the art of boring™

EP 175 | Maintaining an All-Weather Strategy: The U.S. Mid Cap Equity Landscape

[00:00:00] Rob Campbell: This week, Portfolio Manager Jeff Mo joins me to talk through the U.S. mid-cap landscape. While we start higher level on principles of risk management, stick around to the end as Jeff walks through specific examples of how he and the U.S. mid-cap team are building natural contradictions into the portfolio, including a discussion of a company with an epic name, SharkNinja.

[00:00:25] 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.

[00:00:42] Rob Campbell: Jeff, I'd really like to have a conversation with you on U.S. mid-caps, portfolio management, but particularly about risk management and what you do from a risk management perspective. The place I thought I'd start is, in a market that is on fire, what does risk management look like?

[00:00:58] Jeff Mo: At the core of it, I think it's maybe not making as much money as you could have if you just rode the waves. Jokes aside, Rob, I think it's a very important question because my mentor, Martin Ferguson, taught me that there's always two sides to the investment equation: returns and risk. I think when things are going well, investors tend to focus on the returns. A very wise oracle—I think he was located in Omaha—once said that you have to be fearful when others are greedy. The opposite too—greedy when others are fearful—but certainly more applicable today that it seems like a lot of people are focused on returns, i.e., being greedy. So, making sure that even in frothier times, you don't lose discipline and start chasing fads or chasing companies that are growing quickly, but maybe don't have competitive advantage.

There's a company called Super Micro Computers. They help assemble the servers that are used increasingly in AI applications. That's a very hot market. The stock is doing well. We took a look at that company, one of the ones for the first time, probably over two years ago. Clients would have done well if they had stepped in then even with more recent volatility. Also, with the more recent volatility, the stock price would show that this is a company that has a lot of speculative interest in it right now. Fundamentally, there is actually not a strong competitive advantage in this company. There are others who can, or with some small tweaks in their technology and learning, they can catch up. In our opinion, those are the companies that, in these times, you would want to avoid and you want to stick to your knitting, which are more of those kind of be boring, make money-type companies.

[00:02:44] Rob Campbell: It does sound like a fundamental piece of risk management at Mawer is simply the discipline to the investment philosophy—buy great businesses—and that in and of itself will help with risk management. What other aspects are there when you sort of look at it from a portfolio manager perspective?

[00:03:04] Jeff Mo: The first piece is that every company needs to be tied together in the portfolio by virtue of having a competitive advantage, whether it's more classically a value company or maybe more of a growth-type company. Another piece that we think a lot about on the portfolio management side is this concept of inherent contradictions.

[00:03:21] Rob Campbell: Yes, I've heard that before.

[00:03:23] Jeff Mo: So, we diversify, but we also diversify with a purpose in mind, and that purpose is to find inherent contradictions. The concept is, if you have a company that maybe is helped by lower interest rates or lowering interest rates, in that environment that company could create some more wealth, you would ideally have a contradiction in the portfolio where that other company is helped by having a higher interest rate environment. The idea is in periods of time when company A is creating a lot of wealth in a low interest rate environment, company B is creating a little less wealth. They're both wealth-creating companies. They're both still creating wealth. But then times are reversed, and sometimes in a high interest rate environment, company B is creating more wealth and company A is creating less wealth. But what happens on a portfolio basis is you sort of neutralize this concept of where interest rates will go because your portfolio should have steady wealth creation throughout the interest rate cycle.

[00:04:25] Rob Campbell: What are some of those variables that are most top of mind to you right now as you go through your risk management process?

[00:04:30] Jeff Mo: Probably to no one's surprise, interest rates. This has been a talk for the last 12 months, but with the election result, thinking through consumption versus investment in the economy, thinking through private sector spending versus government spending, thinking through companies that need to import products into the country versus domestically manufactured or being tied to kind of more of the domestic economy. Those are all variables that we are trying to balance.

[00:05:00] Rob Campbell: I'd love to get into some more detail with respect to what this looks like live with examples in the portfolio, but maybe before or along the way there, what comes first? Do you sort of find a great company, say we should own this and then do a risk management exercise afterwards, if there are adjustments that need to be made? Or do you observe, I think I've got this risk imbalance in the portfolio, let me go find a stock that meets the criteria, but then helps balance that natural contradiction?

[00:05:29] Jeff Mo: I would say a bit of both. First and foremost, we are stock pickers here at Mawer. We look for the best idea. You can't manage risk if there's no return or risk appropriate return in any of your stocks. First and foremost, I think that still needs to be the key factor, but there definitely have been times where I've asked the team to consider looking for a certain style or type of investment, such as domestic manufacturing, look for a company that maybe is helped by rising interest rates or so forth. It's not to say that, therefore, now we're only picking from the best idea in a specific pool. Rather, the way I would frame it is, the U.S. market is so vast, and there's so many good ideas, and as you know, we run a pretty concentrated strategy here at Mawer. So, the 37th best idea versus the 33rd idea, which is perhaps in a strategy, would not have a huge difference in its quality. So I think if the 38th idea happens to be exposed to a particular theme and 37th is one that's exposed to a theme that is already overweighted in our portfolio, then the 38th idea from a portfolio construction standpoint may be more appropriate for our clients for a balance.

