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EP 160 | Navigating the U.S. Mid-Cap Landscape: Resilience Amid Uncertainty

[00:00] Rob Campbell: Today, Portfolio Manager Jeff Mo joins me to talk all about U.S. mid-caps. We cover what Jeff finds so attractive about the asset class, some recent activity within the portfolio, and yes, I asked Jeff about how he's positioning the strategy given the upcoming U.S. election.

[00:00:20] Disclaimer: This podcast is for informational purposes only. Information relating to investment approaches or individual investments should not be construed as advice or endorsement. Any views expressed in this podcast are based upon the information available at the time and are subject to change.

[00:00:37] Rob Campbell: Jeff, it feels like we just sat down on a podcast. What a real pleasure to be back with you.

[00:00:42] Jeff Mo: Likewise. Good to chat with you again, Rob.

[00:00:44] Rob Campbell: We should do this every week. I actually did want to ask you about something that you did recently. Earlier this year, you put out a paper stating the case for U.S. mid-caps, which is one of the portfolios that you manage. And for those who didn't read the paper and would prefer to hear some of the arguments, could you summarize what went into that paper? What are some of the reasons why U.S. mid-caps are such an interesting asset class?

[00:01:09] Jeff Mo: First, I have to thank my colleague Kevin Minas for doing a lot of the hard research behind the numbers and helping write the paper alongside myself. We were trying to convince ourselves on this one as well, which is “Why mid-cap?” So obviously, we thought we had a pretty good idea when we launched the strategy, but we went back and kind of systemically built out the argument and researched the most current up-to-date numbers as well. So for those who haven't seen it, it's available on our website. Feel free to take a look at the case for U.S. mid-caps.

But I'd say that the first and foremost is investing in equities in the U.S. over the last hundred years has been a pretty good proposition. The S&P 500 Index has been the strongest-performing index of most major equity markets in the last hundred years. But also the fundamental reasons. In the U.S., obviously much is made of the current political situation, maybe a little bit more volatile than usual. I would say most would still agree that this is a country that has a strong rule of law and a strong environment for businesses. Whether you take it all the way to the front end of the strongest universities in the world or a venture capital network that is second to none.

So the business environment is there but also the laws, the structure, even strong MBA programs, all of the above, I would say first and foremost, the U.S. is a great place to breed new businesses and have them grow. And then secondly, it is still the largest single unified market in the world by gross domestic product (GDP) in terms of being able to have one product or service and scale it across a large domestic market, which is why many global champions started as U.S. companies because they have a large market to test the products and services in.

Nowadays—demographically and from a setup standpoint—the U.S. also is looking quite strong. I think Europe is starting to look politically maybe a little bit more fragmented, as well. They haven't been handling inflation quite as well as the U.S., although they're now catching up on that front. But if you look at the GDP growth rates of the U.S. versus Europe, we're seeing a bit of divergence since COVID, especially. Obviously, China in past years was talked about as another opportunity or a different place to invest, but certainly since the reopening—or perhaps not so strong reopening—things are also a little bit tougher in the political environment and maybe more of a top-down, controlled view on the economy now is having a dampening effect on the business environment there.

So when you put it all together, I'd say the U.S. actually looks like a pretty good market to be in.

[00:03:39] Rob Campbell: Can I interject for a second? I think everything you've said so far—the setup for U. S. equities and that the U.S. is a place to invest. Sure. You mentioned the S&P 500. I wonder if you could touch more on the mid-cap side because it's my understanding that small- and mid-cap stocks have trailed larger-cap stocks over the past few decades. What is it about the mid-cap space that's so interesting in that paper that you put out?

[00:04:01] Jeff Mo: I agree with part of your statement, which is that mid-caps have trailed the S&P 500, but it hasn't been decades. It's about roughly a decade, essentially, since the technology companies, the mega-tech companies that we've all heard of started to do really well and compound. And to be fair, I think they are world-class companies, and probably many of them can continue to compound in their strong market positions, which is why we own a few in other portfolios.

But in the paper, you can see the data yourself. We did 25 years, up to September 30th, 2023—we put out this paper a little while ago, Rob, you're only asking about it now.

[00:04:37] Rob Campbell: I'm a slow reader.

