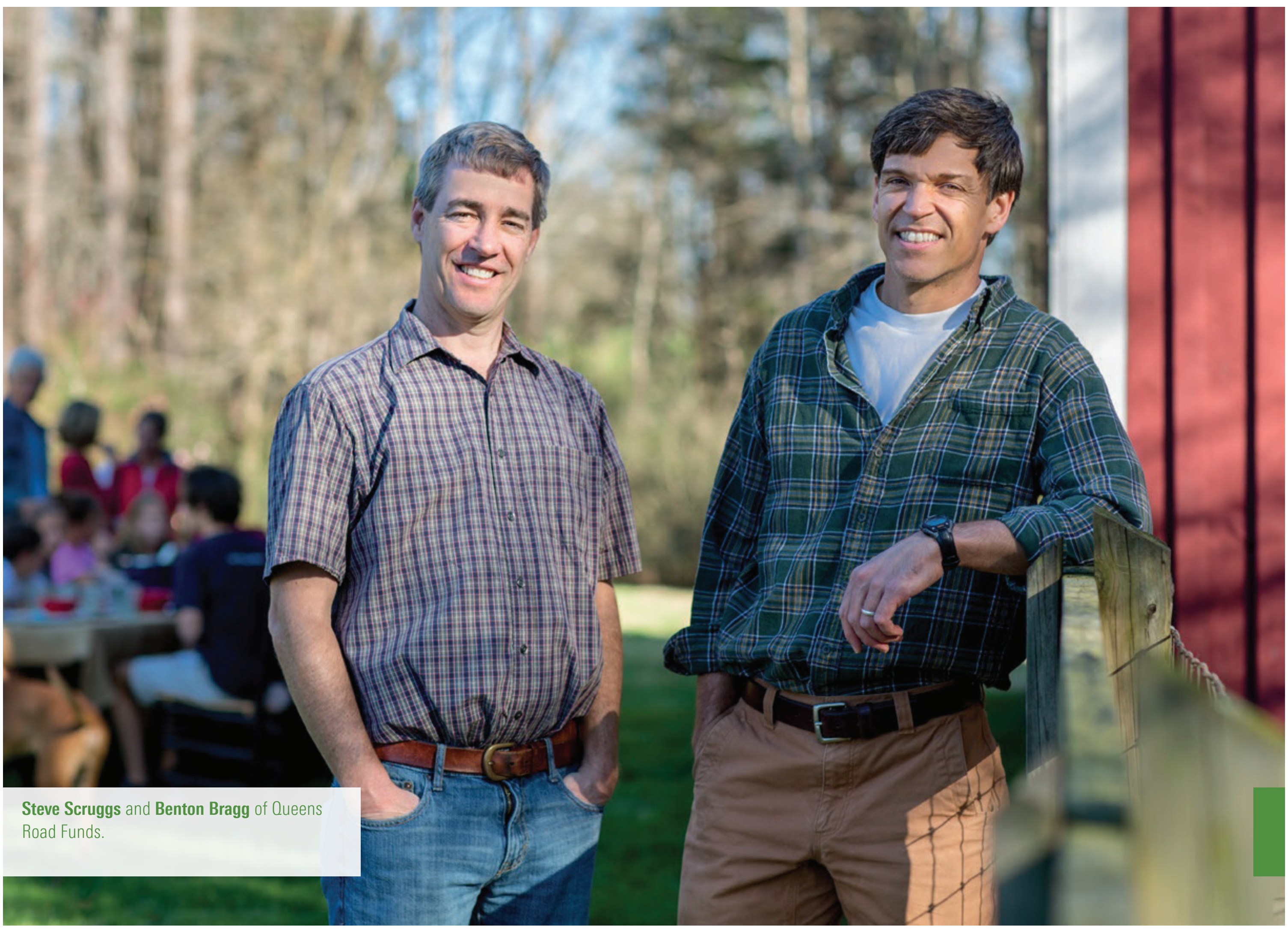
Old-Fashioned Value

The stock-picking approach underlying the Queens Road investment process is to a large degree straight out of the value-investing textbook. The team starts by screening for companies with strong balance sheets, manageable levels of debt, low reliance on the capital markets, and healthy levels of free cash flow.

The second step is estimating instrinsic valuations and stacking them up against stock prices.

The team employs a handful of different models, primarily a free cash flow discount model that looks at historical and current data, and then projects normalized operating margins and earnings. The focus here isn't just on the near future, but on how the company might look over a full market cycle.

Beyond that, the team assesses management's long-term track record and ability to execute on a strategy. "We're not concerned about them making quarterly numbers," Scruggs says. "We don't mind if they miss as long as they have a coherent strategy and they communicate mistakes honestly."



Steve Scruggs and **Benton Bragg** of Queens Road Funds.

