

**The JRo Show Podcast: Interview with Steve Scruggs, Portfolio Manager of the  
FPA Queens Road Small Cap Value Fund  
June 19, 2024**

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*Note: Items in brackets [ ] are meant to be clarifying statements but are not part of the actual audio recording of the podcast.*

**You should consider the FPA Queens Road Small Cap Value Fund (the “Fund”) investment objectives, risks, and charges and expenses carefully before you invest. The Prospectus details the Fund's objective and policies and other matters of interest to the prospective investor. Please read the Prospectus carefully before investing.**

**The prospectus for the Fund dated September 30, 2023 and corresponding supplements, can be accessed at: <https://fpa.com/request-funds-literature>. The most current prospectus can always be obtained by visiting the website at [fpa.com](https://fpa.com), by calling toll-free, 1-800-982-4372, or by contacting the Fund in writing.**

Moderator:            This is the JRo Show. On this podcast, your host, John Rotonti, interviews experts in and outside the world of investing. The JRo Show dives deep into what it takes to achieve mastery and sustain top level performance.

                              As a quick reminder, this podcast is for informational purposes only, and should not be relied upon as a basis for investment decisions. All opinions expressed by John or any of his podcast guests are solely their own, and do not constitute formal advice or recommendation. Now please enjoy the episode. Thank you.

John:                    I'm John Rotonti, and this is the JRo Show, a podcast that explores what it takes to achieve mastery, sustained performance and longevity. The show hopes to uncover the processes, structures, frameworks and

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mindsets that professionals put in place to maintain winning performance in their respective fields. Today, I am joined by Steve Scruggs.

Steve has served as the sole portfolio manager for the FPA Queens Road Small Cap Value Fund since its inception in 2002. The FPA Queens Road Small Cap Value Fund has a Morningstar Rating of five stars overall and five stars over the 5- and 10-year periods.

It also has a Morningstar Rating of Gold. I think what's most incredible about Steve's performance is that he has beaten his benchmark, the Russell 2000 Value Index, since inception and has done so while taking less risk and dramatically outperforming in down markets. Consider this.

Since the Fund's inception in June 2002, the Russell 2000 Value Index had 28 down market quarters and the FPA Queens Road Small Cap Value Fund outperformed 100% of the time when the Index was down 10% or more. And since the Fund's inception, anytime the Russell 2000 Value Index has declined 20% or more, the FPA Queens Road Value Fund has outperformed by over 1,000 basis points and by an average of 1,370 basis points or by a whopping 13.7 percentage points. During Russell [2000] Value drawdowns of 20% or more, Steve's fund has had an average downside capture ratio of only 58%.

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So let's find out how Steve is able to generate such attractive risk-adjusted returns for his investors. Steve, welcome to The JRo Show.

Hello, everyone, and thank you for joining us today.

Steve: Thanks, John. It's nice to be here.

John: Thank you, sir. Steve, tell us about the Queens Road Small Cap Value Fund.

Steve: Sure. As you mentioned, I started the strategy in 2002. I work for Bragg Financial Advisors.

We're based in Charlotte. And I've been the PM since inception. And we started with a very straightforward philosophy. It's based on the timeless Benjamin Graham principles. We're bottom-up, take a long-term view. And I think a lot of our success has been... it's really behavioral. I talk about temperament a lot. And we work really hard to take emotion out of all of our investment decisions.

And I think that patience and the discipline have been really key to our long-term success. So we've been around since 2002. Currently, there's about \$750 million in the strategy. And as a small cap strategy, we have capacity constraints, but we think we can handle around \$2.5 billion in the strategy comfortably.

John: Great. So a lot of room to grow there with your current team size.

Steve, tell us a bit about FPA and how your fund ended up at FPA.

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Steve: Sure. It's an interesting story. So when I started back in 2002, I had a pretty naïve marketing strategy.

I assumed that if I could create a small cap value fund that would put up really good risk-adjusted numbers, had style consistency, low turnover, below average expenses, all the things we know advisors look for in a fund. I think that if we did that, we could put ourselves out on the big platforms and we would screen out and attract our fair share of assets, especially in small cap value, which should be capacity constrained. I can't think of any other business where the best businesses have to close their doors due to capacity constraints.

It completely, continuously allows more entrants to come in. We started the fund, managed it from the get-go, and from a performance perspective, it did really well. When we got to three years, we had a five-star track record. Then the five year, we had a five-star track record. The performance was there, but my naïve marketing strategy didn't really work out.

I did that until about 2020. For 18 years, great performance, and we had about \$150 million in the strategy. Around that time, actually, it was in March of 2020, so right when COVID was kicking off, Ryan Leggio from FPA called me, and I had met Ryan, I think it was 2008 or 2009.

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He worked for FPA at that time, but in 2009, he was with Morningstar, and he came down from Chicago to visit with us, and he wrote up a nice article on the fund in doing an undiscovered manager's feature. Unfortunately, 10 years after that article came out, I was still an undiscovered manager. So I knew Ryan, and we kept up over the years, but FPA, I'm not sure if you're familiar with the old FPA Capital Fund?

John: I'm somewhat familiar, yes.

Steve: That was Bob Rodriguez's fund, and he had a very storied record there, did remarkably well, but after he left, it hadn't fared as well, and they were looking to make a portfolio management change and Ryan called to see if I was interested. And I really didn't want to leave my track record and I worked for a family business and didn't want to leave and go work for FPA. So we chatted for a while and we came up with an idea where we would merge the Queens Road Small Cap Value Fund and the FPA Capital Fund.