[00:04:38] Jeff Mo: Up to that point, and I imagine it hasn't changed too, too much since, mid-caps actually outperformed the S&P 500 relatively handily in that time period on a cumulative basis, almost double. And the reason for that, I think, is mid-caps have always been that sweet spot. What I mean by that is when you are a very small company, it's hard for you to possess a competitive advantage because many competitive advantages, if you think about it, have some relation to scale. Whether it's a well-known brand, only large companies tend to have big, well-known brands or scale advantages because it obviously requires...scale.

So it tends to be that as companies grow bigger, they tend to grow into competitive advantages. But the good thing with mid-caps is they're large enough that many of them, especially if they operate in niches that are a little bit smaller, have already scaled up and are quite dominant in the businesses they operate within. On the flip side, mid-caps are still smaller than the large caps, and they still haven't gone into that law of large numbers effect, where it's just really, really hard to grow on a percentage basis because you are so large.

So mid-caps, in our opinion, have close to equal competitive advantages as their large-cap brethren but still much more attractive growth profiles. Statistically, the numbers bear out this deductive argument.

[00:05:58] Rob Campbell: Makes sense. I'm glad you corrected me on that longer-term perspective. If we can move to a shorter-term perspective, we're recording this about halfway through the year 2024 – early July – and at least relative to the larger-cap peers, I think this has been some of the concern, if you did have concerns about

the market, which is funny to say given how far the S&P has come so far this year. I think one of the concerns might be that, “Hey, it's really just at the top. It's these big mega companies that are really driving returns.” Beneath the surface, there's a lot less breadth. I wonder if that spills over into the mid-cap space where you're spending your time. Can you give us a sense of the current market environment for U.S. mid-caps?

[00:06:38] Jeff Mo: I think there really is a bifurcation coming out there. When you look at the Russell Midcap Index – the most common index used for mid-caps – 17% of its companies are unprofitable, versus the S&P in which only 6% of the companies are unprofitable. What that means is there's just more divergence in smaller-cap indices.

If you go all the way to the Russell 2500 Index – the small mid-cap index – there’s a full 36% that are unprofitable. The reason I bring that up with corresponding return on equities (ROEs), as well as S&P close to 20% and the Russell 2500 in the single digits, is that we have a few champions with really, really high ROEs, really strong business models, dominate the narrative and dominate the performance on a weighted basis. But underneath that, we are seeing a lot more of an active market from a standpoint of companies going up, companies going down, as well as investor confidence shifting. That's why, as active managers, it is very interesting to be able to dodge and weave.

There seems to be really just one theme right now in the market, which is artificial intelligence (AI) and anything related to that, all the way down to companies that are building HVAC systems, air conditioning systems, for data centers. Companies like that traditionally trade at 10 or 15 times earnings. I found one recently that traded at 35 times earnings because AI had to build more air conditioners. That may be, but that seems like that's a little bit of a stretch in my mind.

Other than that theme, I'd say the rest of the market is quite tentative. There's probably as much up as there is down year to date. That's probably why you see it in the numbers that the S&P still looks like it's fine, but other indices are a little bit weaker now.

[00:08:19] Rob Campbell: So far, Jeff, we've talked quite thematically about markets, asset classes, and AI as a theme. I wonder if you can bring this a little bit more down to the bread and butter, the work on individual businesses. Not the last time we sat down but perhaps the time before that for a podcast, you were on to talk about one of your learnings from last year, which is the need or the desire to lean a little bit harder on the inductive evidence and the numbers versus the deductive. I can imagine in a market that's maybe more thematically driven that becomes more important. What have you and the team been doing more recently in terms of following through on that learning that you had from last year?

[00:08:56] Jeff Mo: One thing that we've had for a while now, but we're using a lot more rigorously, we actually have a dashboard in Power BI (business intelligence platform) that will show us the fair value ranges every day of a company. I say every day because although we're not updating the models every day, the models are updated in the background as the discount rates change and as new information comes in. We're just putting a lot more scrutiny on the companies that seem to be trading at the high end of their fair value range; to your question of following the inductive evidence, that is inductive evidence. What's a historical growth rate? We’re usually modeled in the range of what the past is unless we think there's a reason why it should be different.

[00:09:37] Rob Campbell: Are you saying you're being less tolerant of companies that are really toward the right-hand tail of that fair value range?

