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EP95 | Introducing the Mawer U.S. mid cap equity strategy

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Rob Campbell: 00:39 Jeff Mo is back on the podcast this week. I know Jeff, you were just on a few episodes ago, so welcome back.

Jeff Mo: 00:46 Thanks, Rob. Great to be back again.

Rob Campbell: 00:48 Perfect. Well, our topic is a little bit different this week. We're here to talk about Mawer's U.S. mid-cap strategy—it's a relatively new one at the firm. And so, before we get into the portfolio and perhaps some of the holdings, wondering if you can share for our listeners just some of the background and history around our interest in U.S. mid-cap stocks and the strategy itself?

Jeff Mo: 01:09 This is a new strategy at Mawer. The mutual fund part of the strategy launched on September 27th of this year. The strategy itself has been around as an asset class since October 2020. We kept it internal for the first year. We've called it a "Sandbox" process, where we can just work through the kinks of launching an asset class, as well as testing the strategy and seeing how well it would perform.

But the idea I guess, of investing in U.S. mid-cap and smaller stocks has been around for many, many years. First and foremost, as most of our listeners know, our U.S. Equity Fund is an all-cap strategy. So, that fund has been around since 1988. And so, we've been investing in U.S. mid-cap and smaller cap stocks since that time. In fact, as part of the case for considering whether or not we could add value for clients with this new strategy, we actually went back and looked at the holdings—the mid-cap holdings—in the [Mawer] U.S. Equity Fund as well as other asset classes that could buy mid-cap and small-cap U.S. stocks, like [Mawer] Global Small Cap and [Mawer] Global Equity.

	02:22	And we found that over (depending on exactly the time-period and which fund), but over either 10- or 15-year time period, it seemed like Mawer's mid cap picks tended to beat various U.S. indices by anywhere from 5% to 7%. So, that was a big catalyst I think, for us to say, "Hey, we have historically created a lot of value for our clients in this asset class."
Jeff Mo	2:46	It's just that we've never chosen to expose the stock picks directly to our client base in a specific strategy. And so I think that is why we chose to consider U.S. mid-cap as a separate, standalone strategy.
Rob Campbell:	03:01	What's the benefit to client allocations and having a dedicated U.S. mid-cap exposure in their portfolio? What role do you see this playing in a client's overall asset mix?
Jeff Mo:	03:12	Like some of our other smaller-cap-size strategies, such as Global Small Cap or the [Mawer] New Canada Fund, which I also manage. (That's a Canadian small cap strategy, for those who don't know.) The main attribute here is that we are looking at the companies in the U.S. that aren't the household names. So, when you talk about an Amazon, a Walmart, a Proctor and Gamble, a Nike—these are the companies that define America, of course, but below these top 300 or so companies, there's a huge swath of companies that are defined as U.S. mid-caps. The U.S. is historically and still today, I believe, the most entrepreneurial country in the world. And there are constantly companies rising up and perhaps creating destruction—taking some down as well.
	04:01	And so, when you think about Mawer's investment strategy, buying, creating relatively more concentrated portfolios of wealth-creating companies—so out of the 1-2,000-stock universe and picking 42, which is what we've done—we think that there could be a lot of value that is added for our clients, both from a perspective of absolute return, but also risk. We think that we can really balance the portfolio by being stock pickers in such a rich universe of stocks.
Rob Campbell:	04:34	I would also think that just up-cap, if I think about the S&P 500… I mean, that index has gotten significantly more concentrated. You mentioned Amazon, but just the FAANG stocks and some of their success. Is another rationale for mid and smaller cap companies in the U.S. just to offset some of that rising concentration in the more typical large-cap portfolios?

Jeff Mo: 04:56 It is. And this is my personal opinion, but if you look at how U.S. investing has gone over time, more and more people have gone passive for the U.S. There's sort of this view nowadays amongst asset allocators that, "Hey, you find a good active manager for your EAFE exposure. Maybe you find a good active manager for say, your global small cap exposure. And in the U.S., just buy the S&P 500, because a) it's the most liquid index in the world; it's also the lowest fee index in the world. And the S&P itself is very broadly diversified." But to your point, it isn't really, because the top five tech stocks are over 20% of the weight of the S&P 500 now, and that continues to increase over time.