So that's the genesis of the FPA Queens Road Small Cap Value Fund. So January of 2021, we consummated the transaction and our agreement, we have a long-term agreement outside of the advisory contract that FPA handles the compliance, the administration, and the business development. And we're left to manage the portfolio using the same philosophy and process that we've been using since the beginning.

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So that's how we came together.

John: Yeah, that's such a great story. And like you said, FPA has this great value investing legacy.

Bob Rodriguez had a fund there, Steve Romick is still there, h has a fund there, and now you merging with the old FPA Capital Fund is just a great story and you're continuing that great legacy. You've had five stars basically, your fund's 22 years old, and you've had five stars basically since three years and then five years in, and now 22 years in, you still have a five star and you still have five stars of the last 5- and 10-years. S you're doing something right, Steve.

Steve: You're very right, I should say.

John: So what type of businesses do you like to buy stock in?

Steve: Yeah, we like to say that the philosophy is very straightforward. We have a bias towards quality, and I know a log of people say that now, but we have throughout, and we're constantly balancing quality with valuation. We are definitely value investors. We look down before we look up, which is an FPA slogan that we really believe in.

John: I like that.

Steve: So when we're looking at companies, the first thing we want to see is consistent profitability. We look at the volatility of the operating margin. That's very important for us.

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We want companies that are going to make money year in, year out. We want to have a strong balance sheet. We want companies that can endure whatever the uncertain future is going to bring, because there are going to be things that come up that we can't predict, whether it's a recession, a financial crisis, or a pandemic.

There's always going to be something. And the companies with strong balance sheets can weather through that and come out on the other side better off. So, high returns on invested capital, consistent operating margins, strong balance sheets, and all those things are backward looking, but that's what we start with.

And then we look forward to try to determine, is there reasonable expectations that we can expect this type of performance in the future? So, in a nutshell, that's kind of our framework, the perspective that we're looking at these companies from.

John: I love that. Strong balance sheets, consistent history of profitability, stable margins, high returns on invested capital, and then you try to project forward to see if the company can maintain those strong fundamentals into the future. What is your portfolio management philosophy?

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Steve:                    Basically, how many stocks in the fund? What is your average starter position size? What does a full position size look like? And do you hold cash or are you typically fully invested?

                              Sure. Yeah. Generally, we're going to hold 50 to 60 companies. We think that gives us the full benefits of diversification. Risk management is very important to us, but through security selection and portfolio management. But 50 to 60 is, I think, a number that, as I say, each company can be a meaningful component of return, but we are broadly diversified.

                              Right now, we have 52 companies, and that's pretty typical. And as far as when we initiate a position, we cap a position at 5%, and it is very rare that we would enter a position there. But generally, it's going to be between 1% and 3%, depending on our conviction.

                              And it's really a matter of what the market is offering us at a given time, how, what the, any additional investments in the fund, position sizing will be. As far as cash, historically, we have held cash and we've at times held what I would consider kind of a high level of cash. I think most people would.

                              It's been as high as 30% at times. We have a policy in place. We did some analysis in 2018 and we looked back at our performance. You mentioned our [outperformance in down markets versus the Russell 2000



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Value Index] and that's very true. Part of that was from our cash holdings. But when we did this analysis, we looked at the fully invested portfolio. It was pretty clear. It was really clear. Over two-thirds of our [performance in down markets] was from security selection. And so we realized if we had held less cash during that period, our shareholders would have been better off. We would have had a higher long-term absolute return. We would have had slightly higher volatility and downside risk, but not, as I say, most of [that outperformance during down markets] was from the security selection.

So when we did that, it became, it was obvious that we were being too conservative with our cash holdings. So we instituted a policy to get cash under 10% and keep it under 10% during normal times. And right now we're right at 10%.

John:                   Awesome. So you touched on a lot of this. I want to ask you about, you know, risk management, but you already touched on two-thirds of your [outperformance during down markets] came from security selection.

So the quality, strong balance sheet, high return on invested capital, free cash flow, generative businesses that you invest in. You know, that's one big level of risk management for you. You also mentioned you invest across, your portfolio is invested across 50 or 60 stocks.

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So it's diversified in that way. And you also mentioned that you cap individual position sizes at 5%. Any other, I mean, it's a lot, but any other risk management layers in there, like for example, do you have industry or sector caps or anything else that you factor into your risk management philosophy?

Steve: We do, we're 20% at the industry level. We monitor that. So when you look within a sector or industry, we're continuously looking how we are diversified within that sector. We're purely bottom-up. We don't make, certainly not macro calls, we don't make sector bets, but we do deviate, our sector allocations will deviate significantly from our primary benchmark, which is the Russell 2000 Value Index. But it's never a call on a sector.

It's a result of the process of looking at these companies bottom-up and going where we're seeing the most value. And currently we have what would be considered an overweight to technology, and that's not necessarily a bet on technology, but the companies that we run through our process, it's leading us to those companies.

John: Yeah, yeah. So I think your investing team consists of you and a senior analyst. So I assume you're both generalists. I guess my first question – is that right? Are you both generalists? And then are there any

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sectors you and your analysts are more comfortable with, and are there any sectors you tend to avoid?

