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TRANSCRIPT: EPISODE 64
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Please note that these are unprecedented times and markets can react very quickly to news. The views expressed are at the time of recording and could change.

[INTRODUCTION]
Sam Slator (SS): I'm Sam Slator from FundCalibre and today I've been joined by Bob Kaynor who's the manager of the Schroder US Mid Cap fund. Hi Bob.

Bob Kaynor (BK): Hi, how are you? Thank you for having me.

SS: Very well thank you.

[INTERVIEW]
[0:16]

SS: US large-caps have outperformed small-caps in recent weeks, how have mid-caps done relative to their peers? And have you noticed that any particular sectors or individual companies have done better than others?

BK: Sure. We've seen a continuation of a trend we've seen the past couple of years when you're in an uncertain economic environment and growth is harder to predict. You tend to see market participants gravitate towards large cap and safety. That has certainly continued in the sell-off and exacerbated in the sell-off that we've seen recently. And the mid-cap space is performing unfortunately closer to the small-cap space and the large-cap index, the S&P is down about 10% year to date, the small-cap index is down around 21%, which is a tremendous spread and the mid-cap index is down around 18%.

From a sector perspective, you've definitely seen outperformance in utilities, which you'd expect in an uncertain environment, but healthcare has really been an outlier on the upside. Biotech in particular is an area that you typically wouldn't expect to hold up in a market sell-off, that's done extremely well. I think given the nature of what we're going through being a health crisis and biotech being able to deliver a solution to that problem has certainly buoyed that space considerably. It's actually positive on the year, which is interesting in that about 60% of the companies in the biotech index will need to raise money in the next four quarters. So not typically thought of as a safe haven.

But healthcare has certainly been strong. Technology has been strong. And then the classic defensive sectors like utilities and staples. You've seen a tremendous amount of weakness in consumer discretionary, which you would expect. The outlook for the US consumer has changed dramatically in a very short period of time. The US consumer was in an exceptionally strong position going into this sell-off and economic slowdown that we saw. We had high savings rates, we had strong employment, we had slow and steady wage growth. That all changed very quickly.

Unemployment, we will see unemployment rates in the mid teens and that's not something anybody frankly in this industry today has ever experienced. So discretionary has done what you have expected. Energy, we're all familiar with what's happening there. Thankfully it's a very small part of the mid cap index. And financials have been struggling, mostly banks, we've seen strength in the insurance sector actually, and it's an area that we had an overweight in, that's held up surprisingly well in the sell-off.

[3:20]

SS: So you mentioned the technology sector there, the big tech giants like Facebook, Amazon, Apple, Netflix, et cetera. They've led the last bull market and could actually emerge stronger than ever because they'd been in some of the few companies to benefit from lockdown. But they're excluded from your investment universe because they're mega caps rather than mid-caps, so are there any mid-cap tech stocks that you think could be long term beneficiaries of this?

BK: Yeah, I mean there's certainly been the 'stay at home theme' within the market recently. The big FAANG stocks that you referenced. You know, one of the things that we say about technology is there is no supply chain in software, so those companies can continue to perform well, even in a significant disruption environment around the globe.

The big tech companies that you referenced, the FAANG stocks, they're not in our index. Amazingly, they are 22% of the S&P 500 in those five stocks. That's larger than we, that's a larger concentration than we saw in the late nineties. I think it peaked at 18%. So we don't have that dynamic in our space. It's a much more diverse universe. There are certainly companies that are benefiting from that stay at home theme, companies like Peloton, gaming companies, software gaming companies like a Take Two, which we own in the portfolio, has a game, a tremendous franchise in Grand Theft Auto.

I would say there's other companies that are benefiting, that we have in our portfolio, not necessarily in technology, although technology is the delivery platform. One of the companies is a company called Teladoc. They do telemedicine. Obviously with doctor visits down considerably, they are benefiting through an interactive exchange with their doctor. That business has seen exponential growth, which is what you'd expect recently. And frankly, I think just front-ended five years of penetration in the environment that we've been in.

So there are some companies that will certainly benefit. The question for us is always what's priced in. And we're certainly at the maximum point of that fear. And, you know, I think some of those companies have certainly priced in an environment like this that will extend, you know, well into the future. And our job is to make that assessment when too much is priced in.

[6:07]

SS: And you've mentioned Teladoc and seeing a doctor virtually rather than going for an appointment. Do you think that this will continue into the long term and do you see any other long-term changes in the US?

BK: Yeah, I certainly think that that is a trend that will continue. It works for the patient and frankly it works for the doctors and optimises their time, especially not having to be in the office. So I would say that that is certainly a trend we expect to continue. I would say that work at home frankly has been tested and proven to be successful, the technology to support that I would say has withstood the test.