[00:06:44] Rob Campbell: You mentioned the election, you mentioned domestic, you mentioned government spending. Can you walk through the last couple of weeks and months with the U.S. election and what that meant in terms of either new ideas, adjustments, risk management in our U.S. mid-cap strategy?

[00:07:00] Jeff Mo: It's funny because certainly there has been a little bit more volatility in the market. In the grand scheme of things, this is not a very volatile time in my career. I remember in 2008, a month or two after Lehman Brothers went bankrupt and then Merrill Lynch was rescued by Bank of America—regulatorily forced to be rescued—I remember one day where the S&P 500 peak-to-trough had a 14% swing intraday. That's volatility. The markets are moving a little bit more now than maybe they were three or four months ago, but I think in these times, it's really important to tell yourself: You don't fix the ship in the middle of a storm. And this is not a major

hurricane. This is just kind of a drizzle, a few more things going on. You just continue with the process. So, companies that were on our inventory list, we continue to pick the best one off the inventory list and work on it next. We continue to monitor the earnings of the companies that are coming through. What people forget is actually, this is also a busy time for us because this is when most of our companies are reporting their third quarter earnings. That's what we're doing. Are we spending a little bit of extra time thinking about which companies of ours are a little bit more exposed if tariffs on all U.S. imports get enacted? Yes, we have run through that exercise. At the end of the day, we actually did run through that exercise months ago. The results aren't very different. Frankly, I don't think there needs to be much portfolio adjustment. This should be an all-weather portfolio, and we'd like to think that you went through this more of all top time and has proven to be a more all-weather strategy.

[00:08:33] Rob Campbell: So the risk management was done ahead of time. You mentioned the 33rd versus the 37th or 38th best idea. I can imagine Jeff that another aspect of good risk management is just having options, so if something happens to one of your chess pieces out there in the portfolio, and you don't like what happened, you've got something else to act with. Can you talk a little bit about the value of inventory from a risk management perspective?

[00:08:59] Jeff Mo: I think inventory is very valuable, especially in a market where there is a wider number of options, and therefore the best options not in the strategy are closer in quality and return potential, so closer in investment matrix to some of the less-convicted ideas in the portfolio. We have a pretty extensive inventory management process here at Mawer. Regular listeners probably have heard us talk about it, but we have a three-stage process for managing inventory. We initially will screen for companies and literally there's thousands of companies in our database, M42, that have been screened by someone on the team. The screening would mean spending anywhere from 30 seconds to maybe five or 10 minutes on a company. It's a pretty quick process. In that time period, we're just looking at a really high level, do we think there's a chance there's a competitive advantage, a chance that an excellent management team runs it and a chance to trade at a discount to intrinsic value. Then stage two is—when you get to the preliminary analysis stage, obviously you don't have time to analyze everything—so you want to analyze the most high-potential ideas. So, you spend one or two hours and for those that make it past that stage, then you go into intensive analysis. Once a company is done with intensive analysis, it goes to stage three, which is finished goods. We would have well over a hundred finished goods in the U.S. mid-cap universe. Not all of them have been touched in the last 12 months, but in every case we've done the full report on that company. We have the discounted cashflow model, maybe in some cases a little bit out of date, but as a company that we can choose to move on very quickly, if we think the opportunity presents itself.

Then finally, this is maybe a slight innovation to our process: For a long time, we would kind of use off-the-shelf inventory alerts. You can upload this inventory status, this group of companies to Bloomberg or Capital IQ, but it didn't quite think as well with how we wanted to do things, and so recently we're kind of in the beta stage of testing on an inventory alert system that we built internally connected to M42, where you can do some kind of more creative alerts, things like the changes in the P/E ratio relative to a list of other companies based on where its z-score has moved statistically. It's generated a couple of interesting alerts. Actually, we just finished doing a Delta report on a finished good inventory idea because of one of these alerts, so we'll see if it's proving its value.

[00:11:27] Rob Campbell: Interesting. It does connect for me that the question started with inventory and risk management, but it does go back to our earlier discussion of one of the foundational things with risk management for us is just does it meet the criteria? Is it a great business? Another part of a risk management process, Jeff, that I think you just completed recently is we get a second pair of eyes: Our CIO, twice a year, will perform their own assessment of the portfolio and meet with you and share notes, the goal of which is to ensure that we haven't

missed something, that the risks or the bets, the exposures that we're taking are well-intentioned and well-understood. Was there anything surprising or noteworthy that came out of your most recent conversation with Christian with respect to the U.S. mid-cap strategy?

[00:12:11] Jeff Mo: When a company does an audit, you hope that the auditors don't find anything. I'm glad to report that was the finding of our chief investment officer, Christian. I think certainly there were some risks that we talked about and highlighted, but in many cases they were deliberate. The risk we took on because there's opportunity, a lower valuation or maybe higher growth potential or just stronger businesses. I would say we're relatively clean bill of health on that point, which is good because I think this is just your periodic check from another experienced investor. The team should constantly be thinking about this and already rebalancing and readjusting the portfolio for any unintended exposures.