Steve: Yes, we are generalists, the two of us. And Ben Mellman is the senior analyst. We hired him several years ago. He came from IVA. He'd spent about a decade there. And he was an amazing addition. But we're generalists.

And I think on the buy side, being a generalist is a huge advantage. It's not being constrained to just a particular silo where you're looking across the spectrum. You're looking across industries. You're getting to see different types of business models and how the economics in different industries look. And I think it helps you have a more holistic view of the investing universe and, again, not have you so focused, you know, the expression you can't see the forest or the trees. So we're very much generalists.

We all, we each, we both spend a lot of time on each holding in the portfolio. But if I had to say financials and particularly insurers, I tend to kind of drift more towards, we would have what would be considered an overweight in insurers, but that's just where we're seeing the value. And Ben, I would say Ben probably spends more time on industrials. That was

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one of, when he was at IVA, he had a few industries and industrials was one, so he has a lot of experience there. But everything overlaps.

John:                   Yeah, yeah.

Steve:                 To the second part of your question, regarding, you know, are there sectors that we kind of shy away from? And definitely, I would say, basic materials and energy are two that we will have limited exposure to or no direct exposure to. And, you know, our thinking on that is we're looking for managements that can create long-term shareholder value and just be compounding machines.

                          And when we look in those areas, you know, where there's no pricing power, you're dependent on the price of the underlying commodity. We know we have no ability to predict movements in oil prices or any material. And if you look over time, those industries just generally don't have the things we're looking for. Long-term, high returns on invested capital, consistent operating margins, etc. They typically tend to be pretty indebted. So those are areas where we will typically be underweight or have no exposure to.

John:                   How do you and Ben divide the work? So you serve as lead portfolio, the sole portfolio manager as well as an analyst. So how many companies can you cover as a lead analyst while also being the sole portfolio manager?

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Steve: Sure. You know, we as buy side analysts, I think we're looking at things differently. If it was on the sell side, I would give you a different answer. But as a buy side analyst, I think 50-ish is reasonable. We have access to research, so we can get the data and the information in an efficient form. But we think, we kind of see ourselves more in the judgement business as opposed to fact-gathering and what we do with the information, not necessarily just pulling information together.

Having said that, we spend our days, you know, we're digging into companies, using sell side research technology so we can do it efficiently. But, you know, getting down in the weeds is a must. But I think more importantly, identifying the three or four primary aspects of a company that may make it a good investment is probably more important than that.

John: Yeah, you know, I didn't call it out earlier, but you mentioned that you and Ben are both looking at all the names in the portfolio. There's a lot of overlap, and you're constantly both monitoring all the names in the portfolio. I think you said that.

Steve: Yes, and that works great.

John: Exactly. And then, like you said, I love how you phrased that. You're in the judgement business, not necessarily the fact-gathering business. And as a buy-side analyst, you have access to all of these resources, including sell-side research that can get you up to speed really

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quickly, that can help you determine what consensus is and what's priced into the stock from an expectations investing standpoint. And so you can handle 50 companies as an analyst on the buy side. And then finally, I've spoken to a log of great investors like you over the last 20 years. And all of them, almost to a point, called out what you just called out. You have to zero in on those very few factors that are the drivers of value at the business, the long-term value drivers at that business. You have to identify those. And those are really what could potentially move the stock, right?

Steve: Exactly. And, you know, it's a very straightforward, I use the word straightforward a lot when I describe the process. And I think there's kind of an inclination, something about human nature where it's more exciting to find these extremely complicated, messy situations where the analysts can hope to see something that nobody else is seeing. And our experience with that has not been nearly as good as our experience when we stick to that process of finding these high quality companies that meet the thresholds that we just went through. So, yeah, focusing on the primary drivers of shareholder value creation. At all times is what we try to do.

John: Yeah. What is the fund's average turnover and how many new ideas do you hope to add to the portfolio each year?

Steve: Turnover, it's varied. The last four or five years, it's been mid-teens.

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John: Which is still low.

Steve: Yes, oh definitely. But we've been in the 30% or 40%. And it has a lot to do with market volatility. The more volatile the market, the more opportunities that are going to rise for us to sell something and buy something that we think is more attractive. But we like to say, you know, like Buffett says, our preferred holding period is forever. And I think Charlie Munger said it best when talking about patience, that we really buy into this. And he said, you know, it's not in the buying and the selling, it's in the waiting.

John: Yeah, in the holding, right? In the waiting in the holding, yeah.

Steve: Exactly. And it goes against human nature. You come in and you want to do something and you're looking, and it's something that I as an investor have kind of evolved over the years. If you look at the portfolio turnover earlier on, it was much higher. And a lot of us learn from mistakes of one of two things. Selling something too early, which I've done a few times.

And it's significantly, I don't know if you know the company, Constellation Brands. We started buying that in 2002 or 2003 when it was a small cap. And then we sold it four or five years later, purely because it had gotten, I think at that time, it was a \$5 or \$6 billion market cap. We still love the company. What the Sands brothers have done there is truly

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phenomenal. But we sold it just because we had a policy that we would sell it when it got to that threshold. And the last time I looked, I think it's a \$50 billion market cap company. So if we would have been a little more patient and not felt like we needed to do something, now we're not going to own it all the way up to \$50 billion, but we could have made a lot more money on it.

John: Do you have a hard cutoff as a small cap fund? Is there a market cap that you just have to sell out?

