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EP 117 | Playing the plan: Mawer U.S. mid cap equity portfolio

Disclaimer (00:25):

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Andrew Johnson (00:40):

All right, welcome back to the podcast! Today we are going to be diving into the U.S. Mid Cap strategy here at Mawer. And to help us do that, we have the portfolio manager for the strategy, Jeff Mo. Jeff, always great to welcome you back to the podcast. How are you?

Jeff Mo (00:55):

Thank you Andrew, [it's] good to be back. I'm doing well. It's still a beautiful summer day here in Calgary, where we're recording. And it's almost over, so making good use of it.

Andrew Johnson (01:04):

Yeah, I can attest to the heat. All right, well, let's get into things here. U.S. Mid Cap is still, relatively speaking, a new kid on the block here at Mawer. We had you on about a year ago, when we officially launched the strategy for investors. Can you give us a refresher on why we launched it and perhaps what mid cap means in this context?

Jeff Mo (01:24):

Sure, happy to. So, we launched it (this strategy) externally a year ago in September, because we really felt that there was a niche that was unfulfilled in our strategy lineup for clients. Many clients would often like U.S. exposure. That makes sense, because it's the largest economy in the world; it's the most dynamic economy in the world. Lots of great entrepreneurs start companies there. And in many cases, immigration also allows the best and brightest to go to the U.S. And so, it makes sense that that country is very strong.

Jeff Mo:

However, it seemed that there definitely had become somewhat of a large cap bias with respect to how people interacted with the U.S. when they invested there. Sometimes investors prefer the low-cost ETF option, in which case the S&P 500 is the most widely invested in ETF in the world. And sometimes even when they came to Mawer and looked at our U.S. equity strategy, which is an all-cap strategy—it is what we call more of a "core" equity strategy, and so it does bias a little bit more blue chip, a little bit more large cap. And as I was saying earlier, the U.S. is the most dynamic economy in the world. There are constantly companies becoming public in the U.S. and usually, they maybe aren't quite at the stage of development that would make sense for our U.S. equity strategy. And so, we said, "Hey, let's launch a standalone U.S. mid cap strategy."

And the way the market defines it—and it's the same way we've chosen to define it—is using the Russell Midcap Index. And its market capitalization goes as low as around $600 million and goes as high as about $60 billion. And that does float over time, but that's roughly where it is right now.

Andrew Johnson (03:26):

Great, thanks for that. And as you said, we've been open to investors in this strategy since roughly a year ago, September of 2021. Before that, we had it in what we call our "sandbox" since October of 2020, I believe. As a portfolio manager launching and running a new fund, what are some of the things that you've learned along the way?

Jeff Mo (03:45):

It's been actually slightly over two years now since myself and our team started looking at U.S mid cap securities with an intention of starting a strategy. As you correctly pointed out, we first started a sandbox portfolio with just internal test money back in October 2020. But as you can probably imagine, even the months leading up to that we were doing ground-level research and putting together a portfolio. And so, yeah, there's been lots of learnings. There's been some highs, there's been some lows [laugh].

I would say a few of them would be, first, the U.S. market moves very fast. For those listeners who perhaps don't know, I've spent the majority of my career at Mawer in Canadian small/mid-cap equities. I am the lead manager of the Mawer New Canada Fund. I think—and not to say that Canadians are less speedy than our U.S. cousins—but I think perhaps the severity and the quickness with which the U.S. market chooses the price news in is different than what I experience when investing in Canada.

On the flip side to that though, is, we think that sometimes the desire to move fast in the U.S. perhaps causes stocks to sometimes overshoot on either the upside or the downside. And that can sometimes provide opportunities.

Another learning for us—and it's not really a surprise, but it was confirmed—that management meetings are a little bit harder to come by in the U.S. It's a larger market. There are more investors clamoring after management's time, but we think (and we found) that our long-term investment horizon really helps here. Both, because they're more likely to grant access to long-term investors. But also, as you develop the relationship with the management teams and the investor relations teams, they are more willing to grant access to you, to the CEO, eventually, after you persist and show your interest in these companies over a longer period of time.

Andrew Johnson (05:46):

And I know it's been quite a short time period so far as you just alluded to, and it's been anything but a normal market environment—and actually as I hear myself saying that... you and I have been at this for a while, maybe there isn't anything such as a normal market environment [laughter]—but I'm curious on your observations from a performance standpoint. How has the portfolio been doing through the last couple of years?

Jeff Mo (06:09):

We've been relatively happy with it, because to your point, we started the portfolio still relatively in the early innings of the COVID-19 market rebound, after the crash of Q1 2020. And then we of course had the experience of the recent market drawdown, again.

