

TRANSCRIPT: EPISODE 289

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[INTRODUCTION]

Staci West (SW): Welcome back to the 'Investing on the go' podcast, brought to you by FundCalibre. This week we delve into the US equity market, exploring market trends, investment strategies and the potential shifts that may shape the future of US equities in 2024. I'm Staci West, and today I'm joined by Bob Kaynor, manager of the Schroder US Mid Cap fund. Bob, thanks for joining us.

Bob Kaynor (BK): Thanks for having me.

[INTERVIEW]

SW: Now, I want to start with setting the scene a little bit for US equities, which many headlines that our listeners will have seen and know about have been strongly dominated by the 'Magnificent Seven'. Do you think that this is set to continue? Maybe touch on a little bit what it is and how that's influenced what you're seeing.

BK: Sure. I mean, the dynamic in the US equity market is that we really have two markets: we have a market of seven stocks, and everything else. Earnings growth this year, as well as price performance, has been dominated by just seven companies - I think we all know who they are [Alphabet, Amazon, Apple, Meta, Microsoft, Nvidia and Tesla]. But, excluding those companies, the S&P - I'll say 493 - is basically flat on the year. So, all of the return that you're seeing is dominated in a handful of stocks.

The market, frankly, is as concentrated as it's ever been, both from a weightings perspective as well as an earning growth contribution perspective. So, that's kind of the market we're in. I think that if you look ... one way to kind of gauge this is if you look at the difference in return between the S&P 500, which is market cap weighted, and the S&P Equal Weight Index, you will see that the return has never been this wide unless you go back to the late nineties, so it's a very similar dynamic that we saw in the late nineties, and I would say generally, it's not necessarily a healthy market where you have very narrow leadership.

So, do I think it is set to continue? The answer is, we are at historical extremes, so there's no reason that can't continue. But I would also say that it's probably about as far as it seems to go. I mean, we

TRANSCRIPT: EPISODE 289

are so dominated by just a small handful of stocks and you're starting to see the market broaden out recently where participation's expanding, beyond those just Magnificent Seven. And I think that that's a very healthy dynamic, not just for mid-cap companies, but really for any index that is not so market cap dominated.

SW: And the Magnificent Seven, for those who don't know, are pretty much tech companies or heavily influenced by AI, which we've seen recently [**BK:** Yes.] Do you think that the kind of tech / AI bubble is about to burst, have valuations just got too high?

BK: I think the fundamental momentum behind AI and the spending behind that is certainly set to continue. Large language models have been kind of with us for a long period of time, but they're certainly going to the next level in terms of capability and compute power.

So, do I think that the bubble is going to burst? I don't know. Valuations are certainly high.

If you look across those Magnificent Seven, those companies are trading at multiples (other than Google) those companies are trading at multiples approaching 40 times earnings. They're EV - enterprise value - to revenue multiples are high single digits approaching double digits. Those are huge valuation numbers, relative to any other equity asset class globally. They are expensive.

Ultimately, what causes the bubble to burst is what better opportunities exist. And when you have - if and when you have - improving fundamentals in other parts of the market, that will cause the flow of funds tide to change, and that's when you'll see markets move away from just a small kind of handful of stocks or handful and a half of stocks. Valuation matters and valuations are at an extreme, but ultimately you need a change in fundamental backdrop in order to catalyse that change.

SW: And what does that mean for you and for this fund? So, your hunting ground is small and mid-caps as you said, for the US Mid Cap fund, which makes sense. So, what does all of this mean for the companies that you are looking at? Do you see more opportunities in your area of the market?

BK: I think that the valuations are at extremes. They are priced, you are getting paid to take risk in the small and mid-cap market. If you just go to your classic, you know business school kind of equity risk premium; there is a large equity risk premium that exists in the small and mid-cap space and a negative equity risk premium that exists in the large cap space. So, that tells me that it doesn't take much to be right and to get rewarded. Valuations are extreme, fundamentals are improving, and I think importantly, it is the fundamental improvement that's going to drive that change. And the fundamental improvement in the small and mid-cap space in the US is going to be driven by fiscal stimulus.

TRANSCRIPT: EPISODE 289

We've had a large amount of stimulus get approved, whether it's the Inflation Reduction Act, the CHIPS and Science Act, the infrastructure bill, all of that is incentivising domestic spend and domestic manufacturing - and the small and mid-cap companies are poised to be the main beneficiary of that. So, that's where I see the catalyst for the change occurring. And I would tell you through our work, we are seeing that money through those fiscal stimulus programmes just start to get released and just start to flow downstream. And that's where we can make the case for improving fundamentals, which is what matters.

SW: So, do you think that investors will see more of that money then coming through in 2024, ultimately making kind of now the good entry point to get the access, before all that money comes through to the companies that you've just talked about?

BK: It is always hard to pinpoint the exact time when the tide is going to turn. From our perspective, we build mosaics; we, everybody in this industry works with hopefully less than perfect information, so you try to build mosaics and make the case.

