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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]
**Darius McDermott (DM)**: Hello I'm Darius McDermott from FundCalibre and this is the Investing on the go podcast. Today we are talking to Mark Sherlock who is the lead portfolio manager of the Hermes US SMID Equity fund and Steve Chiavarone who is also a portfolio manager within the firm. Hi guys, thank you very much for taking the time to come and talk US SMID cap ideas with us today.

And maybe just before I jump into the questions SMID cap refers to small and mid-size companies within the US market and the opportunity set that they have within them. So let's jump in then to a few questions.

[INTERVIEW]
[0:47]

**DM:** Wow. What a year we've had so far but, as you went into 2020, the portfolio was positioned for a positive economic environment, I'm assuming that views have changed, you've been probably reasonably busy in the last few weeks. Can you tell us about some of the activity that you've done on the portfolio and maybe some areas that you've actually bought, and or added to, or sold?

**Mark Sherlock (MS):** Absolutely yes, as you suggest the portfolio was positioned going into 2020 for a reasonably benign economic backdrop, clearly the arrival of Coronavirus has changed that markedly. I would say in terms of the actions that we have taken on the portfolio, relatively promptly at the beginning of this crisis, we did a really, rather recent large review of the portfolio and really specifically focusing with a laser focus really on balance sheets.

There were lots of things that we didn't know like the duration of this pandemic and the economic effect that it would have, but what we did want to be sure of was that where in the portfolio really all the companies could sort of make it through. I should note that this was already a strong group of

businesses of the circa 60 stocks we hold in the portfolio, at a portfolio level we are two standard deviations under the market in terms of leverage. In other words, our companies have a lot less debt on average than the market itself.

That being said, following this review and following a large number of calls to our underlying businesses, we chose to exit four out of the 60 positions. Two were oil-related companies, really there we had this double hit of excess supply hitting at the same time as a significant drop off in demand. The oil price has fallen significantly since that period and of course the prospects of those oil businesses. The other two companies that we exited were real estate REITS, so they're companies that own shopping malls throughout the US. Again for obvious reasons people aren't allowed out of their homes, mall traffic was down significantly, this obviously puts in jeopardy the ability of companies to pay their rent and ultimately that goes back to the landlords who themselves have debt themselves attached to those properties. So, in terms of what we exited those were the principle moves in the first couple of weeks.

We then reinvested those proceeds into two tech businesses. One that we'd owned previously called Teradyne, they make testing equipment for microchips. So, anything that you use that has a chip in it needs testing and these guys are the largest provider in test equipment. And the second was a company called Power Integrations, in a similar sort of space, they provide power solutions for microchips and semi-conductors. That could be converted from AC to DC power, altering the volume of power going into a particular chip and so on. So, these are both structural growth stories with fortress balance sheets.

[4:03]

**DM**: One observation that you've made is that sort of the increasing gap, valuation gap, between small and large companies. I notice particularly on the NASDAQ, but to a lesser extent the S&P, that the US large caps have been very robust and traded very strongly in the recovery. Steve, could you tell us a bit more about that sort of valuation gap that you see between the mid and smaller companies and the larger companies in the US please?

**Steve Chiavarone (SC):** Yeah so small cap companies, as is generally the case, underperformed in the initial stages of the crisis. Why might that be? Well first off, you had stress in the funding markets and these companies are looking for external financing quite a bit, smaller companies in general, and so they really did underperform in the first stages of the crisis. However, we're now transitioning from crisis to recovery in its early stages, and in general smaller cap companies tend to do better in that earlier recovery.

So for example, from the market bottoms that occurred during recessions, if you look out one year from that date, small caps as measured by the Russell 2000 have on average achieved a 75% return – that's 7, 5 – which is 25% better than the return that large caps have achieved over that same time

period. So, we think there's a number of factors at play. One, small companies tend to do better in the early stages of a recovery. Two, tremendous support. Both the Federal government and the central bank have liquidity measures and support measures in place, primarily directly at smaller cap companies which we think is going to be a real boost to them. Three, we think that we're seeing the re-onshoring of manufacturing in jobs from emerging markets back to the United States. And we think that small caps about going to be a big part of those reconfigured supply chains. And so, for those reasons we expect to see significant catchup and then leadership by small and mid-sized companies in the kind of months, and weeks and months to come.