Steve: We have a policy. In the Prospectus, as I think you know, 80% of the portfolio has to be considered a small cap at the time of purchase. But in addition to that, we have a policy. We define small cap as the largest company in the Russell 2000, which gives us a lot of leeway, because usually that's a bit bigger than our sweet spot. There's a policy when a company gets to be twice, I'm sorry, two and a half times the size of the largest company in the Russell 2000 is when we'll start selling out of it.

John: Yeah, that does give you some flexibility though. That gives you a lot of room.

Steve: It does, and we have a company in the portfolio right now that we're selling and it's been because of that. We bought it as a small cap maybe a decade ago, and it has continued to perform well, both on fundamentals and the stock price, and it's gotten to a point now where we have been



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selling it purely because of that, but it's a \$25 billion market cap company right now, so we've made our money and we're moving on.

John:                    Yeah. How do you find new ideas? Can you please talk about your idea generation process and how you narrow down your investable universe?

Steve:                    Yeah, so we run screens, dynamic screening. You know, it would depend on the industry or different. I'm sure it's the same thing everyone else is screening for. And it's the things I've mentioned, balance sheets, rank, valuation, all those things. But you know, when we do that, having done this for 20 years, the Russell 2000 Value and Russell 2000 as well, you know, is relatively static. So if I run a screen like that, it's the usual suspects that always pop up in their companies that I have good familiarity with.

                                  And sometimes, you know, maybe something idiosyncratic will happen to a company and it will come down into the Russell 2000 or maybe, you know, an industry event or just some type of panic where a market cap gets cut and it will show up. But generally speaking, we're kind of, you know, fishing in the same pond. And so what we do is we, you know, we spend a lot of time on a lot of these companies and we have a very extensive watch list of companies that we really like, but just the evaluation is not there.

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John: Yeah. And then, like you said, you just patiently wait.

Steve: Exactly.

John: Yeah. Can you walk us through your step-by-step research process? So what steps do you take in your due diligence to process from the idea generation step, which you just mentioned, all the way through the decision to add the stock to the portfolio?

Steve: Sure. Ben and I get together and we have what we call the four pillars of our process. And you can guess what they are. It's balance sheet strength, it's valuation, it's management, and then it's industry and sector analysis. And balance sheet strength, we've gone through what we look for there. Valuation, typically for operating companies, non-financials, we're doing what I think most everybody else does. We're running normalized free cash flow discount models. To make sure that the company is trading at a valuation we're comfortable with. And one thing I'll point out, when we do our valuation modeling, what we come up with is, we call it a range of reasonableness.

We don't come up with a price target. And that's another part of the evolution of the process. We don't think that our models or anyone else's models are precise enough to come up with what a stock price should be down to the penny or even the dollar. But as long as it's within that range of reasonableness, we'll continue to own it. And the weighting within the

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portfolio will be affected by where it falls within that range. So it's balance sheet strength, valuation, it's management.

And we're looking at managements. You know, we want them to lay out a strategy and execute towards the strategy. And nine times out of ten, if they do that, it shows up in the financial statements. We know that a lot of times, you know, executing a strategy takes longer than you might think it should or even what management's expectations are. And again, we'll give them patience as long as they're communicating it honestly and they're making concrete progress. You know, we don't get caught up on quarterly earnings.

We don't model our quarterly earnings numbers. We follow, obviously, earnings calls and what's happening each quarter. But we think, you know, in this short-sidedness of the market today, when a company misses, especially a small cap company misses a quarterly earnings number, you know, stock price can fall 15% or 20% in a day. And we try to take advantage of those. And if it happens to one of our portfolio companies, we're most likely going to add to it, unless there's something fundamental in the call that gives us pause. So, management, we want them to take a long-term view.

We want them to build cultures within their company that are focused on their customers and providing the customers with value for

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whatever it is they're selling, whether it's a paint sprayer or commercial insurance or what have you. And by that, I mean, we see companies that really seem more focused on making as much money as quickly as they can and taking some shortcuts to pump up quarterly earnings. And I have to admit, I think everybody does that.

A lot of folks do that to varying degrees, but it's just a matter of degree. So in building that culture, it's hard to, it's very qualitative and it's hard to discern how good a company's culture is, but it's part of the process.

John: Yeah. I like how you called out not necessarily making as much money as you can, as fast as you can, from the companies, but rather focusing on serving the customer. And over time, that can create more value because you may not be growing as fast right now, but you can extend that growth runway over a longer duration. And that's where the compounding, I think, really happens is when that sort of moderate growth is extended over the longest possible time period.

Steve: That's exactly right. Are you familiar with a concept called Mittelstand?

John: No, but please.

Steve: It's a bit obscure. It's not really clearly defined, but in Germany, there are small and mid-sized businesses and they call it Mittelstand. And

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these companies will have very similar characteristics. They tend to be family-owned or closely controlled. They have a customer service or customer first attitude. They tend to be overly conservatively financed. They have strong cultures of putting their employees first as well. And they take a very, very long-term view in everything that they do. And I bring that up because if you look, a lot of people, if you look at the German economy, I think it's the number two export economy in the world, for a country like Germany that doesn't have that much natural resources, it isn't too terribly big from a population perspective. But when people have done research to figure out how can they dominate certain segments of different markets, they go back to this Mittelstand and this kind of viewpoint of how to run a business. And I'm fascinated by it. And when I'm looking at companies, I often think, what traits does this company share with that concept?

