[MUSIC PLAYING]

We're seeing a market environment now where growth is a little bit challenged. But at the same time, we're seeing lots of companies that are able to demonstrate still very good earnings growth in this environment.

There's probably 150 managers that we may look at and evaluate as a peer group that we're comparing them to. Compare that to probably north of 500 on the large cap side. So you've got a smaller universe to evaluate those managers.

Think like a business owner when you're buying a share of stock. So as investors, we really think you should be focusing on managers that think like business owners. High free cash flow, high return on invested capital, management that makes smart decisions with their money.

Derek, midcaps have historically delivered better risk adjusted return than their small and large cap brethren. Why do you think this is?

So it's definitely true that that's been the case, especially if you look longer term. So if you look at 10, 20 years, the returns in the midcap segment of the market have bested that of both small and large cap both on an absolute basis and on a risk adjusted basis.

And so I think one of the main reasons that that's been the case, when you think about what is a midcap company, it's a company that's sort of graduated, if you will, from its more risky startup phase, yet still has many years of growth before becoming a mature enterprise. And so they're really in that sweet spot of their growth cycle, if you will.

And so that's when you see companies expanding into new markets, perhaps offering new products and services on top of the original ones that they might have developed, and really kind of exploding in terms of their growth potential. And so we see it as a part of the market where you can get access to companies that are really thriving and have many years before they're likely to be mature.

They still have that big runway for growth. But on the other hand, they've got less volatility, more access to debt, better management teams. Would you agree?

Yes, very much so. From our perspective, it's kind of interesting because midcaps kind of straddle both sides of the fence. You're buying the larger end of the small cap space and smaller into the large cap space. If you think about it, a large cap manager, the way they increase the return potential in your portfolio without going out of their

space is you buy the lower end.

Conversely, for a small cap manager reduce the risk, you buy the upper end of that space. And midcap, by definition, does both. So you get less risk in small cap, better returns in large cap. And by and large, it's translating into very good long-term rates of return.

And how do you define the midcap space? A lot of times you see $2 billion to $10 billion in market cap. How do you see it, Bryce?

Yes, that's the traditional definition, is somewhere in that $1 to $2 billion on the low end, all the way up to $10 or $12 billion on the upper end. But I will say it's been unique the last several years. The Russell Midcap Index, which is a common index used, of course, has 97 securities that are larger than $10 billion.

Coming into the year, of course, everything has come down dramatically as we've started 2016. But coming into the year, there were five securities that were larger than $30 billion in the Russell Midcap Index. So clearly we've seen there are some very large companies that are within that index. But that's historically been the common definition for midcap.

And our definition that we use is $1 billion to $10 billion, so very much within the range that Bryce is talking about.

So I guess my definition is a little bit more flexible because we'll look at what the constituents of the midcap indices are. So we'll look at both the S&P 400 and the Russell Midcap Index, and we'll kind of define the universe by the smallest constituent that resides in those two indices, and the largest. So we formally will go up to $30 billion, but we would never initiate a position anywhere near that size. But we could let them appreciate up into the largest kind of constituent of the Russell Midcap Index.

And we certainly let ours appreciate. We won't take them out simply because they've exceeded the $10 billion space.

Which is a good problem, right?

Right, very much so. And Malcolm, do you see midcaps as more of a domestic play? I mean, with all the preoccupations that investors have had around oil, China, strong dollar, how do you see it?

Well, we are, by definition, domestic only managers. So if it's traded in this country and we can get its financials on US GAAP, we'll look at it. Most of what we own is domestically focused, although midcap companies do have international exposure. Many of them have some small overseas offices or they have sales overseas, so you do get some of that exposure.

And particularly over the last few months, really second half of 2015, it really hasn't mattered how big or how small you are. China and energy and all that kind of stuff have really flowed over into our space. So it really hasn't made all that much difference.

Hasn't made a difference. Do you see the same thing?

I think the reality is is that midcap companies do have exposure to overseas markets because it's a global economy that we're in. And they're often serving markets outside of the US, and that makes a lot of sense because they're trying to maximize their opportunities.

And I think the pendulum shifts. So when the international markets are doing better and China is on a roll, everyone wants that international exposure. Right now, when we're seeing a little more volatility and slowdowns in some of the emerging markets, people want to insulate themselves from that exposure.

I think relative to large caps, you're going to have less international exposure, typically, with midcaps, but probably more than you would with small caps.

Well, is there more opportunity right now in midcaps, because when you talk about that insulation, when we're seeing less visibility around earnings and growth, maybe, is that more applying to the large caps, the mega caps than it is to small or midcaps?

Yeah. I think whenever you have crosscurrents in the market from a macro perspective, whether that's a slowdown in China or currency movements, that can be quite impactful when you're translating to US dollars. The impact is going to be felt, I think, across the board. Whoever has that type of exposure is going to feel it. I think large caps, perhaps to the extent that they have a greater portion of their business from those types of markets, might have greater uncertainty.

But if you look at historically, if you use, like, earnings surprise as a proxy for visibility, if you will, you tend to see lower surprises with larger companies, a little more so with midcap, and much more so with small cap.

