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MARKETS

The managers of a fund that beat 97% of competitors in 2023 explain how they have outperformed for over a decade, what they're looking for in an investment, and the stocks they're watching in 2024

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Despite the volatility of a banking crisis, geopolitical conflict, and the birth of a paradigm-shifting technology, beating the market in 2023 was actually pretty simple: invest in the Magnificent Seven and wait for the gains to start rolling in.

George Smith and Chris Pearson, however, took the road less traveled. The Davenport Equity Opportunities Fund managers are unafraid to be different when it comes to finding high-quality investments to add to their fund.

"We don't like to pander to market trends, don't like to chase momentum, and we very much like to stick to our guns and maybe act a little differently than others," Smith told Insider in a recent interview.

The results speak for themselves: the Davenport Equity Opportunities Fund (DEOPX) outperformed 97% of peers in the last 12 months, 96% in the last five years, and 92% over the last 10 years.

Here's how Smith, who's run the fund since its inception in 2010, and Pearson, a co-manager since 2013, have consistently brought in strong returns by being willing to be different.

Invest like you own the place

The Davenport Equity Opportunities Fund focuses on mid-cap stock. Beyond that, there's little restriction on the types of investments Pearson and Smith are looking at.

"The fund is a very concentrated and very differentiated collection of ideas," Smith said. "At any point in time, it's going to look very different than the benchmark, very different than peers and we're just very, I think, flexible in our approach."

With 29 stocks, the fund is indeed concentrated. But the managers are confident enough in the investments they choose that they're willing to put their eggs in a few baskets.

"We do invest with a very high degree of conviction," Smith said. "In other words, we want to own a few things and own them like we really mean it."

Pearson agreed with that sentiment.

"I think what's important to point out is that a huge focus of our investment philosophy is investing like we are owners of these businesses," he said. "And as such, we look to align ourselves with great businesses that generate higher returns on capital, that generate significant amounts of free cash, and can redeploy that free cash flow at high rates of return."

To find companies like that, Pearson and Smith pay particular attention to management teams. Owner-operated businesses are a favorite for the fund managers, who prefer to find management that has skin in the game. Free cash flow is great and all, Pearson noted, but it doesn't mean much if the management team isn't deploying it intelligently and using it to generate returns for shareholders.

Finally, the fund managers aren't afraid to hold onto their investments even if the market disagrees with their thesis.

"We will plant seeds sometimes and be wrong for a decent period of time before seeing those seeds bear fruit for us," Smith said. "But when we know something and like it and it's out of favor for reasons that we deem to be temporary or just wrong, we will actively add to that position."

3 stocks to watch in 2024

To that end, Smith highlighted several stocks that the co-managers have added to their positions in recently, even though the rest of the market isn't particularly bullish on them.

He and Pearson have continued to invest in Live Nation Entertainment (LYV), the parent company of Ticketmaster, Kinsale Capital Group (KNSL), a Richmond-based specialty insurer, and Clean Harbors (CLH), a hazardous waste disposal company. These stocks are "temporarily out of favor and down for reasons that we think the market's just overestimating and for reasons that we think will prove to be temporary," Smith said.

As for the future, Smith and Pearson prefer a bottom-up approach to investing and don't stick with one specific sector or theme. That said, they're very interested in healthcare, one of the worst-performing sectors in the S&P 500 last year. Stocks in the sector struggled in 2023, but that hasn't dissuaded the managers from investing in them — in fact, they see it as an opportunity.

"We're looking for really high-quality businesses that may be facing transitory or short-term headwinds or difficult comparisons, and all these came about from a company-specific perspective, but they happen to be related to the healthcare theme where you have plenty of situations like this," Pearson said. "Longer term, I think healthcare is an interesting place to invest just given the innovation, the stable demand, and the importance to society."

Smith and Pearson have added to three key positions in their fund that operate in the healthcare sector. The first is **Enovis** (ENOV), a medical device and surgical implants company. Pearson noted that it's "a company we've known for a very, very long time, really respect management, and believe that their strategy of growing their higher-margin, higher-growth, surgical implants business is going to result in overall better growth, higher margins, and a higher multiple over time."

Next is **Avantor** (AVTR), a life sciences and diagnostics tools company. Pearson noted that this area of the healthcare sector saw huge demand in the years after the pandemic, leading to oversupply and hurting stocks in the industry, particularly small-cap biotech and bioprocessing companies. But that has opened the door for Pearson and Smith to continue investing in Avantor at a lower price point than they think it's worth.

"That is essentially a toll booth business on innovation in the life sciences space that we think when industry trends normalize the overall earnings power and margin trajectory of the business will improve dramatically," Pearson said. "So leaning into what we believe is a short-term headwind and a great business with great long-term growth characteristics."

Finally, Pearson highlighted Align Technologies (ALGN), makers of teeth aligners like Invisalign. Clear aligners have been taking market share away from classic metal braces for years now, Pearson noted, and discretionary spending on dental procedures like those that Align can help with was growing consistently pre-Covid.

Demand has plummeted post-Covid as consumers close their wallets, leading to a tough few years for Align. But the company's position in the space remains secure, and Pearson and Smith have taken advantage of the opening that a lower price presents.

"At the end of the day, Align is the dominant brand in this segment," Pearson said. "It should be able to continue to grow alongside the industry, has tremendous margins, has tremendous manufacturing capacity, and essentially we're making a bet here once again that this really attractive business can get back to its longer-term growth rate. And as that occurs, we think the earnings ramp will be quite powerful."

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