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Roubaix Capital's Hillary Bullish on Defense Stocks, Cautious on Autos, Housing

Christopher Hillary, CEO and Portfolio Manager, Roubaix Capital

- Focus is on small-cap stocks as dispersion is about double that of large-cap stocks and there are fewer resources being spent analyzing smaller companies
- The $90 million Denver-based firm likes financials "for the first time in several years," and is more bullish on the business economy

Interviewed by Melissa Karsh on Nov. 15 and Jan. 9. Comments have been edited and condensed for clarity.

Q: Describe your strategy.

A: We focus on small caps. The dispersion in smaller-cap stocks is about double that of larger caps. That creates better opportunities structurally for longs and shorts, and for our fundamental approach. Secondly, as the markets have evolved, there are less resources being spent analyzing smaller companies. So that means less research coverage. Some of our best longs and shorts are situations where there's little to no official coverage. That's a trend that's going to continue.

I've run the fund to be about 40 percent net long. We're above that now, given that we've gotten more bullish on the business economy.

Q: Why are small caps more attractive than larger-cap stocks?

A: There's a greater ability to add alpha in small caps because of that dispersion. We try to identify the outliers — the really good and bad businesses and situations— and when you find a compelling investment case that meets the parameters of our process, you can typically generate a significantly higher return in a narrowly focused small-cap company than in a larger, more diversified peer. To find a terrific short, there are lots of smaller companies that might have a challenged business model, that might have people involved running the company that aren't top notch and they may, in often cases, have poor capital structures. You can really generate returns shorting a situation like that, and it happens less frequently in large caps, where you have more diversified businesses. Conversely, if you have a company that's a new tech startup, a new health-care product, you still have a lot of innovation, new ideas and opportunities in small-cap land, that have space to grow.

Q: What sectors do you like?

A: It's hard not to like financials for the first time in several years. There's a chance the 2016 U.S. presidential election was a paradigm shift. It wasn't just that Donald Trump was elected, it's the fact that Republicans also got a majority across the board. That's going to enable them to actually do some of these pro-business policy changes, including tax reform, de-regulation of financials, health care and energy, and then potentially, although less likely, a significant infrastructure spending plan, which are undoubtedly pro-business and stock markets are a reflection of the health and prospects of businesses.

We're cautious on REITS, autos and housing, even more so now that we've had higher interest rates. Due to a stronger U.S. dollar, we are short certain areas of technology and industrial sectors with significant international exposure. We're constructive on U.S. domestic stocks, given the potential for better earnings outlooks and now ever more so with this change in tax policy, which could end up driving a virtuous circle for U.S. domestic companies.

Q: Are there other sectors where you have increased exposure?

A: We've been somewhat positive on things like defense spending. Trump is going to try to fund the defense budget, and defense companies are domestic, so they also benefit from tax code changes. We are also investing in domestic restaurants and staples companies.

One of our largest positions is Coca-Cola distributor, Coca-Cola Bottling Co. Consolidated (COKE). We like COKE because its parent (KO) decided to divest a number of distribution businesses it previously owned that weren't executing well. One of the primary beneficiaries of that is COKE. Over a five-year period, their distribution or business is going to go up 100 percent. They used to earn nearly 8 percent margins, but as they've been going through this transition it's been cut in half. We believe there is an opportunity to expand margins above the previous peak. It's 100 percent domestic, and you can plug in a lower tax rate and earnings will be substantially higher.

Q: What other companies do you like?

A: We've been bearish on diagnostics within health care. There's a diagnostic company that has a cancer test that costs about $3,500, and there's an upstart that sells a test with the same efficacy for $500. The commercial ecosystem in health care is increasingly aware that they have to play their part in driving costs down, so this company with the more expensive test is consistently losing market share and now they're also having some issues with the overall business, such as stability in the sales force. We're seeing a lot of short opportunities within the health-care ecosystem.

Another long is Ingevity (NGVT), which has a series of businesses. The most exciting one is they sell activated carbon products that reduce vehicle emissions. The company is a recent spin out and as a result has limited analyst coverage at a time when their most profitable business is growing the fastest.

At a Glance

Professional Background: Spent 15 years on the buyside, including the prior 11 as a founding partner and senior analyst at Independence Capital Asset Partners
Education: BA Rutgers University, MBA University of Colorado
Investment philosophy: Process, discipline, independence, creativity