I think you'd be surprised to see that international small cap and midcap was one of the better performers in 2015. That's an asset class that even most investment professionals don't spend a lot of time in. And I think when you saw what was going on, especially with the emerging economies, the developed countries a little bit better, but nonetheless to see positive returns in 2015 from the international small cap. And I think it goes back to your point, Derek, about they're more insulated from issues that might be happening outside of their borders.

Well, was this mostly developed ex-US, because emerging markets really got hit.

Definitely developed.

All right. And then what about when you are looking at domestic-based midcaps, when you're evaluating those funds, are you seeing a lot of look-through as far as international exposure?

Yeah. So that's a common question that, when we're interviewing managers, we really want to understand how they look at their companies, and do they really understand their companies? So I've seen some statistics as high as 30% of the midcap index could be getting revenue generated from overseas. May not apply to every security, obviously, in the midcap index, but could be there.

It's not important to us whether a manager has that exposure or doesn't. It's really understanding, do they know their companies? Do they understand what's going to happen to their companies in different environments? And so that would be the question that we will want to know ahead of time, and then be able to challenge them later on in terms of, you said this was going to happen and then and then something else played out. What went on in that situation?

And there's certain industries that tend to lend themselves more toward international exposure. So if you're a transport company, the Jones Act here in this country limits your international exposure in terms of ownership. If you're a railroad company, you're a midcap railroad company or a midcap railroad service company, you're not going to have sales overseas

Yeah. So it's very nuanced by sector. And I do want to get into sectors later. What do you guys think was the key catalyst that really drove performance for your particular midcap portfolios in 2015?

For us it was two things. If you had exposure to energy and materials in any way, shape or form, whether it was direct or guilt by association, that really drug your performance down. For us, what really helped performance was acquisitions. And that tends to be one of the reasons we lose a name in a portfolio, which is great for midcap. Midcap is prime breeding ground for M&A activity because they are larger companies.

But we tend to lose more companies due to acquisition because of what we own. And that was definitely the case in 2015. We lost quite a few of them to acquisition, which means we have to find more to replace them with. A good problem to have.

And it was a banner year for M&A as well, 2015.

Yeah, so our portfolios actually did quite well last year, at least on a relative basis, and we were in positive territory in terms of return. And I think one of the reasons for that is we really tend to focus on higher quality companies. And since 2009, it's been a period where higher quality has been more of an impediment than a help in terms of

investment returns. And I think there's a lot of reasons why that might have been the case. We think the primary one has just been the monetary environment that we've been in since the financial crisis.

And so we saw that start to wane in late 2014. And by 2015, we started to see quality really start to outperform as an attribute. And so when I talk about quality, I'm talking about stocks that have high returns on capital, good free cash flow generation, strong balance sheets. And those types of companies did better than lower quality companies last year, which has been true for most of the time periods that you would look at.

There's really been kind of two periods where that hasn't been the case. Looking at five-year rolling returns, it's been the late 1960s is really the last time up until this most recent period. Other than that, you see high quality companies really outperforming low quality companies on a pretty consistent basis to the tune of maybe 700 basis points per year. So I think having a high quality orientation last year was definitely beneficial.

And you mentioned the monetary environment. Dig a little deeper and explain how that impacted midcaps.

Yeah. So when you're in an environment where money is cheap and easy, having leverage, for instance, is not a bad thing. It's a good thing because you're paying very low debt service cost on that extra, extra capital that you have. And so it's an environment where you tend to see a rising tide lift all boats, to use a common analogy. And so it doesn't matter whether you're a low quality or high quality. And often, in many cases, lower quality tend to do even better in that type of monetary environment.

So that's kind of been a struggle, I think, for active managers, and certainly those that focus on quality companies for the last several years up until recently. And so that's sort of the phenomenon that we've been kind of dealing with and trying to manage.

Yeah. Do you think there'll be a change, though, that this is becoming a stock picker's market, that we're going into one?

I think that's very much the case. There are certain sectors that, by and large, we don't think are going to do very well. We've been very underweight financials for a long time. I know a lot of people think the financials will do well in a rising rate environment. And eventually they will. But what tends to happen is rates start to rise, margins can track. They don't widen initially. And as they contract, most financials are going to be hurt.

So we've chosen to step away from them, which is kind of odd for a value manager. But we tend to steer clear of sectors that we think there are problems in-- financials, energy we've really reduced our holdings and because of the huge supply demand imbalance that exists there. And we really don't see an end to that in the near future.

Well, digging in with financials, that's an interesting case because we were supposed to see, or we're supposed to

see, four rate hikes, supposed rise in net interest margin. If we don't see that, the virtues of financials maybe attenuated there. Also, you know there's a lot of sell side chatter that a lot of sovereign wealth funds have held financials. And that's kind of been giving them a hit.

So there's a lot of interesting dynamics. How do you see financials?

Yes. So in general, our approach is to actually take a relatively sector neutral approach, so a little bit different than what Malcolm is talking about. And the reason for that is we believe that we can really add the most value by selecting stocks. We feel that our competitive advantage is really getting to know businesses well, valuing them, and having that reflected in the portfolio.