But the space, I would tell you, small and mid-cap stocks feel like a ball being held underwater. You started to see that outperformance last year. In fact, I think what's lost on a lot of people, or a lot of investors, is if you looked at the end of February of 2023 and you look back over the trailing 12 months, small and mid-cap stocks were outperforming large cap by 500 basis points. That was into an environment of the Fed raising rates, of downward earnings revisions, and the market pricing in at the time everybody expected an imminent recession. And yet small and mid-cap stocks were outperforming because we had a similar dynamic to what we're experiencing today. And I've always argued that it's not the cycle you're in that matters, it's what the starting point is. And the starting point was extreme.

Not to go too far into it, but what unraveled that kind of momentum for the asset class, frankly, was what happened with the regional banks in March. Those are small and mid-cap banks. If you think about regional and community banks, they're very large in small and mid-cap indices. In the large cap indices, you're dealing with big money centre banks. What happened, the banking crisis in March of 2023, was a small and mid-cap problem, created significant downward earnings provisions in the space. And I think that that is what prompted the trade out of small cap into large cap that we saw in March of this year, further exacerbated by what we saw in May with NVIDIA and their tremendous earnings report.

So, understanding kind of what changed the momentum is important, and I think that the pendulum is poised to swing back in the favour of the small mid-cap space as you start to see improving relative earnings. And that's what's going to matter.

TRANSCRIPT: EPISODE 289

SW: And you and I have talked a number of times throughout the years, and one thing that you have always said is that the mid-caps you believe, are the heartbeat of the US economy. So I want to talk about the US economy for a little bit, and I'm going to start with something that's near and dear to my heart which is student debt. We have student debt repayments starting again in the US combined with higher interest rates. Do you think that the US consumer can continue to power the US economy onwards as it has recently?

BK: It is a great question. And when I think of student debt, you know, we have a bifurcated consumer in the US. If you look at spending behaviour and savings rates by income cohort, it's very different. The low end is clearly struggling, higher interest rates, we're seeing revolving debt increases, we're seeing subprime auto loans start to deteriorate, we're seeing deterioration in credit card debt. But when I think of student debt, student debt is really, it's not the low end consumer. The US individual that has student debt is of a higher income cohort; they tend to be homeowners; they tend to have good income. I don't think student debt is going to be the problem for the US consumer.

I, frankly, am more concerned about what happens to the employment cycle. We've started to see deterioration in some credit metrics that impact the low-end consumer, but we haven't yet seen unemployment turn the wrong direction. I get concerned with the US consumer when we see the services industry slow down and that's where many of the low income consumers, where they get their jobs. So, that's the part that concerns me.

I think the US consumer is in a very tenuous situation. We talk a lot about pent-up savings. I don't spend a lot of time looking at the savings rate data. I think if you go back, you'd see that it is the most revised set of government data there is, and there was a big revision again that was made to pent-up savings last month. So, from my perspective, I am worried about the consumer. I take some comfort in the fact that a lot of our enthusiasm for the fundamental improvement is being driven by fiscal stimulus that's already in law, where the money is already allocated and is finally starting to flow downstream.

I don't think the US consumer is what is going to pull us into a recession, unless we see a quick and sudden deterioration in the employment picture.

SW: I was going to just say on the employment side of things, is that something that you talk about or see with the companies in your portfolio, as a potential concern on any of them?

BK: Yes, we build our views generally based on the conversations we have with our companies; we speak to over a hundred companies a quarter. One of the things that became clear at the beginning of this year, and frankly one of the complicating factors for the Fed, is that there is there is labour hoarding in the US — companies that are slow to lay off employees. Because what they

TRANSCRIPT: EPISODE 289

experienced through Covid, when they tried to manage their discretionary expenses quickly, they lay people off: quick recovery in the market, they couldn't hire them back. And when they did, it was very expensive.

Through this cycle, we're seeing our companies and companies broadly in the US hold on to labour even though they're experiencing some modest, top-line deterioration because they don't want to try to hire those people back six months from now if things recover, given the experience they had during Covid. And I think frankly, that's one of the problems or struggles for the Federal Reserve is they've been raising rates for 18 months and there's been no real deterioration in employment, and I think that's a function of this labour hoarding that I was referencing.

SW: Just talking about things that you are speaking to your companies about, and as you mentioned, you speak to hundreds of companies a year, so one of the things next year in particular a lot of people will be looking towards is not only the US election, but there's a number of global elections and how that influences the economy and the stock market. Is this a discussion that you are having with companies already or in the future? Or is it something that, you know, isn't really on your radar because you are talking about other things?