Queens Road Small Cap Value QRSVX

Category	**Small Value**
Expense Ratio (%)	**1.24**
Morningstar Rating	★★★
3-Yr Annl Total Rtn (%)	**6.00**
3-Yr Total Rtn % Rank	**69**

Data as of 02/28/2017

Lastly, the team pulls the camera back a bit and puts companies in the context of their sectors and industries. "There are plenty of companies that look cheap, but are in a dying industry," Scruggs says. "We're looking for industries that have favorable economics and aren't overly competitive so there is reasonable pricing power."

The fund's willingness to hold cash is a byproduct of two factors, Scruggs says. The first is the team's ability to find enough investments with suitable margins of safety for initiating positions. The second is its ongoing assessment of the valuations of stocks it already owns to determine whether discounts to intrinsic value warrant adding to positions.

The dynamic around cash holdings played out clearly in 2008 and 2009. During 2008, as the financial crisis was unfolding, the fund had roughly 15% in cash. Then, as stock prices were falling sharply as 2009 got underway, the team took the cash stake down to 2% by February. They were buying stocks such as Winnebago WGO, which the market was valuing at just a little bit more than all the cash on the company's books. "It was priced like they were never going to sell another RV ever again," Benton Bragg says. Winnebago's stock doubled in value in 2009.

Stock by Stock

The portfolio generally holds roughly 50 to 60 stocks. The fund has an upper weighting limit on each stock position of 5%, but names are usually kept below 3% of the portfolio. "We think this gives the benefit of diversification, but every position has a meaningful impact," Scruggs says.

At the same time, the portfolio's sector weightings aren't tethered to the fund's Russell 2000 Value benchmark. The fund, for example, had nothing in real estate at the end of 2016, while the index had more than 11%. Financials comprised 30% of the index, but the fund had less than half that. (This underweight has contributed to the fund's recent underperformance, as financials have rallied strongly since the election. Scruggs and team believe that valuations are simply too rich even if the regulatory climate becomes more friendly for financials.) The fund's large stakes in technology and industrials reflect the opportunities they've found there.

With a five-year targeted holding period for individual stocks, turnover is limited, sometimes in the low single digits. Turnover tends to jump during market downturns as the team finds more stocks hitting attractive valuations, such as in early 2016, when small-cap stocks started the year down double digits and Queens Road put money to work as valuations fell into its buy zones.

While the cash cushion contributes to the fund's defensive characteristics, the team asserts that valuation-sensitive stock-picking often contributes more to the portfolio's buoyancy in down quarters than the cash stake. The team points to data showing that the fund has outperformed the Russell 2000 Value Index in 15 of 17 negative quarters since the fund's inception in 2002. According to its attribution analysis, the fund's average outperformance for all 17 quarters was 3.7 percentage points, with 2.6 points of that owing to stock-picking (and the remaining 1.1 point attributable to cash).

Among the fund's recent winners is Harman International Industries HAR, which Queens Road started buying in the spring of 2016 amid growing demand for the company's automobile touch-screen infotainment systems. The stock had sold off by roughly 50% from north of $140 amid concerns that overall car sales were peaking. But Queens Road believed that even in the face of slower industry sales, touchscreens would proliferate in newer models, especially ahead of a regulation mandating all new passenger vehicles have backup cameras and screens by 2018. "It was a nice tailwind for Harman," Scruggs says.

When the team crunched the numbers, it arrived at a normalized operating margin of around 8%, and pegged revenue growth in the 8% to 10% range. After adjusting for some additional factors, it put the stock's intrinsic value in the $100 to $106 range and starting buying when shares were in the low $70 range. Then last fall, Samsung made an offer to buy Harman at $112 a share, about a 60% premium to where shares were trading. The team considers the stock fairly valued now and is holding on until the deal closes in June for tax reasons—and because there may be competing bids in the works.

Hanging Tough

The team is hanging tough on another stock it considers undervalued, even though the market hasn't cooperated lately. For five years, the fund has held shares of Synaptics SYNA, which makes the technology behind touchscreen controllers and fingerprint sensors for smart-phones. The company has seen margins slide from the low teens into the high single digits. But the team thinks it's possible for normalized operating margins to get back to 10% or higher, and it likes the strength of the balance sheet, where there is $350 million in cash against $217 million in debt.

"From there it doesn't take much growth for the company to be worth $68 a share," Scruggs says. The fund started buying Synaptics in April 2012 at $32 per share and since then has both added to and subtracted from the position on valuation. Shares hit a high around $100 in mid-2015, but the stock was a detractor from performance in 2016. Most recently, the team was buying shares in the mid-$50 range last year; the stock was at $53.68 on Feb. 28.

Scruggs says he knows it's hard for investors to weather underperformance, but he voices confidence that the process will again show the value of focusing on risk-adjusted returns. "It's not uncommon for valuations to depart from fundamentals, and we're in a situation like that now," Scruggs says. "History shows it always gets back to the fundamentals." M

Tom Lauricella is the editor of Morningstar Direct.

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