Once you start taking big sector over and underweights, it does sort of reflect a more macroeconomic view that you're reflecting in your portfolio. And we feel that our chances of being right, in terms of calling interest rates or oil prices or GDP growth, is just lower than that of finding individually misvalued securities.

So all that being said, within financials, we do tend to be a little bit underweight right now, and that's mainly because of REITs. And so REITs have become a pretty large component of the financials benchmark within midcap. And so that's an area where we're just not seeing much value, to tell you the truth.

We are seeing banks that are attractively valued. And I understand that you know a rising rate environment is maybe under a little bit of uncertainty right now because we're seeing slower economic growth, and the Fed might not raise rates as quickly as we think they will. But we're still seeing a lot of banks that are trading below tangible book value, which to us is very good value.

And so we do own some banks. We do own some diversified financials. We own some asset managers. We own a boutique investment bank which is doing very well. So we're really just kind of picking our spots within financials.

So it seems like the flip side, the good case for financials in the midcap space, is that probably none of them are SIFI. None of them are systemically important financial institutions. Therefore, they don't have those arduous Basel III capital requirements that their mega cap or large cap peers would have. Is that weighing into it?

No, I think that's true. I think the regulatory environment for financials, and particularly large banks, has gotten difficult, to put it mildly. And so there's a lot of regional banks and smaller cap banks that really don't have those impediments. And so we do think that that's something that's beneficial. When you're investing within midcap segment of the market, you can kind of avoid those problem areas.

But at the same time, there are some larger midcap banks that do fall over the SIFI threshold.

They do, OK.

There's a few, but not many.

All right. So it's right on the cusp. How are you viewing financials and midcap portfolios, Bryce?

Yeah. I think you hit the nail on the head in terms of the central bank policy. We think that's elongating the economic cycle. And typically, when we're evaluating managers, we want to see them through an entire cycle. We want to see kind of peak to peak or trough to trough to be able to see how they perform in different market environments.

And what you're getting is an environment where, over the last three to five years, which might be a typical cycle, you're seeing only one environment or one style in favor. Derek talked about lower quality, or those types of attributes. And we want to make sure that we're not firing managers for the wrong reason.

So we need to take that into consideration. And to your point, if it's going to make the cycle extend out even further, we have to be careful about how we evaluate those managers.

And what, about from your perspective? Are you looking at style drift at all? For instance does that good problem we talked about earlier when an original midcap stock is now in the large cap, is that something you look at when you're evaluating midcap managers?

Absolutely. You want to understand why they own something. We use a lot of different tools. Something like Morningstar's Ownership Zone helps plot the individual securities in your portfolio. And we can look at the spectrum of those, find out how you're behaving in this type of environment. And especially if we've married up to different managers that may do something very different, like each of these do, we want to make sure that they're not overlapping at the same time, because then we've got unintended bets within the portfolio.

Well, let's talk about your valuation process.

Sure. So we look at valuation in a variety of ways. And so I think Malcolm talked a little bit about discounted cash flow analysis, and we always start there. But at the same time, we want to also look at other valuation metrics as well because the inputs to a DCF framework, if you change it just in a small way, you can have a very large kind of differences in terms of the output. And so we recognize that.

So we also look at things like cash on cash returns. So that's looking at a current point in time, how much cash flow is being generated relative to the enterprise value of the firm. We also look at free cash flow yield. We'll look at traditional PE and EBITDA multiples. And it'll change based on the type of business that we're looking at.

So more cyclical businesses, we might put more weight on price to book versus a PE or free cash flow yield because the earnings volatility is just too high for us to rely on any single point in time what that earnings is going to be. And so we're taking that into account.

And with a growth year focus, would you ever evaluate companies that may have a negative free cash flow at this point?

Yes. So when were looking at earlier stage companies, and in certain sectors like biotechnology, for instance, you often have companies that are in a stage in their lifecycle where they might not have commercialized product yet and they're investing for future growth. And so we are willing to look at certain companies that might be free cash flow negative today-- not to a very large degree- and we are quality oriented.

So this doesn't happen often, but from time to time we will have the flexibility to look at companies that might be free cash flow negative today for the promise of very nice free cash flows in the future if they're successful. And so we need to use our judgment in terms of whether they will be successful, and to what degree, and make sure we don't overpay for that at today's price.

And even we will buy companies that on occasion have negative free cash flow. There may be a reason. Perhaps they've get a large capex for plant equipment. They're doing a major expansion that will cause free cash flow or be negative for a year or two. If we can understand when that cash flow will turn positive, and we can present value that and buy it at a level that's lower than the present value of the future cash flow streams, we're willing to look at short term free cash flow negativity.

How important is return on invested capital?

Very important. I know a lot of people look at return on equity. And one of the first things they teach you in business school is that you can make ROE go up and down by doing one thing, adding and subtracting leverage to the balance sheet. We don't like companies that use a lot of leverage. We'll buy companies that have it in the business model, but by and large, we want companies with management that make smart allocation decisions. And it doesn't make sense for us to have management that invests in projects that have a return on invested capital below the cost of capital. You're destroying the value of the business.

