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EP 140 | U.S. Mid Cap Equities: Tech, Regional Banks, and Valuation

[00:00:00] Rob Campbell: Coming up, I sit down with Portfolio Manager, Jeff Mo, who leads our mid cap strategy in the U.S. We talk about a number of subjects that are top of mind for investors today, like tech, regional banks, and I try to push Jeff for his outlook on the economy. Or, put differently, what the behaviour of various holdings in the portfolio might imply about the economic backdrop. We end by discussing a topic that Jeff doesn't think is getting enough attention today as it really should, and that's valuation.

[00:00:30] 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.

[00:00:44] Rob Campbell: Well, hey Jeff.

[00:00:46] Jeff Mo: Hey Rob. Thanks for having me on the podcast again.

[00:00:49] Rob Campbell: Of course, welcome back.

[00:00:50] Jeff Mo: Thank you.

[00:00:51] Rob Campbell: Well, much of the conversation, Jeff, about U.S. equities so far this year has been about big tech. The so-called "Magnificent Seven" mega cap stocks that have really driven the overall market. And I'm wondering how has this played out in the small and mid cap space where you're really spending your time as an investor?

[00:01:10] Jeff Mo: Well certainly there is a reasonably large technology component in probably all parts of the cap size in the U.S. I'd say tech has generally done reasonably well year to date for U.S. mid caps, as they've obviously done in the large caps. Overall, though, I'd say that there is less concentration in the mid caps than in large caps for tech.

Not to say because of that mid caps haven't done as well, but mid caps generally haven't done as well year to date just on a straight performance basis compared to the large caps. The index as we're recording today [September 11, 2023] is probably up in the high single digits in U.S. dollar terms, whereas obviously S&P 500 is doing considerably better than that. I think it just goes to show you that the U.S. market, even outside the S&P 500, is really being driven by a few large technology related stocks.

[00:02:07] Rob Campbell: And even there, for many of them it's really related to AI. Presumably you and the mid cap team have been thinking a lot about AI and its potential and impacts. How has it influenced your thinking or performance among the holdings that you have in the portfolio?

[00:02:24] Jeff Mo: Well, first and foremost, I think they've already replaced about 50% of my brain with AI, so, I'm hoping that today's podcast will work out better than past podcasts.

[00:02:34] Rob Campbell: They're gonna replace me as a host soon too, Jeff. Don't worry.

[00:02:36] Jeff Mo: The generative AI is really making its mark. I would say in general though, turning to kind of how it's impacting equities and the companies and the fundamentals… I would say we're still in kind of that speculation stage of AI, especially when it comes to investing. So, when we look at the companies, nothing really has come through in the results yet.

Certain companies that we own, like Elastic, are speculated [to be] maybe beneficiaries or winners because of AI, since on their software platform if you add AI, they could just sell a lot more productivity and functionality to the customers.

On the flip side, you have a company in the portfolio like Concentrix, which is seen as a relative loser for AI. They focus on outsourcing customer experiences which is somewhat fancy way of saying that when you chat with a company often they don't have a bot.

[00:03:35] Jeff Mo: And the theory, although certainly not yet the practice very much, is that these interactions can be replaced by AI. Even there, it's unclear because Concentrix is making a big deal about how because they have these customer relationships, because they have the most data and the most interactions to analyze, they believe they can implement AI better than an average customer, which may be quite a bit smaller than them from a standpoint of kind of a contact centre footprint.

But overall, I'd say, the stocks certainly are moving. If you look at Concentrix for example, it's one of our worst performing stocks year to date, but they've actually, if you just look at earnings growth or revenue growth, kind of look at that, I'd say it's kind of mid-pack to slightly above mid-pack in terms of the portfolio.

[00:04:22] Rob Campbell: Okay, so the narrative is kind of dominating the numbers there, at least in the near term.

[00:04:26] Jeff Mo: That seems to be it. Although, who knows, maybe I'm just a fuddy-duddy who hasn't been fully replaced by AI yet.

[00:04:33] Rob Campbell: Is there any company where the impact is a little bit more tangible that you've seen?

[00:04:37] Jeff Mo: I would say the only one that's tangible from a standpoint of not only influencing but really driving corporate strategy and the success of the company is Moderna, which is a small portfolio holding of ours.

[00:04:52] Rob Campbell: I didn't think you were going to say a healthcare company, but yeah, please go on.