[00:12:49] Rob Campbell: My last question on this topic I wanted to explore with you, Jeff, is: we've talked a lot about how we're in a particularly strong market. Risk management itself, perhaps not being rewarded as much today, but I suppose there's another way of looking at risk management, which is to say the risk of missing out on genuine great ideas or of posturing a portfolio to be more defensive than it ought to be. As you sort of look at that SWOT analysis of the portfolio, what's got you really excited or where you're looking to make adjustments from that perspective?

[00:13:21] Jeff Mo: I'd like to highlight some of our top positions in the strategy—companies like SharkNinja, which has probably a little bit more risk than the average company in the portfolio, but also has more opportunities. SharkNinja is one of the largest manufacturers of small consumer appliances, globally, and their competitive advantage is an internal one where, through very focused R&D, they have centers in North America and Europe and in China. Essentially, they can pass the blueprint from the end of the work in one geography to the next geography. They have 24/6—I believe they get Sundays off research—so their competitive advantage is their speed to market. They can launch a new product from concept to full launch in nine months, whereas most of their competitors take about four years. Their competitors require almost two years to make an improvement to an existing product. That's how much faster SharkNinja is. Because of that, they've gained a lot of market share. This is because of the management team, one of the co-founders, the CEO, but it's risky because it's consumer discretionary. It probably has more exposure to tariffs than any other company in our portfolio. We still think the valuation is reasonably attractive. When we first bought it a year ago, we thought the valuation was very attractive. One of the few times I get to say publicly, oh, and maybe our team was somewhat right on that one because I think the company has almost tripled in price in a year. But I would say, we wouldn't necessarily let the desire to counterbalance the portfolio take away from jumping on genuine opportunities that are strong bottom-up ideas. One way to handle it could be, we probably slightly overweighted two other companies in our portfolio than if SharkNinja was not a big weight in a portfolio.

[00:15:20] Rob Campbell: You're talking about the natural contradictions to SharkNinja?

[00:15:22] Jeff Mo: Correct. Exactly. This is how we're kind of thinking about portfolio considerations or management and mismanagement in real time. One company was probably slightly overweighted—FTI Consulting. I think we've talked about this on the podcast before. They are today globally the largest bankruptcy consultancy in the world. So, when times are good, work is a little slow for them. They're a bit diversified, so they do have some other things that you can do, like helping private equity, turnaround companies, and so on. But when times are bad and a lot of companies are going bankrupt and maybe consumers aren't spending as much on the Ninja blender or their Shark vacuum, there might be a bunch of small businesses or medium-sized businesses getting bankruptcy protection, and so FTI Consulting is doing really well.

Or a company like CACI, which is a defense IT contractor: They've been growing quite robustly recently because coming out of the learnings of the Ukraine-Russia war is that electronic warfare—distributed assets, unmanned assets—are the future of warfare and you need a lot of IT software and so forth to drive all that. So, CACI is really well-positioned in several of those themes. They've had strong increases in their growth rate because of the market position and also because of their exposure to government spending. So again, in a world where the U.S. government becomes a little bit more insular, puts on tariffs to outsiders, defense spending may be one area that is actually increasing in relevance. It is very appropriate, we think, so CACI is not a direct offset to SharkNinja, but again, consumer spending is depressed, perhaps government spending continues on, again, a little bit of a ballast. Those are some of the decisions that we would be thinking about as we always look to optimize and balance the portfolio.

[00:17:14] Rob Campbell: Well, that's fantastic. It actually really clarifies for me your natural contradictions. So on the one hand, a SharkNinja, which is maybe a bit more discretionary, more exposed to tariffs, and on the other hand, two stocks that both from a cyclicality perspective, a discretionary perspective, and a geopolitical perspective provide some offsets, all three of which have those elements of wealth creation tied to competitive advantages. Jeff, any last words for clients before we sign off?

[00:17:42] Jeff Mo: It's a long-term process. This year may have been a good year. I think maybe some who are interested in Mawer and follow Mawer or even our clients may say, 'Hey, we could have gotten even greater return by following the hot confluence of the day.' But I think what's really important in times like these is that your investment manager doesn't change his or her strategy. That's how we think. We don't want to be tossed around in the wind by the winds of the market. Rather, we have a singular investment philosophy. We have a disciplined investment process. We think that work through the market cycle and we're happy. We've created a lot of wealth for clients in this year. We still think we have a great portfolio of resilient businesses that will do well in probably all market scenarios.

[00:18:29] Rob Campbell: Very well said, Jeff. Thanks for your time.

[00:18:32] Jeff Mo: Thank you, Rob, for having me.

[00:18:34] Rob Campbell: Hey, 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, leave a review on iTunes, which will help more people discover the "be boring, make money" philosophy. Thanks for listening.