So we love companies that generate high returns on invested capital. That's one of the things we look at.

Yeah, that positive delta and profitability for management, I'm sure that's a universal, right?

Remember, you're in the midcap space. It's not being followed by as many street analysts. These companies are not as well-researched. They're not as well institutionally owned. So the work that they're talking about doing on

companies is extremely important.

That's a great point, too, that you don't have the sell side research competing with your own bottoms up research. I mean, it's an advantage, right, in some cases?

Absolutely. If you look at sort of the degree of sell side coverage for midcap companies relative to large cap, for instance, it's far lower. And in our experience, the quality of the analysis also tends to move down with the size of the company. So I think that affords us an opportunity to find those companies that have great financial characteristics that are potentially being overlooked by the market.

So things like return on invested capital are critical to understand. And we see that as one of the most important metrics that we look at in evaluating companies. And if you look at our overall portfolio, you'll see our return on invested capital is probably twice that of the benchmark, if not higher.

And midcaps are often described as being in the sweet spot of their business cycle. Tell us why that matters and how you apply that in your evaluation of the individual securities.

Yeah. So I think it matters because one, the investments have been de-risked to a certain extent because they've really gotten past that startup phase. They've achieved $1 billion in market cap at the low end, and oftentimes a little bit higher than that when we enter a position.

But at the same time, they still have a lot of growth potential ahead of them. So they might be expanding into new markets. They might be adding new products and services to their clients. And they're really at a point in their life cycle where they're going through very rapid growth, and they have market share opportunities to gain. They might have an innovation in terms of something that's not being offered in the marketplace today, or something that's superior to what's being offered in the marketplace today. And they're capitalizing on that, and so they're growing rapidly.

And then they're also at a point in time where they're probably well-financed and able to show increasing profitability as they grow their top line. And that has very powerful effects on the earnings growth of these businesses. And so we see it as really the sweet spot of a corporate lifecycle, and really an area in the market where you can gain outsized returns.

Very much. You get past the small cap space where you've levered up to try and grow the company and grow the business of the company. In the midcap space, many of these companies are delevering. And so cash flow initially is going to pay down debt, which is a good thing for us, and become a company that is very focused, which, again, leads back to M&A. It tends to be a very good bolt on acquisition for a larger company that wants to diversify its book away from a specific product or service.

That shows up in those risk adjusted returns that you talked about at the very beginning. So as Derek mentioned earlier, over the long term, they've had the best risk adjusted numbers, higher returns than large cap, with lower volatility than small cap. And when you talk about you're end client, small cap may be a volatile asset class for them. And they may tend to make bad mistakes in terms of investing, whereas in the midcap space they can utilize an asset class that's going to get a better return, but not have as much volatility.

And let's talk about midcaps. We're talking about their own business cycle, but what about in the broader economic cycle? Where do midcaps fit in there, and are there nuances between growth and value?

So I think when you have midcap companies that are not entirely mature, and really dependent on GDP growth per se to grow their businesses because they have some unique business or product or service, that they're capitalizing on, sometimes the economic cycle can be less important because they have a superior product or service that's really gaining share. And whether GDP growth is one, two, three, or four, they're still going to succeed in any case.

So I think certainly there are more economically sensitive industries and companies than others. And you need to be aware of where you are in the economic cycle, and how that's going to affect that individual business. But we feel that within this segment of the market, we can always find businesses that are able to grow, generate free cash flow, have high returns on capital, and in many cases, allocate that in a very shareholder friendly way, whether through dividends or debt paydown or buying back shares, so that we can find companies-- we have 2000 to choose from within the midcap segment of the market-- that can manage through even a tough economic cycle.

Right. And because so many of these things are focused, and they operate in subsectors within the broader economy, they're growing faster than the economy. Just by definition, you're getting a better growth rate. You're also able to buy companies because of their financial position because they're larger than their small cap brethren, and because their balance sheets are relatively clean, can use the difficult environment of a down cycle in the economy to pick up assets from smaller companies that have gotten into trouble from a leverage perspective, or even larger companies that are trying to divest and become more focused and goose their growth. So it's really a benefit in many ways because of their size.

So it's a buying opportunity not only for you, but maybe for the companies themselves.

Most definitely. Most definitely.

And we keep hearing about share buybacks across the board. How common was that in midcaps?

So it's been a common phenomenon, I think, pretty much across the equity spectrum. And so we've been in a situation where companies have really high profit margins on average in total, and they're generating a lot of free cash flow. And leverage is not particularly high right now, and so there's not a lot of debt paydown that needs to occur if you're taking a very broad look at things.

And so what are they going to do with their cash flow? They can do M&A, so that's an option. They can pay dividends and grow their dividends. That's another option. Or they can buy back stock. And so we've been in an environment where stock buybacks have been pretty robust, and that's definitely helped earnings per share growth.

But we want to make sure that companies are being smart about those decisions. And they should only be buying back their stock if it's trading at a discount to the intrinsic value. Otherwise they're destroying value. And so we spend a lot of time with the management teams to make sure we understand how they're making those decisions, whether it's just programmatic and they'll buy back stock no matter what, regardless of the price.