Jeff Mo: 05:37 So, when we look at the [Mawer U.S.] mid cap portfolio, this is a great way for investors to expose themselves to U.S. and really get that, I guess, "American dream" exposure without needing to have a 20%-25% weight in big tech stocks. They're great companies, but at the same time, they probably all tend to trade in a block with each other. And this year, I think they've been a little bit weaker because of the antitrust issues and some of the other headwinds they're facing.

Rob Campbell: 06:08 Jeff, we've been talking for a little while. A question I've had since the beginning basically is, how are we defining mid cap? And this is maybe just a pet peeve of mine, but these terms—small and mid cap—tend to get thrown around quite a bit. Everybody's got a different definition, whether it's the market cap hurdles that define these categories, or are there certain qualities of the companies that you're looking for and you're trying to invest in that distinguish them more qualitatively versus larger cap stocks?

But I guess to put the question a little bit more simply, what is the universe that you're looking at? How are you defining the types of companies that you're looking for in this portfolio?

Jeff Mo: 06:42 You're right, Rob, [it] seems to be [with] small cap/mid cap [that] these terms are bandied about a lot. And when we started doing our research on this topic, we actually had the same kind of learning that you just described, which is everyone has a different definition of what mid cap is.

So, we initially tried to come at it with a very mathematical, analytical approach… "here are some set of numbers," and so on. Certainly, we do have guidelines around market cap, but I think the second point of what you said there to us made more sense when we were trying to define the universe—kind of the qualitative characteristics of what makes a mid-cap company. We really tried to start there.

07:20 And so, when we think about mid-cap companies, these would be companies that are, I guess, not fully dominant already in their niche yet. These are companies that are certainly strong and have established competitive positions, and we can analyze their competitive advantage, but at the same time, they're not so saturated in the market that the potential for growth and change is no longer there. And so, when we look across those companies and then also just reference some of the indices that track mid-cap stocks in the U.S., we actually felt it's kind of in that $60 billion-ish and under. And that's not a number that we pick per se, that was actually roughly where the U.S. Russell Midcap Index pops out at today. But it really is a very wide range. For example, the mid-cap index goes down to a little under $1 billion. In fact, the smallest company in Mawer's U.S. Mid Cap portfolio today is just around $800 million market cap.

Rob Campbell: 08:27 So, it sounds like the portfolio—at least the way we're defining it—is mostly mid-cap in nature, focused on these companies that have perhaps a little bit more growth, a little bit more runway ahead of them, not fully formed, while still presenting the ability to go down the capitalization spectrum where we're seeing opportunities. Is that a fair characterization?

Jeff Mo: 08:46 That is. I would say that it's just a very wide canvas. We're going from below a billion all the way up to kind of that $60 billion mark. And that mark may continue to go up with where markets are going these days. That mark has actually increased since we first started looking at mid-caps a year and a half ago here at Mawer.

Rob Campbell: 09:04 Makes a lot of sense given the year that you've been doing the Sandbox. We've presumed something so far, and maybe you mentioned earlier, but similar investment philosophy and process to what we're doing and what listeners would already know about Mawer to the extent that they've been listening to the past 100 or so podcast episodes [laughs].

Is there anything different about the [Mawer] U.S. Mid Cap portfolio or the U.S. itself that you and the group focused on U.S. mid caps is doing that you think is important to share with our listeners?

Jeff Mo: 09:33 So, just in case, I won't presuppose that every one of our listeners has listened to all of our 100 other podcasts [laughter]. So, just very quickly, same investment approach as the rest of Mawer. Mawer is a one investment philosophy organization, which is that we create broadly diversified portfolios of wealth-creating companies run by excellent management teams bought at what we believe to be a discount to intrinsic value.

So, what I think we focus on as all the other Mawer portfolios focus on, is really identifying these wealth-creating companies. And so, a company can only create wealth if it has a sustainable competitive advantage. And so, that's what we're looking for. We're going into this market as we have in all the other markets that Mawer invests in looking for companies with sustainable competitive advantages. And I think the slight nuance in the U.S. though, is Silicon Valley.