BK: Yeah, so we certainly don't try to pick election outcomes. But we are always aware of what potential policy shifts may occur. If you go back to 2016, that was probably the most significant impact from a policy perspective; nobody expected Trump to get elected. There was massive policy implications around that election. When we think about what's at stake, if you will, as we look into 2024, a lot of what's driving the interest and enthusiasm and excitement around the asset class is a function of fiscal stimulus plans that have already been made into law and already gone through the rule-making process. So, I don't view that as a significant risk. We have a very tight Senate and House of Representatives, so unless there was a landfall, not just in the presidential election, but in the Senate and in the House and a massive swing one way, I don't really see how that would change our working view of the direction of travel here. And based on everything we've seen, it's unlikely and perhaps fortunate that one party won't be dominating <laugh> all three branches of government.

SW: Slightly shifting, just to look specifically at your fund is that you have three insurance companies in your top 10. So, just a little bit curious about this, are you seeing a lot of opportunities in insurance and the financial space or is it something else entirely?

BK: Yeah, so I mean, when we have overweights in - and I'll say sub-sectors, because this really isn't about the high level industry of financials - our financials exposure hasn't changed too much over the past year and a half, but we've gone from significantly overweight banks to underweight banks and from underweight insurance to overweight insurance. And that view is driven by a bottom-up view on individual companies.

TRANSCRIPT: EPISODE 289

But when we do that work, we tend to step back and say, well, we have a number of companies that are all fitting in the same space; is there a macro view that we need to have a better understanding of or a structural change in the industry that we should start thinking about?

So, one of the things we like about insurance is they are cyclical businesses, but they are not tied to the macro-economic cycle. You can target certain verticals within insurance - they could be non-standard auto, they could be homeowners' insurance, it could be insurance brokerage - so, the overweight in insurance is a function of ideas, bottom-up driven. It's a function of not being dependent on an economic cycle to drive increasing returns. And the general view is that we've had loss of capital come out of the insurance industry over the last few years. Up until this year, we've had a number of catastrophes, storms, tornadoes, earthquakes, the past year it's been very benign and that those loss events are going to keep capital on the sidelines, and the established industry players are going to have a multi-year runway to improve returns. Ultimately, capital will come back and change the pricing dynamic. But for the next couple of years we see a very favourable dynamic that's not tied to the broad economic backdrop.

SW: And well, speaking of looking forward, we are at that time of year where we ask everyone to get their crystal ball out. So, what is your outlook for US small and mid-cap? Let's focus on your area, we'll leave tech and the 'Magnificent Seven' aside for this bit, but what are you looking at internally? What are maybe your companies saying to you? How are you feeling about the US consumer, putting together all the little bits that we've talked about throughout this podcast; how do you feel about that outlook for 2024 and further afield, three, five years?

BK: So, I think when you look through the telescope as opposed to the microscope, you know, when cycles change, they're not short-term in nature, they're multi-year. So, I see an improving fundamental backdrop in the small and mid-cap space for all the reasons we discussed and valuations that I would say are unsustainably cheap. I do think that what happens in small cap is somewhat a function of - from a fund flows perspective, not from a fundamental earnings growth perspective - is somewhat inextricably linked to what happens with the 'Magnificent Seven'. They're expensive, they're crowded - what causes allocators or investors to move away ultimately will come down to better opportunity sets. Whether that better opportunity set is small in the small US small / mid-cap space or if there's improving opportunities in other developed markets.

I think one of the dynamics we've seen this year is that global allocators don't feel like there's a lot of opportunities and equities so they end up buying the ACWI [MSCI All Countries World Index]. I think there's a view that somehow this is a diversified benchmark when in fact almost 20% of the ACWI is in those same seven stocks. So, perhaps an improving backdrop in Europe, improving backdrop in China, causes money to go out of an ACWI-type index, which is almost by definition forcing buy-in in these seven stocks.

TRANSCRIPT: EPISODE 289

Perhaps that's what ironically improves the outlook or the flow of funds into the small and mid-cap space in the US; that I'm not entirely sure of, but what I am sure of is that valuations are fundamentals are improving absent a rapidly deteriorating economy, which we don't see, and that the cycle that we're in is not connected like we've seen in other cycles; things aren't moving up and down in unison.

The way that we went into Covid and different companies and different industries came out of Covid with supply chains opening and closing at different times, leads us to an environment where the cycle is pretty diverse. There's companies, there's lots of industries, opportunities within particular industries, irrespective of what's happening around the broad economic backdrop because of the way we went in and the way we came out of Covid.

So, I think it's an exciting time to be frankly in active management. I think it's an exciting time for the small and mid-cap space because I see valuations that are extremely depressed and fundamentals that are improving, but it's going to require a continuation of fundamental improvement for investors globally to take notice.

SW: Bob, thank you very much. You've certainly made the case for US mid cap and always it's lovely to catch up, so thanks for making time for us today.

BK: Thank you so much.

SW: Run out of New York by Bob Kaynor, this fund invests in equity securities of small- and mid-cap US companies. Bob's goal for the fund is to offer access to a risky asset class, but at a lower level of risk. To learn more about the Schroder US Mid Cap fund, visit [FundCalibre.com](https://www.fundcalibre.com) — and don't forget to subscribe to the 'Investing on the go' podcast, available wherever you get your podcasts.