We don't think that's a smart way to manage the free cash flow. We want to make sure they're thoughtful about really allocating the free cash flow to the most efficient use of it. And in some cases, that might be dividends. In some cases, it might be M&A. And sometimes it might be better just to sit on it. So it really kind of depends. And we want to make sure that the management teams are thoughtful about making those decisions.

Do you find the management teams more receptive to communication than maybe the large cap area, or some other area of the market?

It really depends on the business. We've got a number of managements that are very receptive because, in many ways, we're their view to the marketplace. And so we can be, in many cases, the only company that's following them. And so as they want to build a following and start talking to analysts, then we'll get some access that way.

Some of them in certain businesses are very difficult. We've got one company in our portfolio that management will not talk to anybody. It's just the way they are. And it's nothing personal. They don't talk to anybody. Management happens to own a large percentage of the outstanding stock of the company, so they've got skin in the game. So we think we're least on the same side of the table. But it makes them a little more difficult when you have to really dig into the financial statements.

And that's really the differentiator for us, is that we spend a lot of time digging into the K's and Q's, digging into what the management is saying and the footnotes, which there are a lot of people that don't want to take the time to do that. And particularly in smaller companies, that's where management is going to tell you what they're doing and how they're making their decisions.

And when you mentioned M&A, usually you're thinking of the large caps being acquisitive and buying up midcaps. But are the midcaps actually being acquisitive in buying up small cap companies as well? Is that happening?

Yeah. So we've seen M&A all up and down the market cap spectrum. So there's certainly been a lot of cases where larger cap companies are buying small midcap companies, and that's very common, and maybe typical. But you also see a lot of mergers of equals, if you will, within the midcap segment of the market, and just larger midcaps buying smaller midcaps.

And so given the environment we've been in, where there's a lot of cash on the balance sheets, the economic growth has been slow, so people are looking for ways to augment their growth, financing is very cheap. They're generating a lot of free cash flow. We've been in a boom in terms of an M&A cycle, and so we're seeing lots of permutations of how transactions are being formed.

In the midcap space, if you get an industry that's very highly fragmented, a midcap company that's got a clean balance sheet and good management can really use that balance sheet to roll up some of these smaller offerings and grow market share at a much higher rate of speed than they could do organically.

And with a free cash flow and all the cash on the balance sheets that we've seen, you mentioned dividends. Talk to us about the dividend phenomenon in midcaps. It seems like they're among the highest yielding between small and mid.

Yeah. We don't specifically look for dividends. As chance would have it, the dividend yield in our midcap product is reasonably high. But that's almost an accident of what we're buying. Management only has a few options of what they can do with the cash that they've got on hand. And if they can't find acquisitions, then they really need to return that cash to shareholders. You can do it through buybacks, certainly. But if you don't want to go private-- and in some cases you have to buy back so much of the stock you've got to go private-- the end result, then, is to pay a dividend.

And the payout ratios are very low in general. So you can pay a dividend, grow the dividend, and still invest a lot of money back into capital. It's a really interesting phenomenon within a midcap space.

An earnings growth is such an important factor. Walk us through that.

Yeah, so clearly earnings growth is something that we focus on, both as just investors in general. But certainly when we're focused on growth investments, we want to see good earnings growth. And it's a way for companies to really create value by growing their businesses and returning that cash, in some cases, to shareholders, but also reinvesting in the business so that they can continue to generate good growth.

And so we're seeing a market environment now where growth is a little bit challenged. But at the same time, we're seeing lots of companies that are able to demonstrate still very good earnings growth in this environment. And so it's something that we focus on and we pay a lot of attention to. And we want to make sure that companies are just being smart in terms how they manage their growth, that they don't give up long-term opportunity to maximize short-term profit because that's not going to work in their favor in the long term.

Malcolm, how's your portfolio currently positioned? Without getting into sectors, I want to get into that next.

Well, like I said, we're not sector specific. Sector is really a byproduct of the investment process. There are certain businesses and business models that right now we think don't lend themselves as much to investment opportunities. So what we're finding a lot more opportunities in is in technology-related businesses, both on the hardware and the software side, businesses that are related to the cloud and the growth in the cloud and the growth in storage needs.

A larger portion of our portfolio than has historically been the case, which is, again, odd for a value manager, is technology-focused. We have had fairly large exposure to energy and materials in the past. We've really pulled that down because the opportunities aren't there, the valuations aren't there, the cash flow isn't there today.

With energy in particular, do you think that with oil cratering, maybe we haven't seen a bottom yet? But do you think that there will be a point of capitulation there, and then--

Oh, eventually there will. But the big problem you have in energy right now is you've got two- to three-million barrel a day supply demand imbalance. And until that comes back into balance, it's purely economics. If supply exceeds demand, price has to drop until demand and supply come into equilibrium.

And you've got a number of the players in that business that are playing a massive game of chicken. Who's going to get out of the business first?

Saudi comes to mind, yeah.

Exactly.