And so, if you go all the way back to when the sandbox was started, back in October 2020, I would say that the strategy has performed quite well. We've returned just over 10% for that time period—I believe that's [a] since inception annualized number. And then the index was maybe three points back of that, roughly. And year-to-date on the strategy, it's been a little bit more challenging as we all know. So, on a Canadian dollar basis, it's down kind of in the mid-teens and down in the high-teens on a U.S. dollar basis, and it's actually been a couple points behind our index in that time period.

Andrew Johnson (07:16):

From your standpoint, does any of that surprise you? Again, realizing that this is quite a short time period to be assessing things.

Jeff Mo (07:22):

The year-to-date number did surprise us a little bit. Our investment philosophy and process tends to emphasize wealth-creating companies as probably most of our listeners know. And wealth-creating companies tend to do better in a downturn because they are the ones with competitive advantages. They should be gaining market share in a downturn and generally, they should have more defensible cash flows. And when we look through some of the differences between our strategy and the index, we notice that in the index, there was a meaningful weight in securities like utilities, real estate—REITs especially, and lots of regional banks in the U.S.

And at least the way this current market downturn has played out, those are some pockets of strength, but they don't really fit our investment philosophy very well because those tend to be areas that don't have very high competitive advantages. Or in the case of utilities, they tend not to have very high returns because they're regulated.

And so, certainly from a statistical perspective we think the portfolio looks much stronger, whether it's on something like return on equity compared to our index or gross potential compared to the index. However, this did surprise us a little bit that in a down market, we've—depending on your view on statistics—we've largely just kind of marked time with index as opposed to having provided more downside protection.

Andrew Johnson (08:56):

And of course, perhaps this downturn is just beginning as well, and maybe we need to prepare ourselves to a lengthy downturn, which maybe some of our holdings could do well over time.

Jeff Mo (09:08):

Well, as another podcast participant has said before, "Prepare, don't predict."

Andrew Johnson (09:15):

And one of the major things that you need to prepare for and one that has emerged during the life of this strategy, is inflation. This is something that we can't avoid, both literally and figuratively, as many listeners and clients are curious about the impact that it can have on a portfolio. So, I'll pose that question to you: how has inflation been coming through in U.S. mid cap? And how have some of the management teams navigated this?

Jeff Mo (09:40):

Yeah, it's a very topical question, Andrew, for sure. I would say it comes through in two ways. So, let me talk at a portfolio level and then let me get into some of our companies as well.

As probably most of our listeners know, we think about the valuation of our companies by building a discounted cash flow model and then discounting the future cash flows back to the present value. And when interest rates go up, because inflation is high and therefore central banks are wanting to increase interest rates to try to cool the economy, that also causes discount rates to go up. And so, across the board, every cash-flow-generating asset will have its value decrease because discount rates are going up.

And so, that largely is the reason, many speculate, as to why the market is quite weak this year. However, the way we insulate from that is we keep an eye on equity duration. Duration is a concept that's most commonly used with fixed income securities or bonds. And essentially, it just means how much will the value of my security change if the interest rate moves up or down 1%? And that's your duration number. And because we do discounted cash flow analysis on every single company we own, we can actually calculate an implied equity duration. So, we take our discounted cash flow model and we go in and we change the discount rate by 1% up or down and voilà, you have your implied equity duration. So, this was a topic that we were thinking a lot about throughout this year. And if you look at some of our trading history—especially near the beginning of the year—we were definitely looking to change the equity duration of the portfolio down a little bit. But beyond that, I would say that we've always had a philosophy of staying diversified. And not only does that mean being diversified across different economically sensitive variables, but it also means being diversified across the spectrum of duration.

We think our portfolio was well structured for this environment. By and large, we've been relatively happy with the fundamental performance of the portfolio, perhaps slightly less happy with the equity value performance i.e., the stock price performance. But when we look at the fundamentals, it's very strong.

Jeff Mo:

And that actually is a good segue to the next point, which is, well, fundamentally when we look at the revenues and the profits of the companies we own, how has inflation impacted them? And I would actually say inflation is a positive in two ways for wealth-creating companies. First way is, I call it, "the long game." So, if you are a wealth-creating company with a sustainable competitive advantage, when economic turmoil comes in, whether it's higher inflation or slower growth or what have you, these are the companies that tend to gain market share and do better.