John:                   That is a great mental model. And you now have me fascinated on it. So I'm going to go do some reading on it. As soon as we get off this podcast, thanks for sharing that.

Steve:                   It's kind of the antithesis of the Wall Street mentality, though, I would say, to a great extent when you think about it, which is a whole other story.

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John:                   It is. Let's talk briefly about your small team dynamic. So as a smaller team, are you all working in the office or are you working from home and communicating, you know, via Slack and Zoom or Teams and stuff like that? And then how often do you and your analyst, Ben, meet to discuss existing positions in the portfolio and how often do you meet to discuss new stock pitches?

Steve:                 So we are in the office and Ben's office is adjacent to mine, so we can shout through the wall if we need to. But we have two scheduled weekly meetings to go over holdings, watch list companies and talk about ideas. And those are just structured meeting sand we have a schedule of kind of what companies and whatnot. But throughout the day, continuously, we are in and out talking about ideas and news and what have you. So we have a very collegial relationship. We're a little bit different.

                          We like to say that 80% of our kind of investing philosophies overlap. And there's 20%, you know, it's a little bit different. And it's in a really, I think, constructive way. And it leads to a really good discussion. And I mentioned the four pillars a second ago. And so one of the things we do is we go through each company in the portfolio and rate it across the four pillars and put an empirical rating.

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And then we have kind of a weighted average of those ratings to come up with an overall quality score for the company. And it's not mechanistic. It's not as though that number is going to determine its sizing in the portfolio, but it does impact it. But I think most importantly, using that tool and thinking about things in this four pillar process, it just keeps us a perspective on, you know, focusing on the things that we think really matter.

John: I'm curious, how often do you update those ratings? Is it yearly? Do you look at it or more frequently or less frequently than that? For every company in the portfolio?

Steve: Yeah, that's what we're doing as we go through those weekly meetings. We're going through different companies within the portfolio to make sure, because it's constant, as you can imagine. We do it on a time basis, but if there's a new story, for instance, if there's a merger, if you're going to take on some debt, that's going to affect the balance sheet, it's going to affect your valuation. If there's a change in the executive office, we have to go and research where they're coming from and come with an assessment on that. So it's a continuous process.

John: Yeah, like you said, it's constant. So one question I like to ask all my guests is, what do you look for in a stock pitch? And what do you believe makes a good investment thesis? But I think maybe you already

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answered it with the four pillars, which you said were balance sheet, valuation, management, and then industry and sector context. Is it those four pillars that you're looking for in an investment thesis and a stock pitch?

Steve: Well that's a big part of it. But I would say it gets back to that two or three things, the fundamental things that really matter and how that's different than either their competitors or alternative investments. One of the things, it has to make sense. It should be as straightforward as possible and the overly complex rarely works. In my experience, and maybe some people can do that, I like to point out when you look or I look at investors who have been doing this for the longest time, with the greatest success, almost universally, there's a quality focus there. There's somewhat of a diversification focus, and there's a quality focus. And you see some folks that will have short-term performance that's through the roof in these special situations, you know, overly complex situations.

But to me, it's just much harder to do. And I think if you look at the various track records out there, I think it kind of stacks up over time. When I go back to, you know, we've had three years of significant underperformance. It was in 2006, 2012, and 2016. Those were really strong years for the market. We were up, but just not as much. Not nearly as much. We trailed a significant amount. And so going back through



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those years, looking at the portfolio and trying to learn from that and say, what did we do wrong?

You know, how can, what were the mistakes we made that cause that to happen? And that pointed us to this, you know, in those periods, you know, valuations seemed a bit stretched. And so in those periods, I moved the portfolio more from these high-quality companies that were trading at premiums to what I would call junkier companies that were really cheap, but had a lot of hair on them and made a lot of mistakes, classic value traps. And so that's really informed part of my, you know, the keep it simple, stupid mentality I have.

John: Yeah, I mean, it just goes back to everything you said so far today. It has to make sense. And you said you're in the judgment business and you don't really need to solve a puzzle. It doesn't have to be overly complex. Keep it simple. Find a high quality business, long duration growth opportunities, selling at an attractive valuation, and good management. Keep it simple and just make it make sense. As Munger said, you don't get extra credit for the degree of difficulty.

Steve: Exactly. One of our best holdings, a company that we've had, we have a handful of companies in the portfolio we've had since the early 2000s. One is a company called Graco. They're in the fluid handling business. Which is as boring as you can get. They make paint sprayers

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and lubrication systems. It's kind of a GDP plus growth industry. But interestingly, a lot about that company lines up with the whole Mittelstand concept. But the way they have managed their company over that period, it has been a phenomenal performer. And as you said earlier, it is slow, steady, constant growth.

They take out expenses every year, have a very sharp customer focus on staying on top of what their customers want and need and what's going to provide value to them and innovate their products that way. And it doesn't have to be sexy and exciting and a disruptor or anything like that. It can just be a really well managed business with a good business model.

An interesting thing about that company, during COVID, when components were so hard to find for so many products, they could not find components, they could find components, but not components that met their specifications at the level that they wanted. And they said, we're not going to put, you know, these components, these subpar components in our sprayers just to hit a revenue number, to make some money this year. We don't want, you know, that level of quality associated with our brand.

And when you have a company that says and actually does something like that, to me, it makes me feel good, and you know, that's why I have so much confidence in them.