What we try to do is find companies that are attractively valued within the energy sector that are high quality, that have good balance sheets, that are generating free cash flow despite oil being where it is today. And so that's where we're focused. We tend to have more of an orientation towards the service companies than the E&P companies. The E&P companies are really having a difficult time with oil where it is.

And they're sort of in a Catch-22 where they can just stop producing because they're not really getting good

economics at oil prices where they are today. Or they can continue to produce and have a loss. And so they're trying to battle for survival at this point. And they have debt covenants that they're running up against, in many cases. And so it's really a mess for most of those companies.

But on the service side, they can take their capex down to a pretty low level such that the capital intensity just is not there with most of the service companies.

Like it would be in E&P.

Like it would be in E&P. And E&P's, over time, tend to outspend their free cash flow generation through the cycle and are often issuing equity to cover that. And so we don't think that that's an attractive sort of attribute when you're looking at investments. We tend to focus on the companies that can earn a good return on capital, generate free cash flow, and live to fight another day.

And in the midcap world over the last several years, it's been one of the toughest benchmarks to beat. I think the statistic's somewhere between 75% and 85% of managers have underperformed over the last couple of years. And energy is a part of that.

Remember, you've got an index, in the case of Russell, that that reconstitutes every year. And just because we're in the middle here, sandwiched between small and large cap, you're going to get more rotating in and out of that index than you are in many other indexes. And so many managers have been a little bit overweight energy. Once again, not a bet on oil, but just thinking the free cash flow and the analysis. they've done on the companies. And they're not necessarily going to sell a company unless something's deteriorating within their business model.

And I know you both look at companies from the bottom up, and sector biases and themes may just emerge from that. What about health care, technology?

Health care and technology-- again, technology has been a focus, health care has been somewhat of a focus. But it's been that because of a macro issue that we really see driving the whole thing. And you've got a major generational shift going on as the Boomers get older. I'm at the tail end of the Baby Boom generation. We tend to want to stay active. Unfortunately, as you get older, your body tends to break down a little bit, and we'll do anything to stay active. So the need we have for various medical products and drugs and so forth will certainly rise.

We have been focused in areas that are focused on cost containment, particularly in the United States with the Affordable Care Act, Obamacare, if you prefer, has really put pressure on certain businesses. And there are certain businesses within the health care space we just don't like because the economics aren't good.

Because of the Affordable Care Act.

Because of the Affordable Care Act. Hospitals, for instance. When the Affordable Care Act first became law, you saw a lot of hospital companies that saw a nice pop in their stock price, the thought process being a lot of the pro bono work they were doing for people that couldn't afford it was all of a sudden going to get paid.

But what people were forgetting was the other side of the equation. Costs were going to rise pretty dramatically, and the things that they were getting paid nicely on from those that were insured was probably to come down as reimbursements were going to go down. And we just didn't see the real benefit there. It was very difficult for us to find a good business case for investing in hospitals long term.

You mentioned the demographics with Baby Boomers. That seems like it would be a tailwind with so many people needing more services within health care.

It can be. But there are certain sectors within there, for instance, nursing skilled care. I would love to be able to invest in that business. There's just no good way to do it. You can buy REITs, but we don't like the structure of a REIT.

Like a senior housing REIT.

A senior housing REIT. They're highly levered. The only way you can expand your bed count is to lever up or dilute your shareholders, and neither is a particularly good option in our mind. So places that we would love to invest that are pure beneficiaries of the Baby Boomers is just not a very good way to do it.

On the pharmaceutical side, if you got branded pharma, you're facing a patent cliff, as they've been facing for a number of years now. A lot of generic competition, a lot of pressure to push prices down. Generics are a very interesting place to invest, and we really looked at those very closely.

Biotech is also an interesting place, and there are some biotechs that are earning nice cash flows from their business line, even though they've got a fairly small product mix. There are also businesses that are blending the branded business and the store business to allow you to minimize, to a certain extent, the patent cliff that exists in pharmaceuticals.

And when you mentioned the smaller, nichier products, are these the orphan drugs?

Orphan drugs, or they are more focused drugs within an indication that's been around a long time that provides better efficacy relative to an indication that there's been a non-biotech alternative available for.

So health care is a sector that we actually like a lot. It was a great sector last year, as you probably know. And this

year it's been a little bit more challenging. And so there's always a lot of crosscurrents in health care. It's a regulated industry. So things like what the health care policy is in the United States is very important. You can see a presidential candidate post something on Twitter that gets everyone excited about drug pricing, and that could have a major impact on security prices, believe it or not.

So it's something I think you need to tread carefully and find the companies that really have good, durable businesses that are going to be able to do well even if the regulatory environment does shift in some way, shape, or form.

But let me ask you, too, with that TWEET which, from a presidential candidate, Secretary of State, that's what you're referencing. Do you just see that as a buying opportunity, though, that people just sort of got scared? And it was a Tweet.

So I think what gets drug investors and biotech investors very concerned is any form of potential price control because this is an industry that has kind of been able to operate unfettered in terms of the ability to increase prices. I think the Affordable Care Act more or less institutionalized that because it doesn't allow the federal government to negotiate prices directly with the companies.