Jeff Mo: **10:27** When I say Silicon Valley, I should also say healthcare technology as well. And I know for our listeners they'll say, "No, no, that's not in Silicon Valley. No, healthcare is kind of centered in the Boston area or kind of that New York to Washington corridor and so on."

And I acknowledge that a lot of healthcare research is not there, but what I mean is this kind of innovation in newer technologies, newer parts of the economy, is not uniquely American, but it's probably most concentrated in the U.S. compared to anywhere else in the world.

10:58 And obviously, that has created some giants like the FAANG stocks that you referenced Rob, but below them, there are hundreds of companies that are secular growers that are or are trying to or have established strong competitive advantages in all sorts of different niches. And so, we have actually have some of those holdings in our portfolio, whether it's a Charles River Laboratories that dominate and outsource early stage research and also starting to be about manufacturing for biotechs. Or companies like a Roku, that's really kind of making their name heard now in connected TV and the move from linear TV to connected TV and how ad dollars are going digital.

11:45 So, these are just kind of examples of companies that we've had to...not necessarily tweak our process, but we've had to gain additional expertise in those areas. And so, one of my colleagues, Justin Anderson, equity analyst on our Canadian equity strategy, he has also broadened his focus to kind of be a global tech analyst. And so, Justin has worked collaboratively with the U.S. mid-cap team several times. In fact, last October we did a U.S. mid-cap tech roadshow.

This was during the height of COVID, so this was a virtual roadshow, of course. We spoke with over 40 tech companies in two weeks, and not only was Justin on the call, he brought in some of our colleagues on our development team who may have encountered some of these software products. We were really able to get down to how they developed, do they have agile teams—

Rob Campbell:	**12:39**	So, you're talking about our own business technology analysts that are coming into these conversations?
Jeff Mo:	**12:43**	Correct. Yeah, so [our own] guys who are developing our client portal, for example, for our clients.
Rob Campbell:	**12:48**	Got it.
Jeff Mo:	**12:49**	When you log into your myMAWER app, they're also turning around helping us analyze if Elastic indeed has a strong competitive advantage against Splunk.
Rob Campbell:	**12:57**	Interesting. Well, you've actually touched on a couple of things where I wanted to go next—first the team. You mentioned Justin, but what is the team focused on U.S. mid caps? Who's working alongside you in analyzing these securities and looking at portfolio construction?
Jeff Mo:	**13:12**	Thanks for asking that, Rob. So, first and foremost, I am the lead portfolio manager. As many of our listeners know, at Mawer we have a leader decides with input model. What that essentially means is all the mistakes, I own [laughs].
Rob Campbell:	**13:27**	Can you describe the input a little bit more?
Jeff Mo:	**13:30**	Absolutely. Samir Taghiyev who works with me on the Canadian small cap strategy is one member of the U.S. mid-cap team as well. And then Alex Romaines is sort of on what we call loan. He was a global equity analyst and our global equity strategy was looking to unchain, and it did in fact, unchain itself. That's a separate discussion, I guess, for a different podcast, but essentially the thought was global equity will also go out and potentially buy stocks that aren't in anybody else's portfolio. But a big portion of what they were targeting was in U.S. mid caps. And so, when we actually chose to go ahead and launch a standalone U.S. mid-cap product, it seemed to make sense for Alex Romaines to kind of spend the majority of his time on U.S. mid caps as well. So, I would say those three individuals are the core team where the majority of their time is focused on this asset class.

14:24 Outside of that though, because it's the U.S., and because as I mentioned earlier on, there are already three unique strategies at Mawer that can invest in U.S. mid-cap stocks, we do get a lot of support from the U.S. equity team, the global equity team as well. And then it seems like U.S. companies compete with almost every company in the world [laughs] and so I've had a chance to work with people on our EAFE large-cap team, people on our international equity team, people on our Canadian equity team. Just one- or two-off companies or industries where there's a U.S. mid-cap company we're interested in that had an overlap competitor, supplier, what have you, with a company in another portfolio.