[00:04:56] Jeff Mo: [Laughs] Healthcare, the bastion of AI. Which may be a joke to many, especially for some of who are listeners here in Canada. But Moderna, specifically with their world class mRNA platform has really built their company in kind of a cloud native, digital native environment. And so, even, you know, years before they came out with some vaccine that helped accelerate the end of a global pandemic, they were taking all the mRNA patterns and uploading it into the cloud and having all these nucleotide-based pairs be available for an AI to essentially analyze and predict what future sequences might work out better for certain disease indications and so forth.

We actually—back in March—the team toured their facility in Boston, and we learned that something like a thousand new sequences are uploaded to their cloud, I think it was every week.

[00:06:00] Jeff Mo: So, that's a lot of extra data for their AI to analyze. And I think frankly that comprises the main part of Moderna's competitive advantage—is that they have all this data that, even if a big pharma company (and there's lots of big pharma companies out there, lots of deep pockets), but it'll still take many years for other competitors to catch up.

[00:06:20] Rob Campbell: And also that they've really designed their platform this way, I think too, right?

[00:06:24] Jeff Mo: Exactly. Yeah, I was really impressed. The management team was showing us the actual manufacturing plants and rooms and every single, essentially, unit or vial was uploaded to the cloud.

[00:06:40] Rob Campbell: Oh wow.

[00:06:41] Jeff Mo: So they knew what happened when through the entire chain of manufacturing, as well as pre-manufacturing and all those steps.

[00:06:47] Rob Campbell: Somewhat related, I guess, to technology, but I guess my question's more valuation in general—whether it's in the U.S. equity space more broadly or more specific to U.S. mid caps, whether it's with some of the hype around AI, real or not, the U.S. has always been kind of a more expensive asset class.

Is that just simply because there's more technology companies there? Or is there something else about the U.S. market that tends to command more premium valuations relative to other parts of the world?

[00:07:21] Jeff Mo: Oh, I think there's some recency bias in that Rob, because you and I have been around long enough to remember that the U.S. was the worst performing development market from '98 to '08. Could be endpoint sensitive of course, '08 not being the best endpoint for market performance measurement.

Every asset and asset class and strategy goes through these things, right? And I think we are coming through 15 years of people thinking the U.S. is a really good place to invest. And rightfully so. I think the U.S., compared to some other developed market peers, has more population growth and despite some of the recent political rhetoric, generally [has] had higher immigration growth as well, [is] generally a bringer of new talents to an economy, and probably one of the best kinds of management complexes globally.

[00:08:01] Jeff Mo: The U.S. has always been seen [as] kind of the bedrock of capitalism and the world's largest economy. There is that dynamism, that creative destruction that comes into play. Currently, I agree. I think the U.S. markets look—compared to other developed market peers as well as many emerging markets on just a straight up P/E ratio measurement—I think the U.S. market is a little bit more expensive today. But again, maybe that's justified given the better macroeconomic setup in the U.S.

[00:08:46] Rob Campbell: Okay. I want to shift gears and how's this first segue? You mentioned creative destruction… regional banks, another theme that's been a big deal in your universe so far this year.

Can you just provide us a refresher as to just everything that's gone on and in particular, at least from my perspective, it's been out of the news for a little while. What's the state of affairs with the regional banks in the U.S.?

[00:09:11] Jeff Mo: Well, it depends on how far back you want to go, Rob. Back in the financial crisis, lots of banks were making residential mortgage loans and generally consumer loans. That caused a financial crisis. And so the regulators decided that, "hmm, maybe the banks should be doing fewer consumer loans." And lots of banks are able to make commercial loans, but usually only in their niche. Commercial loans tend to be a little bit larger, a little bit more complex. You need specific underwriting capabilities. And so, what ends up happening is in periods of easy money and periods where deposits start growing a lot faster than—call it the long-term average, which was the case in the banking system the last maybe two or three years. [Which was] probably not helped by the fact that the government essentially flooded the economy with a lot of extra capital that ended up in deposits.

A lot of these regional banks (like a Silicon Valley Bank that's probably become quite famous), they weren't able to loan out enough of their deposits in their traditional business, which is kind of venture capital lending and lending to founders in Silicon Valley and that type of business.