And so if there is a threat that there could be a change in administration and that policy might change, I think there is some warranted caution, and there is some sense in being nervous about that. But in our opinion, it did create buying opportunities for sure.

And so you mentioned orphan diseases. There are some companies that we own in that particular space. And the nice thing about that is that you have small patient populations, but you do have high prices. In order for these companies to earn a decent return for investing in the R&D to address those small patient populations, they need to be able to charge a fair amount in terms of the price of the drug. Otherwise they wouldn't make that investment and it wouldn't make any sense.

And I think that's recognized by policymakers. And the last thing they want to do is shut off R&D such that these unmet medical needs are not going to be met in the future. And so it's a little bit of choppy waters that one needs to navigate in terms of all of these crosscurrents that are happening. But I think if you focus on the innovative companies that really can address an unmet medical need, they're always going to be able to get value for their product.

It's the Me Too type of companies that just generate a small incremental benefit that really doesn't have a clinical significance. I think it's less likely that they're going to be able to charge high prices for those types of products.

And then there's other areas of health care that are potentially more interesting. So managed care is an area that

we have at least one investment. And in the Medicaid side of the business, that's really growing, and managed care solutions within the Medicaid population are more efficient. And so it's part of the solution, not the problem. And so we don't see that as being an area for regulators to target. So there are areas within health care that I think you can navigate and generate very nice returns. It's just a matter of picking your spots.

Yeah. It's so interesting because we do see a lot of this in the news, like the Attorney General of Massachusetts coming out and saying that a drug price is too high. It wasn't offset by the need for innovation in R&D and health care.

Well, you can either try and figure out which company is going to have the best and most innovative drug, or, like it wasn't a gold rush. You could hunt for gold, or you could sell the picks and shovels to the gold miners. And that's where we have found more value is in those people that sell the picks and shovels, that regardless of which compounds make it to drug form and make it to market, they're going to be providing research services to the pharmaceutical industry to do that work. So from our perspective, they're a winner regardless.

Before we leave sectors any last sectors that you just really are avoiding at this point?

Avoiding. We've tended to avoid consumer discretionary names, although we do have a few in our portfolio. Retail in particular we've not liked a lot. Our general thesis is we're over stored, not only within the United States, but globally. And the economics have substantially changed for the worse. And there's a lot of stores that don't understand that and are really hurting because of it. And Wall Street is making them pay.

You get a large online retailer like Penney's, for instance. Same story. Sales may be hurting. Might not be because of the sales in the store. It may be because of their omnichannel. Somebody buys a product, has it shipped to their home. It's wrong size. They deliver it to the local store, and it comes out of that store's comps.

And that whole change in the makeup of the retail business has really changed the economics to the standpoint that old line retailers and traditional retail simply isn't going to be as successful as it has been in decades past.

It seems, too, like Baby Boomers are not spending as much as they probably were at their peak earning period. And then we're hearing that Millennials are really valuing experiences over tangible goods.

And it's interesting. If you look at there is a life cycle of earnings and spending, the Boomers, on average have hit the peak where earnings are starting to decline and spending is starting to decline. The average Millennial is not yet 21 years old. You think about that. So they haven't gotten their first job, their first real job. And so their spending, while it's increasing at a fairly rapid pace, is not enough to offset the spending decline that the Boomers are facing.

That, I think-- we think-- is a big reason for why the economy can't get out of its own way. If you've got aggregate demand declining, growth just isn't going to happen.

Yeah. So as I mentioned earlier, we do tend to invest in a sector neutral way because like I said, we do feel that if we're either naked or massively overweight certain sectors, it does have a macro bias that's embedded in the portfolio, which we try to avoid.

That being said, there are definitely areas of the market that we are underweight, and we're not finding a lot of good opportunities. So utilities, for instance. Not the best business model in the world. Many of them don't earn their cost of capital. But at the same time, they're very interest rate sensitive. And so if you don't own any utilities at a time when interest rates are coming down, you're going to pay for it.

Staples is another area where we think the stocks, for the most part, are very expensive. We're not finding a lot of good opportunities within staples. But we own a few that we really like a lot, so we do have exposure there. I mentioned real estate investment trusts earlier. Again, a very interest rate sensitive sector. We have some exposure there, but we're pretty underweight. And we've found opportunities in other areas of financials to cover up for that. So there are definitely sectors that are less attractive than others.

Tell me, too, about your portfolio management process. Walk me through how concentrated you are.

We're fairly concentrated. We've been running focused portfolios since before it was cool. That's kind of what I started doing when I got into the business in the mid-1980s. We're in 30 to 50 names because we don't think that it makes sense. And I think it's much more difficult for a manager to keep their arms around the companies that they own and understand them to the depth that we understand them if you own a lot of names.

And then something interesting happens. As you get closer to 100 names in your portfolio, your portfolio begins to look and act a lot like an index fund.

Closet indexing.

Yeah. If that's what you want, that's great. But Vanguard does it very inexpensively.

Why pay for that?