Rob Campbell: **15:07** Got it. And how have you guys approached the universe? You spoke just a moment ago about the tech roadshow that you've done. Is that kind of the approach? Do you go industry by industry and take a look at a bunch of companies? Or how have you guys initially looking at the asset class and on an ongoing basis, how are you looking at the universe from an idea generation perspective?

Jeff Mo: **15:26** We're looking at it in the same way, I guess, that any other Mawer strategy will look at its universe. So, we're always trying to find the 40 or so best companies that fit our investment philosophy in that universe. So, I'll just speak to my experience with U.S. mid caps perhaps compared to Canadian small caps. So, in Canada it's a much narrower universe. There's probably…call it 600 or so companies that we can invest in that kind of fit our market cap size, but half of them are clearly not wealth-creating and would just be eliminated by the first plank of our investment philosophy. U.S. mid caps are different. There's probably a few thousand companies that could fit for us. And even if you were to take a more stringent view on the criteria and so on, there's still probably over a thousand company is we would seriously consider.

16:13 And so, because of that, in Canadian small cap we tend to go a little bit more in depth with each of our companies because realistically, there's [200] to 300 companies that our clients would probably want us to pick from. Whereas in the U.S., we're looking at over a thousand companies we realistically would want to pick from. And so, from the time that we started contemplating launching this strategy—which was the summer of 2020 until now—we've run 11 distinct reverse roadshows.

So, that's almost one a month, I guess, where we would kind of poll the team, pull out ideas, and then set up a roadshow. We call these things roadshows because historically we've literally flown to New York or whatever [laughs] and met all the companies that we could in the New York area. Obviously, in the COVID world, that actually is more beneficial because we don't have to fly anywhere, and we can hit all parts of the U.S. in one roadshow.

Jeff Mo: 17:08 And so, we've spoken with, I'd say, well over 200 companies since the asset class launch. And this is on top of all of the conversations that our U.S. equity team, our global small-cap team, our global equity team, have already had in this universe.

And so, in many cases I would say these are companies that the U.S. mid-cap team is revisiting with a new lens, and perhaps just revisiting for the first time in a few years that Mawer has touched the company. And that there are some companies that we've never spoken with as a team. And so that was how we approached the universe.

Rob Campbell: 17:42 All right. Well, let's get a little bit more specific, I guess, in terms of bringing the portfolio to life. Can we chat through a couple of holdings in the portfolio?

Jeff Mo: 17:50 Yeah, absolutely, Rob. I'm a bottom-up investor and I've just been waiting for this section of the podcast.

Rob Campbell: 17:55 Awesome. Well, you mentioned one earlier, Charles River Labs, [I] presume it's based in the Boston area.

Jeff Mo: 18:00 It is.

Rob Campbell: 18:01 Top holding in the portfolio. You gave us a little sense for what the company does, but why is it deserving of a top three/top five weight in the portfolio today?

Jeff Mo: 18:10 Charles River Labs is very unique. It reminds me of that comment about the San Francisco Gold Rush, where you don't want to invest in gold claims, you want to invest in the picks and shovel makers. And so, Charles River is very much making picks and shovels for the biotech gold rush.

[There are] two parts to it. So, one is despite some cyclicality, if you look over the last 20, 30 years, the amount of money spent in biotechnology R&D has steadily increased above inflation. And so, Charles River, what they do, is they are the leading provider of preclinical contract research outsource work for large pharmaceutical companies, as well as smaller biotech companies. And they actually got into that position because they were the leader in animal models, way back in the day. And they still are the leader in animal models. As we probably do know, pharmaceutical research does involve testing certain compounds and drugs on animals before they're tested on humans.

Jeff Mo: **19:13** And so, these animals need to be cared for, and in some cases managed very carefully bred and so forth for specific tests. And so that's what Charles River was 15 years ago. And then CEO Jim Foster, he had the strategy of saying, "Well, because animals are usually used in the early phases of trials, obviously, by the time you get to a phase three trial, you want to be testing on humans to test for efficacy on animals." So they said, okay, well, we kind of have one little sliver of the early stage process—let's get into more. And so they've got into safety assessment—seeing if these potential drug compounds are safe or not. And they got into what's called "discovery," so, actually helping on an outsource basis some of these biotech companies to discover new compounds that they could then see if they could find as easily the cure with. And then they got into manufacturing now.