[00:10:21] Jeff Mo: And so what do they do with all the extra capital? They bought the world's safest asset. They gave it to Uncle Sam and bought treasury bills. Unfortunately, when the central banks started raising rates and the fastest they've done it (whatever it [was] 30, 40 years), all of a sudden those super safe assets don't hold their value as well as the banking executives thought initially. And so Silicon Valley [Bank]… I mean, we're simplifying things, obviously they were the most exposed, but several of their peers were also exposed as it later came out. So, I would say that is what happened.

[00:11:08] Jeff Mo: It's always funny: the regulators are always solving for what went wrong in the last crisis and some of the rules they put in place, such as discouraging residential consumer loans, actually really shrank the avenues for a lot of these banks of where they can lend their money. So they ended up in assets that unfortunately had a lot of market to market issues. And so that caused several banks to essentially run out of capital. Because if you realized all their unrealized losses, they would actually be offside the regulatory capital ratios.

[00:11:46] Rob Campbell: And quite famously, obviously, I mean you mentioned Silicon Valley Bank, but I just wonder with that, at least in your analysis, has the baby gone out with the bath water? In a sense that, are there cases where really good banks have sold down in share price in a way that provides opportunities?

[00:12:04] Jeff Mo: Yeah. So, quite recently our strategy initiated on First Citizens Bank, also known as the bank that bought Silicon Valley Bank.

[00:12:14] Rob Campbell: Ah, okay.

[00:12:15] Jeff Mo: So, there's that tie in there. I would say when you look at valuations being pretty high in the U.S. generally, I think one area kind of post the spring regional banking crisis that maybe didn't follow that kind of rising valuation paradigm was regional banks.

So, this is probably a case of being fearful when others are greedy, to use a [Warren] Buffett quote. For many sectors in the market, we're being a little bit more fearful right now, but with regional banks, we think this is the case where we can be a little bit more greedy because the margin of safety is better. When we do our Monte Carlo/DCF analysis and look at the probabilistic fair value range that we see for some of these banks, First Citizens was one of those banks that we decided to add to our portfolios recently.

[00:13:10] Rob Campbell: Okay. Connected to banks and [I] presume this plays into your discounted cashflow modelling, but another big topic this year, I mean, I suppose every year, but in particular right now has just been the economy. And probably going back a year, the last time that you were on the podcast, I don't want to speak for you Jeff, but I think we all probably thought we were close to recession in the U.S. than we have been. We haven't seen that play out yet. So, I guess I'll just start there. Like, why do you think that is? Why do you think that most were wrong with respect to that?

[00:13:43] Jeff Mo: Well, I wonder if I was one of the ones who was wrong? I don't remember what I said on the last podcast a year ago here, but I definitely think I've been in the camp of expecting an economic slowdown or recession, whatever you want to call the magnitude of that, and so far have been wrong, also.

And for our listeners who may be clients, I do want to point out that while we might spend a lot of time thinking about what could unfold, generally we are preparing and not predicting the future. And so, here's a very good case where I think if someone positioned their portfolio whole-hog for recession, that would've been very, very difficult.

And I certainly could get into the topic with you later as well, but answering your question, I would say—I mean, we're all speculating, right?—but potential reasons might be, back to my earlier point about governments handing out a lot of money during COVID-[19], maybe there was a lot of savings and the system pumped it into the economy. So there's quite a lot of fiscal stimulus that consumers had essentially saved in their bank accounts.

[00:14:54] Jeff Mo: The second is just the standard lag impact of hikes. I was talking about how it was kind of the fastest hiking since the Volcker days, so maybe you just needed more time to see the results play out.

And finally, maybe the right hand not talking to the left hand phenomenon, where in the federal government, especially in the U.S., you're seeing unprecedented amounts of fiscal stimulus through large industrial policy-esque bills targeting various sectors of the economy where the monetary policy is very much trying to put [on] the brakes.

So, I've certainly never done this to my car, I don't know if you're more of an adventurous driver than me, Rob, but when you press the brakes and the gas pedal simultaneously, I don't know what actually happens. I imagine it's probably not good for my vehicle and maybe it makes predicting the economy harder as well.

[00:15:50] Rob Campbell: Can I just try to press you a little bit more on this? I mean, you're looking at lots of different companies—surely there are clues in looking at those businesses that might provide some insight with respect to the direction of the economy just from a bottom-up basis.

[00:16:07] Jeff Mo: Yeah, certainly. I would say… we're sitting in September now, so for all the companies that report with a December 31st year end, we've seen their second quarter earnings announcements out already and yeah, there were several kind of misses. Insperity would be one.