You know, one area that I think was less prepared for this virtual environment, frankly, was education - I don't know if you have children - but my children certainly are having technology challenges with teach from home or learn from home. And so we're looking for companies that help educators deliver content and facilitate online learning. That scenario where we think we're going to see continued investment, especially as we have, universities in the United States that are questioning whether or not the students will be returning in the fall. And so I think there'll be pressure for investment around there.

I think one of the other really unique areas where we're seeing a structural change, in what historically has been a sleepy industry frankly, is food distribution. In the US 60% of the food is consumed away from home, in Europe I believe that number is closer to 20% to 25%. So as we've had restaurants closed, shelter in place mandated, frankly the US grocery distribution channel has not been able to serve that market. The shelves are empty, partly because of hoarding, but partly because the distribution infrastructure is not in place to support eat at home. I think our eat at home trends are going to increase in the United States. I don't think you're going to have 60% of food consumed away from home. And we are identifying companies that can help facilitate that transition to kind of a more eat at home culture then we've seen historically.

[8:30]

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SS: And you also mentioned earlier the unemployment figures and the fact that the US consumer has their outlook has changed completely. Do you think short term that's going to have a really significant impact on the US economy? We've heard reports here that people who have gone on to unemployment are actually earning more than they would do if they were in a job etc, having to go then back to a job that pays less and being uncertain, do you think actually the demand is going to be here for a lot longer than we perhaps expect?

BK: So as part of the Cares Act that was passed, I guess a few weeks ago, it feels like a few years ago, the extended unemployment benefits are very, very friendly right now. In certain States, you can earn $55,000 a year on unemployment. We have extended unemployment benefits to the tune of $600 a week that go through the end of July. It's very likely those might get extended, especially in an in an election year, but so I don't know if the consumption patterns are going to change dramatically in the near term. I think as we get closer to those extended unemployment benefits expiring, you could start to see a significant change in behaviour. We’ve already seen savings rates go up last month in the United States. People are paying down their credit card debt. We're an economy that's 70% driven by the consumer, so that could have a meaningful impact.

So I think the short answer is not necessarily in the near term, but certainly as those extended unemployment benefits begin to expire, you could start to see a real change in behaviour. And the other question is, as some of these service companies start to reopen, like restaurants and bars that traditionally pay their employees lower wages, will they be able to find the employees? Will those employees be willing to come off that unemployment benefit that is very friendly right now in order to take up a lower paying job? I think, in our minds that's frankly when the rubber really hits the road on this recovery.

[10:50]

SS: So you're based in New York, which has been the epicentre of the virus very much in the US. What's lockdown been like, and when do you think that lockdown could be lifted?

BK: I believe that New Yorkers have perhaps hit their limit on compliance. I think you're starting to see, as the weather has gotten nicer, shelter in place is perhaps not being abided to the way it was. Right now Governor Cuomo has a May 15th date to begin to staged reopening of the economy. I think that the New Yorkers are trying to push that. I think as the weather's gotten nicer, you can see pictures around New York City of parks last weekend where things were starting to get very crowded. I can tell you that road traffic around the New York City area has picked up considerably over the past couple of weeks. So I think we're trying to rightly or wrongly force a reopening of the economy. But for now May 15th is the date that we begin the staged reopening and hopefully by mid to late June we see a new normal start to evolve. And again, that will be data dependent and we'll have to be watching kind of how the numbers come in around infections and deaths over the next four to six weeks. But I think May 15th we'll start to begin the reopening process.

[12:18]

SS: As a mid -ap manager, how optimistic are you feeling at this point about the opportunities you've got now over perhaps the next two to three years?

BK: So I've always viewed portfolio management as a process of harvesting and planting seeds. You never really want to be doing one of all and none of the other, I would say that this is an incredible environment to begin planting seeds. The investments you make today in the types of companies that are very high quality with defensive topline characteristics, strong cash flows and visible longer-term growth opportunities. They may not pay dividends in the second or third quarter, but as you look out into the fourth quarter and into 2021, these companies are very well positioned to generate phenomenal returns for shareholders over time. So it's an exciting time to repopulate the portfolio - to plant new seeds. But we have to be realistic in terms of how that, what that maturation curve looks like, and with all of our investments, we're taking a two to three year type investment horizon, and through that lens it's a pretty exciting time.

SS: That's brilliant, thank you. I'm Sam Slator and if you'd like to listen to more of the Investing on the go podcast, please subscribe and if you'd like to find out more about Schroder US Mid Cap fund please go to FundCalibre.com