[6:11]

**DM**: So, what sort of sectors or industries are you finding particularly interesting at the moment?

**MS**: I would say given that we run a broad-based exposure within the portfolio there are two elements, perhaps in areas in different parts of the portfolio which we think look really interesting at a minute. The first in what might be described as the more sort of growthy end of the portfolio is some of our medical equipment manufacturers. Of course, there's been an increased focus on medical equipment given the global pandemic and thoughts round who might be the beneficiary of those.

I would say in terms of the stocks that we own, we have exposure in two particularly interesting areas. First is a company called West Pharmaceutical, and they make the packaging for biotech drugs. As you can imagine as the global search for a vaccine for Coronavirus intensifies, so we feel that this is a business that could benefit from, in terms of its packaging expertise, from that particular exposure. Similarly, we own a company called Bio-Rad, which manufactures the chemicals involved in biotech production. Again, it is currently the only company that is listed in the US that has exposure to COVID-related trials in terms of the kits that they provide for Coronavirus testing, so an exciting sort of space to be in, from a business growth opportunity point of view.

I think the other area that we look at as broad-based fund the other area that excites me is some of the more value sectors. So I'd pull out some of the financials, insurers and banks, they are really trading on incredibly low multiples, there's a lot of pessimisms baked into those valuations which I believe over time will prove unwarranted. While there had been some challenges in terms of interest rates falling, reducing the ability of banks to make money, the valuations fully reflect that and I think they went into this crisis much better capitalised then in the great financial crisis. They've taken significant provisions for loan defaults, which again I think will prove overly pessimist over time.

But I guess I would really sum up that the value opportunity in the portfolio as a whole, the PE valuations, so the price earnings measure of the portfolio, which is the same as the market is down

around 14 times against a history of around 17 times. So a 30% drop in the multiple that you're paying for these types of stocks and within the upside of our portfolio as a whole, you know typically that's ranged between 15% to 25% and that's around 45% currently. So I think a very interesting set up from a valuation point of view and a good base from which to generate decent long term returns.

[9:25]

**DM**: So you're seeing certainly plenty of opportunity for you as a good stock picker. Probably one of the most talked about sectors as a beneficiary of what we're going through, lockdown globally, is of course technology. One instantly thinks of a Netflix or an Amazon, these big US tech powerhouses. What about in the US small and mid-sized areas, are there any tech stocks you can tell us about that are benefiting from the working from home or the delivery type angle, what's interesting you, what are you seeing at the moment?

**MS**: Well I'd say we have a number of exposures to that theme if you like. As you say I think we've all experienced the power of technology over the last two months to really help keep the wheels turning. I'd say you know picking out a couple of examples, we own a company called PTC and they're very much benefiting from this convergence of the physical and the digital worlds. If you think about it, you may be familiar with the concept of IoT, 'Internet of Things' which is in simple terms is really machines increasing their ability to talk to one another and make life easier for those like us who are operating those machines, be it in the home, in the office from a communications standpoint and so on. So I think often these periods of crisis exacerbate and speed up change and I think this could be an example of that really where these IoT endpoints are forecast to grow by 30% a year through the next five years. PTC's - the company that we own - has great relationships with the device manufacturers and is really in a unique position to drive significant acceleration in growth to their nascent IoT business. In simple terms it enables customers to connect smart devices, so that would be certainly a holding we would expect to benefit from this type of trend you talk about.

[11:43]

**DM**: Another observation is the deterioration in the relationship between the US and China. Again at the turn of the year before COVID really spread to the US and Europe, there looked like the trade [war] was improving but now that the rhetoric is very much negative, it's also a US election year and there's always some fallout from that particularly with Donald Trump and his relationship with China. Where do you see potential opportunities? Will there be more manufacturing return to the US from some of these overseas areas and how will that effect maybe supply chains and where the US can actually benefit?