Insperity is what's called a people employment organization. Essentially, they take on [the healthcare benefits [and] HR administration requirements] for small and medium sized enterprises. And so in some ways, they're sort of a proxy on employment. And yeah, they missed their quarter. Partially on the cost side, which is kind of idiosyncratic, but partially on the fact that they gave weaker guidance as well as their actual numbers of new employees coming into the system, [which] was a little bit lower than historically.

[00:16:57] Rob Campbell: If you wanted to look into it and look at it in this way, you could say this might be a leading indicator of where employment might go going forward, I guess is the thought.

[00:17:05] Jeff Mo: Yeah, exactly. Especially the forecast and the guidance that the company is highlighting and essentially pulling back.

[00:17:13] Rob Campbell: Okay.

[00:17:14] Jeff Mo: Another example might be Dollar General. They're a discount retailer, and they were kind of weak. Traffic was weak and inflation has been hitting their business pretty hard on the labour side and on some of the cost of goods side. And in some cases [they were] just not able to pass prices on, or when they have passed prices on, they're not getting quite the same traffic as they used to. So, just kind of showing kind of weakness in the consumer.

But it's not clear, right? Like, for every one of those stories we have an XPEL, which is a company that sells protective film for new automobiles. So, when you purchase an automobile, you want to protect the paint. You can buy, usually, a $2,000 or $3,000 kind of film coating to protect that automobile. They're actually accelerating the last two quarters. I think two quarters ago, back in fourth quarter, they had 12% year-over-year sales growth.

[00:18:12] Jeff Mo: And to be clear, this is a company that's historically had a pretty high sales growth in the kind of 20% range because they have been gaining market share because of their competitive advantages. But 12% growth in Q4, Q1 we saw 19%, and the latest quarter we saw 22% year-over-year revenue growth. So again, it's unclear.

[00:18:34] Rob Campbell: Okay, I see. So, hence, "prepare, don't predict." Shifting gears: the portfolio's done quite well, in fact, very well since you were last on the podcast. Both in absolute terms, but also relative to its benchmark. What's driving this?

[00:18:50] Jeff Mo: Well, I did take a longer-than-normal vacation this summer, Rob, so perhaps I should do that more often. Joking aside—less decisions, exactly—I'd like to think though that it's the same thing that has generally always been driving strong performance across the Mawer strategies. Which is that our careful, relatively concentrated stock picking is paying off for our clients. And strangely, I think there are probably two categories of companies that have generally done well for the strategy over the last year or so.

I think in the first group are companies that should do well in a slow down or recession but certainly maybe nine months or 12 months ago, the market hadn't fully priced them very highly and we thought there were some really reasonable valuations in this group.

[00:19:54] Jeff Mo: So, I would put companies like Winmark, which is up almost 60% year to date. They are one of the largest used goods/used clothing retailers in the U.S. Copart might be another one. They're up 46% year to date, and they are a salvage car auction platform, but they kind of are tied into cycles that are independent of the economy. [They are] more based on miles driven and that type of thing. Verisk as well. They're a data analytics company serving the insurance industry. Insurance, again, usually follows their own cycle, somewhat independent of the economic cycle. They're up over 30% this year and [are] actually a new addition to our strategy.

[00:20:47] Jeff Mo: So yeah, there's kind of one category of companies that have done really well on… call it one end of a hypothetical barbell. On the other end, I would say there are companies that are maybe expected to be a bit more cyclical, and their stock probably got beat up a little bit in 2022. And, perhaps in certain cases, anyway, in our estimation and when we did our valuation work, perhaps got beat up a little too much.

So, companies that maybe we either initiated into our portfolio or added to positions in our portfolio over the last year that have done well would that are also kind of more cyclical in nature—let's say FLEETCOR. They're up almost 50% year to date. And people were worried that some of their payments businesses would see lower volumes because of a recession. Recession didn't come, their volumes [have] actually grown high single digits/low-level digits, depending on the division and the segments. So, they've done very well.

[00:21:46] Jeff Mo: Global Industrial. They're a business-to-business distributor, kind of what's called a MRO (maintenance repair operations organization), and essentially proxy industrial spending or industrial activity in the U.S. And they've also done quite well: the stock's up over 30% this year.