20:08 So, a new area in biotech is cell and gene therapy. We know about gene therapy quite a lot because the vaccines nowadays [laughs]—mRNA are based on using the RNA and DNA of the body itself to create therapeutic treatments. And so, Charles River has really come to dominate. They're the number one player in each of these things that I mentioned. [They] dominate early stage drug research, and early stage drug research happens to be an industry that's doing very, very well. And so, when we look at this and we put it into our DCF models, we think that Charles River is still trading at a discount to intrinsic value and should have a bright future ahead of it as this theme continues.

Rob Campbell: **20:52** Well, it reminds me of when we had Siying on the podcast earlier in the spring, and she was talking about Eroom's Law, basically the reverse of Moore's Law, which says that the cost of bringing drugs to market is getting exponentially higher as the hurdles get higher and higher. So, it sounds like Charles River Labs is a beneficiary of that theme.

Jeff Mo: **21:08** Absolutely. That's a great example.

Rob Campbell: **21:11** Let's move on to another one. Jeff, you spent most of your time at Mawer focusing on Canadian small caps, has that perspective been helpful when looking at U.S. mid caps? Do some of these companies compete? And if so, how has that played out in terms of a name in the [Mawer] U.S. Mid Cap portfolio?

Jeff Mo: **21:25** Oh, absolutely. It's helpful in so many different contexts. So, first of all, [the] Canadian small cap portfolio at any given time… anywhere from 40% to 45% of the revenues generated by that portfolio are actually in the U.S. And so, even though I'm relatively new to managing the U.S. portfolio, I've been looking at the U.S. and economies and locations and how it impacts various Canadian-domiciled companies for my entire career.

Jeff Mo **21:52** So that background has been very helpful. Which is probably why when we looked around the team and we said, "I think it would make sense for us to have this product for our clients because we think we could add value." Then the question was, "Who should be leading this product?" I think that's why others in the team felt maybe I was naturally positioned to do so. But to your more specific question, let me give you the example of a company that very directly related to a Canadian small-cap company.

22:18 Earlier this year, we participated in [an] IPO in [the] Canadian small cap [strategy] in a company called Magnet Forensics. Magnet is actually the second-largest player in the digital forensics investigation software industry. The number one player lo and behold decided to do an IPO on the Nasdaq. Well, technically a De-SPAC transaction on the Nasdaq a few months later. Given all of the work, we did looking into the digital forensic investigation industry—Cellebrite was the name of this company—we decided to initiate on Cellebrite as well for the U.S. Mid Cap portfolio. The research that we did on the industry was completely comparable. In fact [laughs] it was kind of funny because we actually reached out to Cellebrite's management team to do a scuttlebutt on our Magnet Forensics research. And then that obviously was very applicable when we decided to also buy Cellebrite. Both of those companies are a great company because this is just continuation of the theme of finding more efficiencies and more efficacious ways of doing things as the world continues to move digital.

Jeff Mo: **23:20** And so as more and more crimes have either a digital component or in some cases, become a completely digital crime—perhaps like child pornography, unfortunately—Cellebrite are the good guys. They have the technology that can take the data on, say an iPhone or a laptop, and they can find the history of what this user was doing; where he or she moved files; which forums they were talking on in the dark web; what did they download or upload? And so those type of things are becoming more and more critical for law enforcement.

In fact, I think I read a stat saying that over 80% of all law enforcement investigations today have some type of digital component. And when they say digital component, chances are in more than a third of the cases, they're using Cellebrite's technology to access that digital component, which is why Cellebrite has such a great market position. They're the leading provider, they have the best technology. And this is an industry that's growing at 25%-30% a year. And Cellebrite is growing even faster than that given their leading technology position.

Rob Campbell: **24:25** Apple's been in the news recently on this topic with respect to things on your iPhone and them being able to scan and see whether you've got any sort of child pornography materials and reporting those. Would Cellebrite have been involved in that news item that would've come up about a month ago?