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John: I love Graco, Steve. So 2017 or 2018, somewhere out there on the internet, I was on a podcast and did a deep dive into Graco's business, actually. Let me know how I can get in. It's such a great company. Like you said, leading market share in a niche industry, just so well managed, they sweat out costs every year, moderate grower, but at very high returns on invested capital, and just, you know, extreme focus on customer and quality, like you said.

And its performance has shown how, you know, long-term performance, way out, you know, way better than the market. And so it is reflected in its stock price performance and its total shareholder return over time. Let's see. So talk to us about... Let's go macro. I'm sorry. How much time, if any, do you spend thinking about the macro backdrop? And do you have a current macro or market outlook that you hold with high conviction?

Steve: No, we don't make predictions. I think the track record on all that is pretty clear. That's impossible. So that's just not the game we play. But when we're doing our modeling and thinking through the companies, we think about things probabilistically, and we think different types of scenarios that could play out. How will it impact our companies and make our decisions according to that? But it's, you know, I think during COVID or late in COVID, when the 210, the yield curve inverted, and everybody

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was on TV saying, you know, 100% of the time in history, when the 210 gets to a certain level, negative certain level, a certain inversion in the thing, we've had a recession within a year, 18 months or something. And supposedly it was a 100% accurate indicator, and we're still waiting on that recession, and I'm sure it will be right at some point, but not in that time frame. And that's just one simple example of how we kind of, dismiss all of that because it's impossible to predict, and we're not in the prediction business or the crystal ball business.

We're in the nuts and bolts business of looking at these companies from the bottom-up, thinking about them probabilistically, thinking about them in that four pillar perspective, and hopefully coming up with the highest quality companies at reasonable valuations that we can find.

John: What's the saying at FPA? We look down before we look up?

Steve: Exactly.

John: Yeah. Talk to us about small cap valuations at the index level, which seem to be quite attractive relative to large caps in the US right now.

Steve: They are, and I think there's a lot of charts going around that show the PE of the S&P 600 of the Russell 2000 compared to the PE of the S&P 500. And yeah, I think it's pretty clear that generally speaking, small cap companies are a good bit cheaper than large cap companies. But

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what we're seeing when we go through the companies we're looking at, within small cap, there's kind of a diffusion based on quality. And by that, I mean, I can find a lot of companies in our market cap range at single digit PE's, six, seven PE's. The quality of those companies doesn't meet our standards. And then when I look at the companies that we like to invest in, these high return on investment capital companies all the things that we've talked about, they've held up really well.

And there's not a log of bargains there. It's rare, as you know, for high quality companies to be on sale. But there are periods where it happens. And there are few and far between. In March of 2020, when COVID was kicking off, there were some really great bargains. In the fourth quarter of 2018, during that taper tantrum.

And then the most obvious example is in February, the first quarter of 2009, when everyone thought the world was going to end. And it's so much easier making investment decisions when you have a high quality company that you can get at a 12% free cash flow yield versus today when these high quality companies are 4%, 5% free cash flow yields. Generally, they're kind of slow growing.

So it's just a matter of taking what the market can give you at any given time. And right now, we aren't seeing high quality companies at

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great prices. We've got the ones in the portfolio, they're reasonably priced, we're comfortable with them. But yeah, that's kind of where we are today.

John:                   So let's talk about valuation just a bit more for a second. So you mentioned that you are building discounted cash flow models and spending a lot of time thinking about what does normalized free cash flow look like? Are there any other valuation methods you're using or what valuation multiples are you typically most comfortable paying? You just said it feels so wonderful to be able to buy a really high quality company and a 12% free cash flow yield, but there just aren't that many of those opportunities available today.

Steve:                   Exactly. So you just have to weigh, it's weighing valuation and quality and you end up where you end up. I mentioned earlier about avoiding complexity and wanting these long-term compounders and that is our focus. But having said that, we do have in the portfolio, we label each holding as either a long-term compounder or an opportunistic holding. And at any given time, generally those opportunistic holdings are going to be between 10% and 15% of the portfolio. It varies over time, but not outside that range, you know, substantially.

So in a market like this, we've been spending a lot of time on the opportunistic purchases. And contrary to 15 years ago, where there was an overemphasis on a low valuation at the expense of quality, what we do

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now is we're... There are slightly lower quality and slightly better valuation metrics. And that's what's building out that portfolio or that portion of the portfolio that's in what we would call opportunistic holdings. And so we've added a couple companies to the portfolio this year that would fit that bill. We've got some that are a little bit too messy. And on those, what we do, we will put them on the watchlist.

We'll listen to what management says they're going to do to right the ship. And then we follow them for several quarters. And we want to see that concrete progress towards doing that before we enter the stock. And yes, we'll miss part of the bounce off the bottom. But also, we're not going to end up with a company that goes bankrupt, hopefully.

John:                   Yeah, exactly. So just so our listeners know, 12% free cash flow yield is about 8.5 times free cash flow, 8 to 9 times free cash flow. Talk to us about selling. Under what circumstances do you trim and under what circumstances do you sell out completely?

Steve:                   We go back to that. The tool we use when we're rating the companies across our quality metrics, and as valuation increases, we will trim. Some of our best holdings, Deckers is the company that I mentioned earlier. Maybe I didn't mention it by name, I just did. It has grown so well that we are selling out. The entire holding period, we have been net sellers

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of it. And it's really on valuation. What are we comfortable paying? And it's a lofty price.