A couple [of] others: Donnelley Financial spun out of, I don't know if you remember a company called RR Donnelley, but at one point maybe 15 years ago, RR Donnelley was the world's largest commercial printer. I don't know if they still are actually or if that company even exists today, but they spun out Donnelley Financial, which is their subsidiary that printed annual reports or proxy materials—that sort of thing for investors.

[00:22:37] Rob Campbell: A real boring business.

[00:22:38] Jeff Mo: A real boring business. But wait! They got exciting. When they got spun out and probably even before they got spun out, the management team of that business started pivoting the company towards software. So, software to help manage your SEC compliance rules when you're doing your quarterly filings, your annual filings, compliance for your IPO prospectus and that sort of thing.

[00:23:01] Jeff Mo: So, today I'd say it's at least, by revenue, almost 50% of that software data type of contribution as opposed to print. And then there's a huge bucket that's kind of services. So, it's a little bit unclear how much is truly called "new economy" versus "old economy." They are cyclical because when there's an IPO, they tend to make quite a bit more money. And I guess [in] 2022 there weren't a lot of IPOs and so the stock got punished. We actually built a position in December of last year and that's benefitted the portfolio since then, with the stock up about 25% since we bought it.

[00:23:44] Rob Campbell: At the same time Jeff, no batting average is ever a thousand…and maybe just to ask the question a bit differently: are there any decisions that you regret looking back over the past year? Either because of the way things played out or maybe just because you felt that the decision making itself in the moment could have incorporated more or sought better context?

[00:24:11] Jeff Mo: I would say where we quote/unquote "didn't follow the process," would be at the margin. Like First Citizens [Bank], actually. While we bought it for the strategy eventually, we actually looked at them essentially as soon as or even slightly before the Silicon Valley Bank transaction was announced.

And even though the stock was up over 50% the day that transaction was announced because it was a very accretive deal and the FDIC (the Federal Deposit Insurance Corporation) that was administering and selling Silicon Valley [Bank], they gave a lot of protections and extra liquidity for first Citizens [Bank], which made it a very downside protected deal as well.

[00:25:01] Jeff Mo: But the reason we like [First] Citizens is, unlike most regional banks, this is one that's still managed by… sort of the founding family. Not quite the founding family, but essentially, the family that today controls the bank. We really like that this management team thought long term and had actually done this FDIC bankruptcy sales process almost 20 times prior to Silicon Valley.

And this was a case where we knew about the company, our valuation thought it was cheap, but we finished our due diligence and were discussing as a team right around the time that first quarter bank earnings were being reported.

[00:25:52] Jeff Mo: And if you recall [at] this time, this was a time when First Republic Bank, which ended up being acquired by JP Morgan, essentially, in a forced acquisition by the regulators (kind of pushing them into JP Morgan's arms) that happened actually right when First Republic reported their first quarter earnings and other companies also reported earnings and showed that their deposit base was quite flighty.

I remember a bank called PacWest during one week was showing, you know, 50% up days and down days, like huge swings day to day. And so, I think there was some… call it macroeconomic caution. So, do I fully regret that? No, I think that probably was reasonable, whereas when we looked at a process—sorry, go ahead.

[00:26:43] Rob Campbell: Sorry Jeff, just to be clear, so the regret is being gun shy, for lack of a better word. For having analysis, for seeing that this really fit, and basically not being "greedy when others are fearful," or whatever that Buffett quote was that you referenced earlier.

[00:27:02] Jeff Mo: Yes. No, you got the quote exactly right. So, I would say that is the regret. It's tinged by the view that, hey, banking is a riskier business. It's a commoditized industry. And you have asset and liability mismatches and ultimately your liabilities can fly out the door very quickly, your deposits.

So, in periods of higher uncertainty and not only investor fearfulness, but frankly, deposit holder fearfulness, we do want to be more cautious. But, certainly in hindsight, hindsight being 20/20, that would've been the time to have bought First Citizens [Bank].

[00:27:50] Rob Campbell: Okay. And so, to be kind, a risk management aspect that's baked around that, that maybe had an influence with respect to the decision in the moment.

Speaking of which, as listeners may know, part of our process or your process is to indeed consider the risks and I know you and our CIO Paul will sit down twice a year formally to really review the portfolio and discuss any risks. Can you speak to either what was most topical in that conversation or what you and the U.S. mid cap team have been thinking about with respect to risks in the portfolio?