Jeff Mo: **24:41** Well, I think Cellebrite is actually Apple's worst enemy because the reason Apple was in the news for that, was because they built their whole brand image around—

Rob Campbell: **24:52** Privacy.

Jeff Mo: **24:52** —privacy and data protection. And so there's actually a huge uproar when Apple said, "Hey, other than giving you privacy, we're going to take that away if we scan your phone and find certain images." Of course, Mawer is not certainly a proponent of saying, "We shouldn't be going after child pornographers." Absolutely not. But what we're saying is, Cellebrite is indeed, even before Apple went ahead and said they could perhaps do the scan, Cellebrite was the guy that actually allowed law enforcement to crack the iPhone and find these files that perhaps would be in the phone.

And so when I say Cellebrite was Apple's worst enemy, Apple kind of prided itself on its ability to kind of keep data secure, but Cellebrite... it's a bit of an arms race. Cellebrite has always stayed ahead of Apple's encryption technology and so on. So, that in a controlled manner, when it's a law enforcement official with the proper warrants and so on, they can utilize Cellebrite's technology to get into an iPhone and build a forensic case for why a potential perpetrator is in fact guilty.

Rob Campbell: **26:03** It sounds like ESG is being kind of considered throughout this with respect to privacy as you've looked at the investment case. Speaking of your Canadian small-cap perspective, obviously you're working with lots of other teams. Do you have another example of where just that scuttlebutt or working with other teams at Mawer has really helped in terms of your understanding of a business in the U.S. Mid Cap portfolio?

Jeff Mo: **26:24** So, KLA Corporation is probably a great example of that. KLA Corporation is the world's largest provider of a specific type of equipment used to make semiconductors. They're involved in what's called semi-cap—so semiconductor capital expenditures—and specifically, they're the dominant provider of process and control equipment in semiconductor manufacturing.

As you know, or can imagine, we are etching thinner and thinner lines on silicon wafers to make our semiconductors and chips today. As you get to the size where it is literally atoms or a couple of atoms-width apart, your ability to control the precision of that manufacturing process decreases. Ergo, you need more and more process control equipment. And KLA is kind of 20 years down that R&D curve—maybe longer, maybe 40 years down that R&D curve. And as things get more and more complex, other competitors have sort of dropped off to the point that we estimate KLA, depending on the niche, has anywhere from 45% to maybe 60% market share of these various types of process control equipment.

27:38 And so, semiconductors is an area that as a firm we have a lot of experience with. In our International Equity Fund, we hold Taiwan Semiconductor Manufacturing Corporation, TSMC. We've also looked at ASML, which like KLA, they are a dominant provider of a certain type of equipment to make semiconductors. In ASML's case, lithography. My colleague in Singapore, Wen, he has looked at several of the different semiconductor companies for the International Equity Fund. And so Wen was very helpful in getting us up to speed on the industry. His colleague Peter Lampert, who heads our Emerging Markets [Equity] Fund and is a member of International Equity Fund as well, [has] written a white paper to the entire team on semiconductors. Wen was also able to help us set up some scuttlebutt talks with people in the Asian semiconductor supply chain. Because as you probably know, lots of semiconductors are today manufactured in Asia, and so having a Singapore office and a colleague in Singapore was really helpful for us to better understand KLA and its prospects.

Rob Campbell: **28:44** I recently listened to another podcast—the Acquired podcast's take on TSMC. I think it's a three-hour podcast into that specific company and its history and just the moat and as you said, just how other competitors have dropped off. Highly recommend for those who want to do a three-hour deep dive into a business. But interesting. Certainly the learning with TSMC in that one that we've had too, and it sounds like it applies to KLA as well.

Jeff, semiconductors—pretty cyclical business or a business that's got some cyclicality to it. How have you managed that in the context of the rest of the portfolio? In other words, what stocks would maybe provide some offsets to that from a risk management perspective?