And the reason for that is when the economy is hot, I'll make a slight joke, if I can—the economy is hot or something is hot and people really, really want to buy toilet paper, let's say. I won't say what time period this is, it could be any time period. I know toilet paper is always in demand, in some periods of time more than others. So, you probably have your preferred brand, your preferred quality of toilet paper. However, sometimes when demand is high, that's not available, but because you still need to use toilet paper, you would buy perhaps a company with weaker competitive advantages. (Because they just don't have the high quality, or the brand, or what have you.) However, when the economy is slower and the demand is not as high, you are most likely to only buy your favourite toilet paper.

And so in that, of course, I'm making light of what happened at the beginning of the pandemic as sort of a fun example. But if you take that across all the companies that we own, the sustainable competitive advantages across each of the industries and sub industries, you sort of get the picture of, when times are challenging, people tend to no longer need to buy from the more marginal producers. They would focus back on the core producers. And the companies we own tend to be core producers of products and services in their industries.

So, that's sort of the long game. Which is, in times of stress, companies with competitive advantages (such as high inflation, that's a time of stress), they tend to gain market share. Another side is companies with strong competitive advantages tend to have more pricing power. So, if you have really strong intellectual property and maybe you're the only company that can deliver a product or service at a certain quality level, or perhaps you have a strong brand and people demand only your product, then when inflation comes through, you can pass it on.

There are several companies in our portfolio that we think—not think, we've actually observed through them reporting their earnings that inflation has actually been a benefit for them. So Winmark—which is a holding of ours that we talked about last time we were on the podcast as well—they are a franchisor of used clothing stores. They are helped by the fact that they traffic in secondhand good and so they are more attractive in an inflationary environment. We're seeing a very high-volume growth for Winmark. Some other companies I would call companies with strong competitive advantages is where they can essentially just pass through the price onto the customer. So, O'Reilly Auto Parts is one example. They're the second largest provider of aftermarket auto parts in the U.S. And we've actually seen them just kind of pass prices through and in fact, their margins kind of held in very well.

Another company would be Premier [Inc.] and they are what's called a "group purchasing organization" for healthcare purchases. They help hospitals procure better and procure smarter and cheaper. And they've just kind of passed through the inflation. And in fact, it's helpful for them because if healthcare inflation is going up at 2%, their profits will grow at 2%, absent any market share gains. But if healthcare inflation is growing at 6%, then again, their profits will be growing up at 6%. And there are several other companies like that, whether it's Humana, FLEETCOR, Ryan Specialty, Copart… these are all portfolio holdings and they've all done really well in inflation.

Jeff Mo:

So, probably a long answer to your question, Andrew. I'm sorry for that [laughs]. But I know this is a topic that's on many people's minds and on our minds as well. And generally, we think our portfolio is holding up pretty well in this environment.

Andrew Johnson (16:47):

Yeah, no, that wasn't a long answer Jeff because I think that's exactly what our listeners wanted to hear, so thanks for the overview. Also, I just took a note that we'll have to bring you back on for a future episode to dive deeper on the purchasing dynamics of toilet paper, specifically.

Jeff Mo (17:03):

Please, don't. [Laughter]

Andrew Johnson (17:05):

But just to kind of get things back on track here, away from toilet paper, the historical performance that you spoke to earlier and obviously any future returns is an output of all the work that goes into the construction of a portfolio. And you just listed off a few names that went through the process of making it into the portfolio. In all of the continual work that goes into finding those good companies and finding a place for them in the portfolio, can you talk a little bit about that process of finding those companies, ultimately how they end up in the portfolio, and importantly, at what weight do you hold them?

Jeff Mo (17:40):

Absolutely. It's a constant, I guess, run on the treadmill. And I would argue that this treadmill runs at a faster pace than the other treadmill that I've been running on for the last decade and a half in my career, which is the Canadian small/mid-cap strategy treadmill. And the reason for that is there's about, call it, 500 equities that would relatively fit in the market cap range that we look for in our Canadian small/mid-cap strategy. But there's well over 3,000 that could realistically fit or potentially fit in our U.S. mid-cap strategy.

And so, what does that mean? That means we are turning over more stones more quickly and revisiting companies again, because in a larger universe, and especially to my earlier comment that sometimes U.S. equities tend to overshoot or undershoot because of news that's been coming out. That creates more opportunities and more of an opportunity especially to “high grade” your portfolio, whether it's improving the valuation characteristics but maintaining the quality characteristics or improving the quality characteristics while maintaining the valuation characteristics.