[00:28:26] Jeff Mo: Yeah. So, I agree that that is a key part of our risk management process. And for those who maybe aren't regular listeners to The Art of Boring, I would say we have a multifaceted risk management process at Mawer.

The first facet is always our bottom-up stock selection process and philosophy, which focuses on wealth-creating companies, companies with competitive advantages. And we've kind of talked about a few of those today. And we think if a company is competitively advantaged, its position in the marketplace will just be harder to dislodge. Less risks in downturns that way.

But another aspect is valuation and doing bottom-up analysis; making sure we have a margin to safety, which in Mawer language is buying equities at a probabilistic discount to intrinsic value.

[00:29:21] Jeff Mo: And we also have a kind of portfolio level risk management with inherent contradictions. Earlier we were talking about two parts of the barbell. And the portfolio has both for a reason because if there's a recession, sure, some of the companies in our portfolio will relatively benefit more, others will relatively benefit less, but over a five- or 10-year time period, as long as all these companies have competitive advantages and are wealth creating.

And then the last level is the piece you're referring to, Rob, where we have a kind of… call it essentially a check-in or a discussion between the portfolio manager and our Chief Investment Officer, Paul Moroz. And so when Paul and I were meeting, valuations certainly came up as a big risk that we saw in the portfolio. Which is not a big surprise given my comments earlier around how the U.S. markets are [some] of the more expensive ones compared to other developed markets on just the straight P/E ratio.

[00:30:24] Jeff Mo: I would say that is definitely true on an index perspective, but on a on a stock-by-stock basis, certainly I would say the opportunities are a little bit more narrow. Or call it, the margin of safety is not as large as they were even 12 months ago. Certainly, I think this is why we are an active manager with relatively concentrated holdings: to try to de-emphasize or exit out of companies that reach kind of that higher end of our estimate of their fair value range and try to dodge and weave and find a Donnelly Financial or First Citizens. But certainly when an entire market is pricing at a higher kind of average valuation, that does imply a lower future return. So, that definitely is a risk across the index and the portfolio.

[00:31:24] Rob Campbell: I would imagine that valuation's often a topic that comes up at risk discussions, and I just wonder… is there anything specific about today, Jeff, in your view, that… or maybe to ask differently, that you think investors writ large might be underappreciating about that particular risk?

[00:31:40] Jeff Mo: Yeah—the thing that is surprising me is, nobody is talking about discount rates. Or at least not very loud loudly.

[00:31:49] Rob Campbell: I mean, we were last year. [Laughter]

[00:31:51] Jeff Mo: That's true. We were, but I meant that it's kind of not front-page news for The Wall Street Journal. To be fair, maybe discount rates is an esoteric topic that'll never be front page news for any newspaper that wants subscribers to buy their paper. But I remember when I started my career as a summer student back in 2006, the risk-free rates are kind of where they are today. And back then, it was very normal to say, "hey, a P/E ratio of mid-teens is on the expensive side—you better need some growth, or you might need a very, very high-quality company to justify those P/E ratios."

But nowadays, I mean, the market itself…the S&P 500 is trading at a 20x forward P/E ratio. And in individual securities, depending on their kind of perceived quality and growth potential, you know, you see 30, 40, even 50x P/E ratios still. And I think that essentially implies, above the risk-free rate, a very, very compressed equity risk premium.

[00:32:53] Jeff Mo: So, is that because U.S. government bonds aren't perceived as safe as they were 15 or 20 years ago? And therefore, the equity risk premium hasn't moved? [That] actually, that risk premium has increased? I.e., the risk-free rate is not actually risk free? I don't know. That certainly kills a lot of finance assumptions by saying the U.S. government bonds aren't a risk-free investment.

Another theory is perhaps because baby boomers are aging and they're retiring, more and more capital kind of needs to be saved. Although, I mean, that kind of goes both ways because some argue, well, as people retire, they want to spend capital. But at the same time, I think it perhaps shifts the demand for higher quality assets and so on, which is an area of the market we do think is a little bit more expensive today.

[00:33:50] Jeff Mo: Or, you know, could it just be that the investors of today are anchoring off valuation multiples that were used in the last five or seven years but maybe don't really make sense because the risk-free rate is no longer 2% and there needs to be a new paradigm to readjust your expectations. Unless you've spent, you know, your entire career building and evaluating and reevaluating your discounted cash flow model, maybe you don't have that kind of intuitive sense of valuations being a little bit high today.