Jeff Mo: **29:23** As many of our long-time listeners know, we very much try to maintain what we call inherent contradictions in our portfolio. Meaning if you have one company that will do well because of a certain theme, we are actually actively looking for companies that perhaps will do poorly if that economic scenario unfolds. And so, I'll give you two examples of companies that could offset KLA if the semiconductor cycle is weak or strong, vice versa, just offset.

So, the first one will be FTI Consulting. They are the largest provider in the U.S. of bankruptcy and insolvency consulting. So, when a company has declared bankruptcy and has gone into a kind of a court-protected process, they would often hire FTI Consulting to help manage the company, the assets, and kind of work through usually the debt issue that the company has to kind of bring back into solvency and bring it past the court process.

30:25 FTI has obviously very strong revenues when the economy is weak. 2020 was a banner year for them, for example. On the flip side, when the economy is red hot, and presumably that's when semiconductors are being sold-out the most, there's a little bit less work for FTI consulting to do. But using our philosophy, both FTI and KLA are wealth-creating companies. And so, in certain marketing environments, KLA will create a little bit more wealth, FTI, a little bit less wealth. But when you blend it over a market cycle, the portfolio itself will create a stable level of wealth for our clients.

Maybe another company I'll point to is Winmark. They are a company that has a large group of franchised secondhand goods and clothing stores. Plato's Closet, for example, would be one of the bigger brands. And so when the economy is bad, what Winmark has found is typically they get more visits from people going to their secondhand clothing stores. And vice versa, when the economy is good, people are doing better economically, they are fine to go—

Rob Campbell: 31:30 Buy new clothes. Got it.

Jeff Mo: 31:32 —purchase new clothes. And so, again, that's an example of a company that's a little bit more anti-cyclical.

Rob Campbell: 31:36 Interesting. Jeff, I gotta ask you—the third element of the investment philosophy—the buying at a discount intrinsic value… the U.S. mid-cap space just seems to be—compared to other sort of universes or indices, equity asset classes—among the most expensive globally, if not the most expensive if you look at it on a, say, traditional price-to-earnings basis. Is this a concern that you share? And I guess, can you connect that to why U.S. mid caps deserve a place in a client's portfolio?

Jeff Mo: 32:05 Absolutely. I mean, we look at the same metrics that you do or our clients do as well, and absolutely the U.S. stocks and especially in the mid-cap part of the universe are quite expensive on traditional metrics when compared to their historical kind of P/E ratios and so forth.

I would say the offset though in our minds is yes, we are worried about valuation, but there's kind of two offsetting factors. One is by having a very concentrated portfolio, we can kind of dodge and weave; we're not buying the index here. And so we think we've picked our spots within this market. The second piece that I'd highlight is the [Russell] U.S. Midcap Index is also one of the higher growth indices across the world.

Rob Campbell: 32:47 This is the Silicon Valley effect that you talked about earlier.

Jeff Mo: 32:51 Yeah, but for example, one of our top holdings is a company called XPEL based in San Antonio, of all places. Not the first city people think of when they think entrepreneurship. And yet, XPEL has—even in the one year that it's been in our portfolio—tripled in value because it is the dominant provider of film protection for automobiles. And that is a market that's only maybe 6% penetrated globally, depending on which stats you use. And so they just have a huge growth runway and they continue to do a good job protecting their moat. But this would be the example of a company that trades on a traditional P/E basis on a very high multiple. But its competitive advantage, its entrepreneurial management team—they are big shareholders and aligned—and their huge growth runway and their track record execution, shows that they probably deserve that multiple.

Jeff Mo: 33:45 In fact, when we do the work on a DCF basis (on a discounted cash flow basis), we actually think it still trades in the middle of the fair value range with upside skew potential, given how much potential there is for them to continue to penetrate this market.

Rob Campbell: 34:00 Jeff, many clients look at portfolios and holdings kind of in a Morningstar-style box type of exercise. So, capitalization and then your growth/value axis. Based on your comments, is it a fair assumption that this portfolio relative to others at Mawer, might have more elements of growth in it as a result of the universe in which it's focused?