But we followed the management long enough, and there are some unique things about the company that made us comfortable with holding it in such a high valuation, albeit at a lower allocation.

John: Yeah. And Deckers has some wonderful shoe brands, like Ugg and Teva, I'm not sure how it's pronounced, and Hoka, which I know its growth engine right now is Hoka.

Steve: That's exactly right. And that's, you know, we've watched that. That's really what's moving the needle. Although Ugg, what they've done with Ugg, when we started buying, Hoka was, you know, a \$30, \$40 million brand, and Ugg had gone through some troubles in management. They needed to work on logistics. They needed to work on expanding the brand to make it less fourth quarter centric, have more products that appeal to men. And so that was our thesis around that, a great balance sheet. And so we went in small and we saw them. They did amazing restructuring, took out a lot of costs, and that's what got us in.

And then as we were in, this Hoka thing has just been, you know, I wish I could say I had predicted that, but that's just serendipity. And we monitor it closely. We've made a good deal of money on it. But as I said,



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it's at a level now where, and not necessarily just on valuation, but just on the size of the company. I think it's right around \$26 billion right now.

John:                   Yeah. You know, you didn't predict Hoka growing like it did, but good things tend to happen to really good businesses. And so, you know, I think maybe you foresaw that, possibly, you know, that just good things happen to good, well-run businesses.

Steve:                 That's a great point you make right there, yes. And our whole, we talk about looking back, all financial statements are backward looking, and you can just look at those and make a decision. And I don't think that's a good way to make a decision, because the future is going to be different than the past.

                          But looking at those past financial statements and listening to what management said they were going to do, what they actually accomplished, it gives you a confidence that we have no idea what the future is going to bring, whether it's the next Hoka brand or a major recession. But if you have a great management in a company that's going into a big recession, that's really about all you can hope for. You can pretend that you're going to predict the recession, but again, I just don't think it's possible.

John:                   Yeah, one of the lessons I've learned, Steve, is that great management teams, they operate the business well, they allocate capital well, they build teams well, they hire well, but also they build resilience into

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the business model, they build financial strength, they build adaptability into the business model. And so when these recessions do hit, they can invest countercyclically at the bottom, when a lot of other companies, possibly their competitors, are really struggling to survive. You know, these high quality businesses run by high quality management teams that think in this way and prepare in this way can really almost use a recession to their advantage. Invest at the bottom, whether it's in M&A or reinvesting organically into the business or even buying back stock at a discount. And then they come out of that recession even stronger with more market share and possibly accelerating growth and possibly higher margins too.

Steve: We've seen that play out and you're exactly right.

John: Yeah.

Steve: You know, we tend, often we will be invested in companies that Wall Street would say has overly conservative balance sheets. You know, they want you to have the optimal capital structure, which means they want to do an underwriting for you.

John: Yep.

Steve: But in that theory of an optimal capital structure, it doesn't take into account the point that you just made which is a very valuable point.

John: Yeah, you're right. So selfishly, I'd like to ask you about your thesis on MSC Industrial Direct trade on the New York Stock Exchange under

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the ticker MSM, because I also own this stock. At a high level, it has a lot of what I look for, including over 20% inside ownership, a strong balance sheet with net debt to EBITDA of only about one times, and an interest coverage ratio, which I'm defining as EBIT divided by interest expense of 20 times. It generates average equity of 20% and management's incentive compensation is partly based on return on invested capital over three-year periods. The company is not a fast grower, but it tends to grow a bit faster than industrial production.

And I think we could possibly see an acceleration of its growth with the onshoring and the reshoring of industrial production back to the US. And then finally, it trades at 14 times forward earnings and has a dividend yield of about 4%. So what is your thesis for MSC Industrial Direct? And do you think it can accelerate its earnings growth or does it even need to meet your criteria?

Steve: Well, I think you just gave me my thesis. That was everything you just said. And we talked about what's in a good stock pitch. If you think about everything that you just went through right there, that makes sense to me. And I agree with exactly that. And you hit all the salient points, I think.

There's a couple things I would add to that, but you really hit the main points. But I don't know if you noticed, or you probably did. There

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was a corporate action last year that was a share class change. The family that controls it had some Class B stock that they agreed to convert to Class A and give up their super voting rights. And coincidentally with that, they changed the voting threshold for significant transactions. They moved it from two-thirds vote to a majority vote, which to me, we would never buy a company, hoping that it gets taken out.

But it looks like it's pretty teed up. You could see a 15-times-multiple with Granger trading at a 25-times-multiple , it would be immediately accretive to Granger and I think would fit really well with them to get them into MSC's niche of metalworking. So that's more of a sort of an aside, but one thing I point out too is they've made several great hires, I think, in the last few years. They brought the Chief Technology Officer or Digital Officer from Granger actually and he has done really good work. They've completely revamped their e-commerce business. It's a situation where it's taken a little bit longer than was initially thought, but it's moving right along and you can see concrete progress towards that.

So yeah, I mean, as I said, you hit on the reshoring of industrial production, I think is a real thing. And it really, you know, I don't want to say checks all the boxes, but kind of checks all the boxes.

John: It checks a lot of the boxes. And you did mention the improvement in the corporate governance, at least making it possible or more possible

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for an acquisition to happen. You mentioned the discrepancy in the multiple between Granger trading at 25-times plus and MSM at 14 or 15 times. On a standalone basis without an acquisition, do you think 14 or 15 times earnings is a fair multiple for MSM?