[00:09:42] Jeff Mo: Yeah, we were always intolerant but maybe even more now than before. For example, three of our recent exits – Copart, CSW Industrials, and Winmark – all three are still excellent companies, and in a vacuum, or call it independent valuation, we would love to own all three still. But we exited in each case because we felt like the market was really pricing in either a recent run or blind optimism in some cases.

Copart, as you know, used car prices went up quite a bit during COVID because of production challenges for new cars. They've been slowly coming down, but Copart has still had a massive windfall because of the business model of auctioning totalled vehicles. What happened is that this was historically a company that steadily grew its top and bottom line in the mid or maybe high single digits. All of a sudden, it was growing at 20%, 25%, 30% a year. Investors got really, really enthusiastic. Instead of trading this company at 20 or 25 times earnings, (a historical P/E ratio) it went up at some points to 40 times trailing earnings and so on.

[00:10:51] Rob Campbell: Just extrapolating that this might last longer than…

[00:10:53] Jeff Mo: Exactly. And maybe it will.

[00:10:56] Rob Campbell: Probabilistically, it might.

[00:10:57] Jeff Mo: Probabilistically, I think the probabilities are poor. And so we thought, "Well, is there any other reason that maybe they're gaining more share than before or they're expanding to international markets and they're getting more opportunities?" And at the margin, yes. But for every argument yes, you could also find an argument no. Some things are changing about the business negatively as well. For example, the CEO recently changed, and they brought in more of professional managers as opposed to a family-run business, which statistically is unfavorable.

But that's a case where we just thought the market was maybe a little bit too enthusiastic. I can talk about CSW and Winmark, as well. Essentially valuations got too far ahead because of a short-term trend, and we just believed the longer-term track record of how these businesses have performed.

[00:11:44] Rob Campbell: Can I ask you to put on that inductive hat and talk about some other holdings like Amphenol or KLA, where perhaps similarly, you're seeing this outsized growth rate with respect to that AI theme? How are you dealing with those in the sense that those are still names that we hold on to and in quite big size within the portfolio?

[00:12:02] Jeff Mo: Well, we have trimmed both recently, probably for a similar reason, just the valuations look a little bit stretched. KLA on a traditional P/E ratio actually doesn't look too bad; I would say there is more around political risk.

[00:12:13] Rob Campbell: Can you talk a little bit about what KLA is and what that risk might be?

[00:12:17] Jeff Mo: KLA is the world's largest manufacturer of process control equipment. When you manufacture semiconductors, some of these processes are single atom-width sized processes. You need to control these processes within very, very small tolerances, and you need specialized equipment to do that. Apparently, the industry sells something like $15 or so billion dollars of process control equipment a year, of which roughly half is KLA's equipment.

Being the largest provider of that equipment, they have more money to invest in R&D and keep their technological lead. So that's what KLA does. The benefit is AI chips require some of the most cutting-edge manufacturing techniques. KLA is continually selling more and more of its most cutting-edge equipment, obviously the highest price and highest return equipment to customers.

So that's why KLA has done so well. A couple of things that give us pause. One is China has actually become the largest geography of sales, even after the Biden administration restricted some high-end semiconductor technology exports to China. Even just the fact that KLA and others are selling what is called trailing-edge equipment, so equipment used to make chips from 10 or 15 years ago. That alone is still driving a large demand in China, probably because I think that country is trying to become a little bit more independent from a semiconductor standpoint.

I worry that regardless of who wins the next election, the political environment in the U.S. is generally becoming more unfavorable for semiconductor exports to China. That is a part of it. The second part, too, is just plain old cyclicality. If you believe AI is definitely going to keep growing at the current pace for forever, then your KLA is a fine stock to own at the current validation. But if you put any probability in that maybe not being the case, then again, the validation gets more expensive.

Amphenol is actually a great example of a company; they make interconnects. If you plug your iPhone into the wall, chances are Amphenol made that little interconnect in the iPhone to help you charge your iPhone or an Android phone. They're agnostic, of course. There was a case where they actually suffered from a standard industrial recession that's come up in the last 12 or 18 months, but the valuation did not suffer. Actually, it increased. So that was a different case where the market was not believing the inductive evidence. In this case, we decided to trim because the valuation started to look a little too heady.