Jeff Mo:

So, it's a very important part of our job in every asset class, but in this strategy especially. And so, what we've done is we've consistently had some type of idea generation methodology percolating in the background. We've experimented with several different ways of doing this. When we first started the sandbox over two years ago now, when we're putting together the sandbox, we did several what we call, "reverse roadshows." Reverse, because typically [with] a roadshow you go to the companies themselves and the management teams. In this case, we got them to come to us by calling them. Nothing too fancy, but just a reverse roadshow because everyone's in Calgary, technically.

So, a reverse roadshow—what we'll do is our team will screen the universe for ideas for a period of a week or two. We'll collect those ideas. And then we'll pick one week to have all of our management calls at the same time and then we'll book all those calls and do those calls. And then as a team, we will discuss and rank these ideas.

And the reason we like to do it all at the same time is we found that having the ability to talk to many companies very quickly in a short period of time, it really gave us that ability to compare and contrast different business models, different management teams, different risk characteristics. And so, we did that for probably the first year and a half of the strategy. And then, later, as the team started to mature and we started to turn over and see more of the universe and get a better sense of the overall quality and return potential characteristics of our universe, we started doing continuous roadshows. And that's exactly what it sounds like—where you don't necessarily need to bucket all the calls together in a single week because everyone on the team now ha[s] more experience getting a sense of the relative quality and valuation of the holdings, the potential companies in the universe.

And most recently, we've decentralized that a little bit more, even. We now are trying to do intense screening weeks where instead of—typically when we screen, what we call the preliminary evaluation phase of our investment process, we would take about 30 minutes. Instead, we decided to do an intensive screen, which encapsulated both the preliminary screen as well as essentially the amount of work one would do to put in to prepare for management meeting and then do the management meeting and then collect your thoughts after the management meeting. So, this is maybe more of a two-hour or three-hour deep dive into companies.

We actually completed our first intensive screening week just last week and a few ideas came out of that that we are now starting to work through and potentially put through the intensive analysis phase of our investment process. We've done 16 of these sprints since the sandbox conceptualized a little over two years ago. Altogether, we've probably touched 300 companies through that process.

And we have also coming out of that an inventory list that is 74 strong. So, this is a company that we have done work on, we've completed the intensive analysis step on it, we have a full report in our system, but for whatever reason, usually valuation, we've decided not to invest at this time. But they can become a potential idea later on if the situation changes.

And as probably most of our listeners know, the final step, when we go through this inventory process and search for new ideas is when we have a finished good—so, a company that's come through the entire process—we as a team will rank it on our investment matrix. We have five factors that go into [The] Matrix. Three that affect the quality of the company; two that affect the return potential of the company.

Jeff Mo:

So, the three quality characteristics are, how strong is this business model? I.e., how sustainable is the competitive advantage and how long do we think that advantage could sustain the quality of the management team? So, how excellent or how strong is this management team at execution, at capital allocation, at risk management, at building a team and managing their growth? And finally, how large are the risks [facing the] company, both from a macroeconomic standpoint, an operational standpoint, a financial standpoint? For example, high debt or lack of debt, as well as from a forensic accounting and an ESG risk standpoint.

So, all of those factors will get ranked by each team member on the quality side of our investment matrix. Then, on the other axis of our Matrix, we look at return potential. So, we look at a discounted cash flow model and how much of a discount to intrinsic value did our discounted cash flow Monte Carlo simulation suggest?

And then we also have what's called "skew." And so, we'll look at whether or not this company that we are analyzing has a right tail skew or a left tail skew. So, I'm making statistical comments: essentially a company with a right tail skew in certain scenarios—they will have a very good outcome. Meaning, they might be worth quite a bit more than the average of what our model says. And certain companies have that characteristic because of their business model or their growth opportunities. And so all of that goes in, each person on the team will rank it based on their own view, and then we discuss and then that decision comes from that discussion, ultimately. That's how the weights of the portfolio are formed, as well as whether or not the company that we had just finished our work on will make it into the portfolio.

Andrew Johnson (24:47):

Just to come back to some earlier comments there, it strikes me that a part of the process is to tinker and tweak and try to improve the process overall.

Jeff Mo (24:56):

It is, absolutely. So, the reverse roadshow was actually an improvement on the actual roadshow, which is what we did pre-COVID, where we did fly to cities and talk to management teams. And not to say that we aren't planning to do that anymore now that the world is opening up again. We actually are talking about as a team going to the U.S. and actually meeting management teams in their natural environment. But the reverse roadshow concept came from our global small cap peers. They were the first to pilot this, where they locked themselves in a room and just talked to management teams one after another, six or eight each day sometimes. And we said, "Well now, that's very efficient." And it definitely allows you to compare very quickly across various companies on various dimensions.