So, I mean, at the end of the day, essentially what we're saying is a very complex way of saying, investors are not maybe paying attention to the valuations they're paying for some assets. But hey, we like that challenge of finding an undercover gem because it's when most things are expensive that that's hopefully when active management really pays off.

[00:34:45] Rob Campbell: Jeff, I got one more question for you. And it's one that a client asked me recently that I just loved and it was, "are there any elements of process that you or the team are leaning on more, but also less right now. Either as a function of the backdrop that you discussed, or just lessons you've learned in managing U.S. mid cap stocks over the last three years?"

[00:35:09] Jeff Mo: If I were to think about it, it would kind of go back to the same answer that we've been talking about for the last 20 minutes, Rob, which is valuations. And I'll be honest: I would say this is valuations specifically around our discounted cash flow modelling, around doing our Monte Carlo analysis and being very strict with playing around with the scenarios. Thinking not just in scenarios, but thinking through, you know, for a growth rate, what could be the standard deviation on that growth rate? And actually spending thought and debating that, which is a pretty esoteric type of situation, I guess, for investors to be thinking about. Debating the second derivative of one variable in a model that we all know is wrong [laughs].

But that means a lot to us here at Mawer. And I would say it could be the fact that or partially the reason we're doubling down on discount to cash flows. One is the market seems a little bit more expensive today, so we need to be careful with valuations. It could also be a psychological response to the fact that maybe there's a period of time that we didn't perform as well as we had hoped.

[00:36:19] Jeff Mo: Namely, kind of late 2021 to sort of kind of late 2022, when the market bottomed. I think Mawer historically has prided ourselves that our philosophy and our process provide some natural downside protection for our clients. But both this strategy as well as several other strategies around Mawer, while we still provided a bit of downside protection depending on the time period, in our opinion, we maybe didn't see as much as we had hoped there would be.

And so when we did our postmortem, I think a contributing factor to that was perhaps we were a little bit more comfortable in that time period with allowing valuations in our holdings to rise. Or another way to put it, we were accepting of a lower probability of companies being traded at a discount to intrinsic value.

So, nowadays, when we look at the macroeconomic environment as we've kind of talked about a little bit today, you're looking at higher rates, but also lower growth, maybe even negative growth depending on if that recession does actually come to bear.

[00:37:27] Jeff Mo: So, I think valuations are going to be more important. And the duration, the timing of when you get those cash flows are important, as well. So, yeah, I would say when we look at what we've done a lot in the last…call it 12 months, we've been trimming some companies a little bit more when they get to the higher end of their fair value range.

Not to say that we weren't doing that 24 months ago, but I think investing at the end [of the day], it's part art, part science. And I think you have many tools to use and there's always a bit of a debate on which tools you emphasize the most. And so today, I think at the margin, we're emphasizing things a little bit. I don't want to give our listeners the wrong impression, that we [didn't] care about valuation two years ago and now all we do is valuation. But there definitely is a slight shift in emphasis.

[00:38:22] Rob Campbell: Well, and just mathematically, I can understand that if the discount rates are higher today, just looking at five or 10 or 15 years of cash flows, they just feel a little bit more tangible for those near-term cash flows in terms of the analysis relative to a period of time was zero interest rates when a lot of your intrinsic value was based on your continuing value. So, I can imagine there's a lot more importance in that work, as you mentioned.

[00:38:48] Jeff Mo: Yeah. And also more realism, I think. Some of those DCF models (discounted cash flow) models were maybe unrealistic in 2021 because we were saying that, you know, 80% of the value of this company is based on what it can do in 2020, 2038, and beyond. And I mean—

[00:39:08] Rob Campbell: That's a lot of uncertainty.

[00:39:10] Jeff Mo: A lot of uncertainty. And I don't think anyone on our team is smart enough to know what the world's going to look like at that period in time, right? So it just made investing very, very difficult.

[00:39:19] Rob Campbell: Okay, well, that's probably a good place to end it, Jeff. We've talked about, um, in the past just, you know, focusing on what we can control... I think just based on the strategy's performance over the last year, you can control your vacation time. Have another good long one this upcoming year.

[00:39:35] Jeff Mo: Well, thank you Rob. It's great to be on the podcast again today. Thanks for hosting me.

[00:39:41] Rob Campbell: It's great to have you.