[00:14:42] Rob Campbell: Can we go back just a second? Because we are recording this the week after the presidential debate between Joe Biden and Donald Trump. There is an election in the U.S. coming up later this year. In fact, it's a year of lots of elections, but the one in the U.S. really being the biggie. You talked a little bit about how that might influence KLA. From a bottom-up perspective but also from a portfolio constructive, how do you weigh this stuff?

Listeners have often heard from us, “Hey, prepare, don't predict.” What does that look like day to day as you think about different outcomes that could come to bear both in the short term and then also longer-term thinking about the portfolio?

[00:15:18] Jeff Mo: The biggest thing with risks like elections is things that our listeners or our investors probably don't see because we actually made no action. Rather, we've gone through the portfolio company by company and thought through, “Okay, what might happen if there is an election that leads to a change in administration or not a change in administration?” In many cases, I'm glad to say that we have picked companies that are probably pretty resilient in any election outcome environment.

A few may be impacted at the margin a little bit more with one or the other. In some cases, obviously, all companies will be impacted relatively equally, such as if tax cuts or tax increases are on the table for both candidates. When we look through the portfolio, it is actually more services-weighted than product-weighted, so we don't have as much import exposure. Secondly, very few of our companies that import products and then sell them or incorporate them into another product and then sell them onward are competing against a domestic manufacturer.

What I mean by that is take a company like SharkNinja, for example. They manufacture vacuum cleaners, blenders, those sorts of things. They compete against vacuum cleaners or blenders that are manufactured outside the United States. If someone like former President Trump gets in again, he has threatened this 10% tariff across the board. I think all vacuum cleaners would just be 10% more expensive.

I don't think SharkNinja actually would be at a disadvantage other than perhaps there's a dampening effect on vacuum cleaner demand across the industry versus paying for a cleaner to come to your house. I don't know if that's cheaper now. My point is the biggest thing we've done is go through company by company, think through the risks as part of our ongoing risk management exercise, and we've realized that our portfolio is actually quite resilient and is prepared and diversified for many different scenarios, including different election outcomes.

[00:17:15] Rob Campbell: Jeff, just to go back to the beginning, I can understand among listeners, there might be consternation with the uncertainty associated with an election and what that might look like for different companies. We started at the beginning with this idea of why U.S. mid-caps. I'm wondering as you look at either the portfolio today or the setup today, what has you most encouraged?

[00:17:34] Jeff Mo: I think the other work that we've done quite a bit over the last six to nine months is trying to reduce the overall risk in the portfolio, and the largest risk we actually identified six or nine months ago was not the election or any of these macroeconomic themes – obviously, interest rates have been a topical theme for a while, inflation – is actually straight-up valuation. If you measure that on a price to earnings basis, the portfolio on a forward basis six months ago traded over 20 times. And today, it's at 17 times, even though the portfolio is actually up year-to-date on a performance basis.

A lot of that is hard work below the surface, to sell a Copart or a Winmark or trim an Amphenol and find other interesting ideas to replace them with that don't look as expensive on a discounted cash flow basis, which also generally correlates to a lower traditional metrics as well. I think that has me quite encouraged that we have what we still think is a world-beating portfolio of competitively advantaged companies, ROEs of 19% on average, which is kind of equivalent to the S&P 500, let's call it blue chip mid-cap, but you have it now at about a four or five forward multiple point discount to the S&P 500, or maybe even more. I don't track that every day, but I know the S&P just keeps going up and up.

So I imagine the earnings aren't quite keeping up. I think that what has encouraged me is that when you go outside the S&P 500, you certainly should go active because a lot of these companies aren't profitable. If you decide to choose to go active with Mawer, we think a robust, resilient portfolio should stand the test of time in many environments.

[00:19:24] Rob Campbell: Well, Jeff, that's a great way to sum it up. A statistically advantaged portfolio of competitive advantage companies run by a pretty sound portfolio management team. Jeff, thanks so much.

Thanks for coming on again so soon after your last time, and I look forward to the next.

[00:19:39] Jeff Mo: Thanks, Rob. Great to chat with you again.

[00:19:42] Rob Campbell: Hi everyone. Rob here again. To subscribe to the Art of Boring Podcast, go to mawer.com. That's M A W E R dot com forward slash podcast or wherever you download your podcasts. If you enjoyed this episode, please leave a review on iTunes, which will help more people discover the "be boring, make money" philosophy. Thanks for listening.