And then the continuous roadshow was an evolution from the reverse roadshow, just to say, "Hey, we still want the ability to do our day jobs too, and not just be locked in a room for a week." And we found that worked better with our schedule. And then recently the screening week—it was just a recognition that I think different members on our team have probably also maturated. And so, we maybe don't need three people on every management call. We could have each person going through their unique process, whether they want to talk to management or they want to talk to some expert or a sell-side analyst or whatever their process was to ultimately decide whether a company should go into the intensive analysis process or not.

Andrew Johnson (26:27):

And do you have some examples of recent activity that can bring some of that process to life?

Jeff Mo (26:31):

Our most recent initiation is Humana, which is the second largest insurance provider—healthcare insurance provider—in the U.S. And Humana actually was a company that came out of our finished goods inventory. So, this was a company that we had completed the full intensive analysis process back in November of 2021 and we took another look at it more recently. At that time, we were a little bit uncertain on how some of their growth prospects were unfolding in the healthcare services arena. So, healthcare insurance is largely a mature market in the U.S. Humana is still growing probably in the mid-to-high single digits in that market because of their particular focus on the over 65 part of the market, which is, [well,] the population calendar is growing a little bit faster there.

But nevertheless, Humana was trying to push to grow faster. And so, they were buying some of the downstream health services that they would be providing to their healthcare insurance members, things like home care, home health kind of visit-type-of infrastructure, as well as building physician offices. And a year later when we checked in, it seemed like that strategy was going quite well. They had made an acquisition in home health last year, so we also wanted to see that percolate. And then finally as well, I think, from a portfolio construction standpoint, Humana seemed to make better sense for us kind of this year. And that's why we ultimately decided to initiate now.

Andrew Johnson (28:10):

All right, well, that's a great example to bring the process to life. And I always like to close things out with a few examples of stocks that you own that might do a good job of just highlighting, generally speaking, our philosophy and our process for our listeners. That's not to say that you didn't just do a great job of that, but I'm curious if there are any other examples that you have to illustrate it.

Jeff Mo (28:30):

We can talk about CDW Corporation, which is one of the top five holdings currently in the strategy. CDW Corporation is an IT services provider and specifically, they're, what's called a “value-added reseller.” So, they would sell IT products from all sorts of vendors, whether it's software products like Microsoft or VMware, or hardware products like laptops and servers and so on to corporations. And these could be small- and medium-sized businesses, these could be enterprises, these could be government organizations or federal agencies. And in the U.S., CDW is the largest IT value-added reseller. They have about a 7-8% market share. They are probably two and a half to three times larger than the next player. And this is an industry where scale really matters.

Jeff Mo:

The reason for that is twofold. First, is [that] vendors tend to offer more rebates and discounts to their largest customers. In this case, CDW would be a customer for a company like Microsoft or Dell or HP, or what have you. And so, CDW being the largest by far will get better discounts. The other piece is, by being the largest company, they can spread investments across a larger cost base. And so, as [the] IT environment has gotten more complex with things like hybrid cloud, cloud, cybersecurity becoming more and more of a threat and now since post-COVID, kind of a digital or kind of hybrid work environment has really caused a lot more confusion and complexity in most companies' IT deployments. And CDW has increased their ability to service those customers. Most recently they bought a company called Sirius, which is more focused on providing higher level services and value-add for their customers. It's because CDW with their scale can afford to provide those services without, in some cases, even charging that customer. Because they have the scale and the volume discounts that allows CDW to still be profitable.

And it's a very strong company. They grow slightly faster than the average of IT spending in corporate America. IT spending has been growing maybe five or a little bit faster than 5% a year. CDW tends to grow in the high single digits because they continue to gain market share because of their competitive advantages. And we think the management team is excellent. They've executed this strategy flawlessly for over 20 years, continually gaining market share, gaining greater scale, and improving their competitive advantage. And we think the risks on the company are quite reasonable. They are diversified to government as well, so even in corporate recessions they tend to perform fairly well. And finally, when we did our discounted cash flow model, we felt that the company was trading at a discount to intrinsic value. And if you don't believe our proprietary modelling software—or work, rather; it's not software, we just do our models in Excel—it also trades [at] what we think is still a relatively reasonable multiple when you look at something like a P/E ratio; kind of just over 20x on an adjusted basis.

Andrew Johnson (31:52):

All right, well that's a great place to close things out. Jeff, as always, it's great chatting with you and learning more about the portfolio. Looking forward to the next chance that we get to chat.

Jeff Mo (32:02):

Thanks Andrew, great to be on today. Look forward to next time.