Jeff Mo: 34:21 I think that's a fair comment. I'll admit I haven't gone through with a fine-toothed comb on every single holding across every Mawer portfolio, but my sense is that because of the opportunities placed in front of us, it's sort of that "growthy stalwart," I'll call it. So, companies that are growing its bottom line at 10% or 15% a year, that seems to be where a lot of the companies in our portfolio [have] landed. Because the premium that you have to pay for that growth is not very high relative to a company that's say, only growing 3% or 4% a year.

34:59 At the same time, there are a few spots we've picked in the portfolio as well where we think that the market has undervalued the growth potential. XPEL being a great example, Cellebrite another one where we think that companies with maybe 20%+ growth, they still deserve a place in the portfolio as well despite its valuation on a headline basis looking a little bit more expensive.

Rob Campbell: 35:19 Beyond valuation: just as you look at the portfolio and perhaps the market today, you mentioned XPEL being up 3x. I mean, the market overall has gone up quite a bit. What other risks are you and the team looking at or concerned about the most with respect to this portfolio? I guess thinking about the most.

Jeff Mo: 35:36 I would say inflation would be the biggest risk that we are keeping an eye on in our portfolio, because it is something that affects the portfolio so broadly. Even when I look through the portfolio and think, well, a lot of the companies we own perhaps are more service-based and not goods-based and perhaps have less potential for inflation to affect them. The fact that if headline inflation and core inflation, in fact, stays at the levels we've seen the last couple of quarters, I think all companies will be affected. And so, we've spent a lot of time thinking about which of our companies do have that pricing power to pass on their costs. And we're happy to say that when we do that analysis, we think most of our companies do have that ability because we really have chosen companies with very strong competitive advantages which would allow them to pass on their prices to their customers.

Rob Campbell: 36:30 Yeah, I can appreciate how inflation's a concern. I think for most Mawer asset classes [they] would be thinking about inflation and the ability of companies to pass them through as well. I've certainly heard that from other teams too.

Jeff, in terms of... you've been running this for a year, has the portfolio behaved the way that you would've expected it to through the market environment that we've had?

Jeff Mo: 36:48 To be honest, it's behaved or done a lot better than we expected it to. So, if you think about when we launched this portfolio, this would have been... October 22nd [2020] was when we went live with the Sandbox last year. And then some people might remember that in early November, right before the U.S. election, the first vaccine was approved. (I think it was the Pfizer-BioNTech vaccine by the FDA for emergency use authorization.) And so that new really kind of caused the equity markets to take off. If you look at the equity market charts, there was that initial recovery from the March lows into kind of May and June. And then markets were kind of flat-ish from June until October. And then as soon as the markets took off, what really did really well were those companies that the investors were maybe most worried about through the summer of last year.

37:43 So these would be highly indebted companies, companies with high beta to the market, economically sensitive companies like construction and heavy equipment industrials, commodities as well. Often these are companies that haven't maybe made its way into the Mawer portfolios as a whole as much as the index, because we tend not to be able to find competitively advantaged companies in those parts of the market. And that was true for [Mawer] U.S. Mid Cap as well. People probably remember that from...call it early November until probably kind of at the end of Q2 of this year, almost every Mawer portfolio was behind its respective index.

38:27 And that to a certain extent was true for U.S. Mid Cap as well, but it was always behind, I guess, by a lot less than maybe we would have expected or what we saw with our other portfolios. And then since Q2—when the market's become more choppy again—it's been more of a stock picker's market. And this portfolio has actually out-performed much better than the Russell Midcap Index. Overall we felt that it did better in both parts of the market that it's been exposed to in this year. So, in a time that Mawer tends to do well, it's done well. And in a time when the Mawer strategies were expected to do perhaps less well, it also did slightly less well than its index, but maybe less so than we would've expected. So, overall we're quite pleased with results of the Sandbox.

Rob Campbell: 39:15 Okay. So, behaviour largely in line with expectations, perhaps with some positive surprises, but a successful Sandbox experience—hence why we're here today. And Jeff, looking forward to putting you into the rotation for the "Playing the Plan" episodes for U.S. Mid Cap going forward. Well, thanks for coming on the pod, Jeff.

Jeff Mo: 39:33 Thanks for having me, Rob. Talk next time.