Steve: I think right now it's an attractive multiple. I say that because the Industrial Production Index is not at its peak. It is a lower part of the cycle. I don't try to predict the peak or the trough, but you can get a feel for it closer to the peak or closer to the trough. I think that's a good thing. The scale of their business right now is such that they have a good bit of operating leverage. And so I think they said for every 1% in revenue growth, they'll get a, I think it's a 30 basis point expansion and operating margin.

John: I'll take it.

Steve: So you don't have to grow too much. And to be honest, they don't grow that much. But it doesn't take much when you're getting the top line growth as well as your operating margin expanding to really increase your net income. And that leads to probably a higher multiple. And I would never invest in something hoping for a higher multiple. But at 15, I think it's an attractive investment, which is why it's pretty well positioned in the portfolio.

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John:                    Yeah, I think it's attractive as well. I also think there's the potential for multiple expansion. And I just love that you mentioned kind of, you know, you're thinking about this from a mid-cycle normalized earnings point of view. You mentioned the Industrial Production Index and kind of where we are in the cycle. It doesn't look like we're at peak. It doesn't look like we're at trough.

                              Because, you know, P/E's are only, especially for, you know, industrials and more cyclical businesses, they're only as good as the denominator. So you have to kind of understand where we are in the cycle. And so I appreciate you bringing that up. My last question on MSC, do you think the company should repurchase more shares, or are you happy with the capital allocation priorities of both on acquisitions and, you know, fairly large dividends?

Steve:                    That's kind of a tough one. I think they've done a good job, and I don't know. I think they've made two reasonably sized acquisitions this year, or not reasonably, pretty small, actually. I generally have a bias towards reinvesting capital in the company as opposed to share buybacks, but I do understand it's a thing now. But I would say they're doing a really good job, and I'm not going to try to Monday morning quarterback what they should be doing, but we'll keep an eye on it. You know, one thing I'd say is we don't know where they are in the cycle, and at, I think, just under

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\$500 million in net debt for a company this size, we could go into an industrial recession later this year, and they will most likely get through hit just fine.

I'm not predicting one, but we always think about, you know, worst-case scenario, best-case scenario. And I think the way they are going about their capital budgeting has been good to the extent that they're in that position that they're in. That is, they didn't lever up a bunch to buy a lot of shares back or make major acquisitions and get the balance sheet in a condition that we probably wouldn't like.

John:                   Yeah, I think that all makes sense to me. Thank you for that. How do you spend the quiet time in your office? What are you reading and what's on your screen?

Steve:                   Yeah, I probably read five or six hours a day. That's really what I do. And so reading five or six hours a day, I read absolutely everything. I mean, it's all across the board. It's articles, journals, it's 10K's and sell side research. It's just constantly looking for good ideas and trying to make sure that the ideas we're invested in or our judgment on them is right and trying to look for ways that we might not be right and either confirm it or not, as well as looking for new ideas.

But it's the thing I love about this job. I think I have the best job in the world. I have a lot of curiosity and there's nothing I like more than

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digging into different industries and really learning kind of the nuts and bolts of how they work. And it's so interesting that what you think is usually or oftentimes not the case on some of the complexities and nuances of various industries. But yeah, in short, that's how I spend most of my waking hours. Most people around here think I'm crazy.

John: I don't and I'm spending all my day reading as well and I think you have a pretty darn good job too. What investors, if any, do you try to learn from the most? What investor letters are you reading first or what 13's are you looking at first each quarter, if that's something that you incorporate into your process?

Steve: It's the usual suspects. You sent one out that Joel Tillinghast is, I think, just phenomenal.

John: I did too. Thank you.

Steve: I'm not exactly sure how he does what he does, but he is absolutely amazing at it. I'll read anything that he puts out to try to get some more insights on it. I don't know if this is confirmation bias, but I like to think that here we try to think a lot like they do. I'll say when we started the fund, a lot of people say 2002, how did you just come up with a philosophy? Like I said, what I did was I looked all around at value investors, the longest track records of best risk-adjusted performance, and you look across them and you see the similarities. It points you in the right direction, and then



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from that you learn from experience and you continue to learn from these great investors that have been doing it for longer than we have.

John: Well, I know that myself and all of my listeners just learned so much from you today, Steve. I cannot thank you enough. I feel like we covered a lot. I'm a huge fan of yours, and I think the Queens Road Small Cap Value Fund is just top-notch and it gets top-notch ratings from Morningstar, five stars, gold rating, everything. Is there anything we missed or anything else you'd like us to know about your fund, your process, or how your team is structured?

Steve: I think we went through everything pretty in-depth, and I really appreciate you having me, and I listen to your podcasts, and I really appreciate how you take the time to really get into the weeds on some of these things, as opposed to more of a Cliff notes version. So I've really enjoyed your show.

John: Thank you for saying that. I appreciate you, and thank you so much for coming on the show today. Before we sign off, thank you Steve.

Before we sign off, I'd like to provide a quick reminder. Anything discussed on The JRo Show by myself or my guest is solely our own opinions and does not constitute formal advice or a recommendation. The JRo Show is for entertainment purposes only, so please do your own research on any securities discussed in this podcast.



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Thank you for tuning in, and we will see you next time.