**SC**: Yeah I think this question is directly tied to the last question because technology I think is at the heart of this issue. Companies by and large went to China for cheap labour. That was the initial push towards kind of moving manufacturing to China. However, technology - and we talk about it as a digital revolution. It's the Internet of Things that Mark talked about but it's also automation and robotics and artificial intelligence and 5G Internet and advanced bio tech, I mean you can…it's a much more robust set of technologies.

Well one of the effects of that is it decreases the reliance on labour in manufacturing: labour's a smaller part of your input and, you know, to take that to the extreme, once your factory is run by a robot you don't want it in China. Your shipping costs are higher because your primary end markets are still the East [and/or] West Coast of the United States and Western Europe. They have no reliable source of cheap energy. You have no real intellectual property protections. You have uncertainty on the Korean Peninsula - we don't know if Kim is alive or dead half the time. You have the threat of tanks rolling into the financial centre in Hong Kong and, if I may be so indelicate, we've got a global pandemic that originated in a city that most of us hadn't heard of three months ago. And the government in China may or may not have been as forthcoming and transparent as the global community of nations would have preferred, so that's not exactly the ideal setting that they write about in Business School.

By contrast, we think that the centre of the United States is emerging as one of the next great emerging markets, actually. When you think about it there's more land then we can fill with people. For those of you who haven't been there, go to Tulsa, Oklahoma – there's plenty of room. Easy shipping routes to the East and West Coast, which are two of the primary end markets. We have so much oil that we can't store the next barrel. The 750-million-barrel storage facility in Cushing, Oklahoma – is full. We have one of the lowest tax rates in the world, an educated workforce, I've never heard of any weird diseases coming out of Kentucky - although they do make some wonderful bourbons - and, as the song says we have Amber waves of grain. And so one of the things that we expect to see happen is a kind of manufacturing renaissance in the centre of the United States and I think that's.. well the United States, and the centre of the United States, is, you know, is particularly well-positioned.

I think the broader point is that economic growth in the long run is a function of population growth and productivity growth. And if you look at those countries where those are in abundance it's the United States, Australia, Canada and India - it's the former British Empire. I don't know why, just seems to work out that way. And so, we think that those are particularly well-positioned economies and the centre of the United States in particular, especially because policymakers are very much on this theme. And are uncomfortable with facts like 30% of US medication coming from China, we think that they're going to encourage that, they're going to incentivise it, we think this is what the trade war is essentially about, and we think that's going to be great for small caps because again they're going to be part of those supply chains for those companies coming back and they're going to service those employees, there are going to be the restaurants that sell lunch to these folks, there

are going to be the haberdashers that sell clothes to these folks and so it's one of the reasons why in the long run were very, very excited and bullish about not only the US, but small caps within the US.

[16:22]

**DM**: So, it sounds like even in the height of global pandemic and doom and gloom, you actually see some strong positivity. Positivity not just for the US but in particular the centre of the US and clearly the beneficiaries of being US middle and small sized companies.

**SC**: Yeah but it's not to minimise the pressure that we're under, I mean the second quarter of 2020 is likely to be the worst quarter of economic growth, I don't know – ever?

But it does not detract or derail some of these longer term themes: themes of population growth - albeit at a slower rate - but population growth in the parts of the world that I mentioned, themes of innovation. And, when you think about you know what Mark said, we expect to see accelerated spending on technology, as companies re-evaluate their 'work from home' solutions and their cloud computing and their Internet connectivity and, their network security, well that means you're going to see greater spending there, which accelerates this digital revolution we're talking about.

Similarly, with healthcare you know one of the tragedies here is the reason we all had to lock ourselves in our homes is because our healthcare systems weren't prepared for a pandemic. Well, I expect you'll see stockpiling of key goods and medications and investment in that infrastructure and so what we're going through is incredibly painful and sad and I don't mean to minimise that at all, but crisis has both risk and opportunity and we think some of the longer term opportunities remain a) robust and b) maybe accelerated in their progress by the crisis.

**DM**: Listen guys that's a fantastic roundup. Mark, thank you very much. Steve thank you very much for giving us a real insight into some of the opportunities in the US mid and small cap arena. For more information on the Hermes US SMID Equity fund please visit FundCalibre.com and if you wish to subscribe to the Investing on the go podcast please also visit FundCalibre.com