Exactly. So if you're going to be an active manager, have the strength of conviction in what you do and focus what you invest in. It's never made sense to us to own things in bad businesses simply because they're represented in an index. Utilities are a great example. They're bad businesses. They're not earning their cost of capital. They're very interest rate sensitive. And so we don't really see a lot attractive there. And so we just choose not to own it.

It's not a macro bet. It's not a call on where the economy is going. We just don't like the businesses.

So we also run focused portfolios, but not quite as focused as Malcolm's portfolio. So our core product owns about 65 securities, and that's typically where we've been. And so if you look at our active share, which is a measure of overlap between us and the benchmark, it's very high, meaning there's low overlap. So we have about 90 plus percent active share in that portfolio.

In our growth portfolio, it's a little more concentrated. We own close to 50 securities in that portfolio. Again, very high active share in the 90s. So we feel that we're very differentiated from our benchmark, yet we're also diversified and able to control risk to a certain degree by being diversified.

Bryce, how do you evaluate that?

I mean, that's the active share, the concentration. Those are all important to us. Definitely criteria that we look at when evaluating a manager. But we'd also want to evaluate the capacity of the manager, too. We're talking about midcap here. It's better than small cap in terms of being able to find enough names. But that's another criteria that we're going to look at is how large are you?

You've got, like I said, more room to run than small cap. But you can't get up to be many billions of assets under management because then you won't be able to find as many of those good ideas, especially if they're running focused or more concentrated portfolios, which we prefer.

Yeah. You bring that up. How hard is it to find good names? There's more midcap stocks than there are large cap. There's a big universe out there.

It really depends. Because we're valuation-focused, there are times where it's very difficult. I mean, the first part of last year, it was very difficult to find names. We found companies that we loved their business model. We loved everything they do. We just didn't like the price. You get the sell-off in the fourth quarter of last year and the first part of this year. And now all of a sudden, price comes back down, where we've got a lot more names that we're interested in.

So it can be fairly--

Yeah. Well, what are the other nuances when you're evaluating midcaps? I know you evaluate a whole universe of funds out there. But what is it about midcaps that you, in particular, look at?

Yeah. Let's talk about the universe real quick. Within each of these gentlemens' universe, there's probably 150 managers that we may look at and evaluate as a peer group that we're comparing them to. Compare that to

probably north of 500 on the large cap side. So you've got a smaller universe to evaluate those managers. You're looking at all those issues we talked about, capacity constraints, their return profile, a lot of those different criteria.

One thing that we're finding resonates with a lot of clients is we've utilized the SMID asset class, which is, of course, small and midcap. And that allows-- if a client just says, I can't take nine different managers with the Morningstar style boxes with all the diversification in their portfolios either overseas or on the fixed income side-- it allows us not to abandon the asset class because we really do think midcap is important. But it allows it to consolidate the manager, so that way they can let their winners run for a while.

So that's one potential solution if you're running up against headwinds with clients that are saying, I like the asset class but I can't dedicate more assets to an additional manager.

And before I let you go, I would love to get everybody's take on your risk management process.

We focus, really, on the price value relationship. Because we are very value focused, we won't pay up for a company. The price value relationship is really the largest part of our risk management. And it shows up in the variability in of our portfolio returns. Our standard deviation's fairly low relative to the market. We don't like to take risks. And when we do, we want to make sure we get paid for it. Hence, the valuation requirement.

So I would say similarly, the most important thing that we do as portfolio managers is really make good investment decisions. And so that involves really getting to know our businesses and de-risking them, making sure that we understand how the company is likely to perform in different scenarios, stress testing the model.

We meet with each of the management teams to make sure we understand how they intend to manage the business and that we are aligned with them as stakeholders. So we will also seek out probably the most bearish analysts that we can find on each company that we invest in to make sure that we've gone through the bear case adequately and we appreciate the downside risk.

That being said, there are other portfolio risk controls that we have as well. So we have maximum position sizes. We won't go over 5% at market in any individual position. We have sector constraints that I talked about. We run fairly close to sector neutral, but we have some latitude. 400 or 500 basis points within the sector weightings is where we'd like to be. And we do have tracking error constraints. We like to be within 4% to 6% of the benchmark.

And so there are a number of things that we do. We use Northfield Information Services to provide outputs to make sure that the trade-off between stock-specific risk and factor risk is more heavily weighted towards stock-specific risk. We look at the factor risks that we do have embedded in the portfolio. We make sure that we're comfortable with them and they're not unintended. And so there are a number of things that we're doing from a risk control perspective.

In our manager evaluation framework, it's the exact same skill set that they're using in evaluating companies. We're using that to try to evaluate the managers. So we're really trying to understand why they make their decisions and be able to evaluate that.

We do use a proprietary risk optics model when we're evaluating managers. And the way we define risk is not by just volatility, but it's really the potential loss of capital. So we're looking at a lot of different factors that go into that because at the end of the day, all of us are trying to separate out luck from skill. It's the same thing they're doing with managers. At the end of the day, we don't want those me too businesses, where they're just riding the beta of the market. We really want to be able to identify a manager that can separate themselves and really be able to have a repeatable process.

And so we'll look at rolling period analysis because a lot of times, you'll look at an endpoint and a starting point. But clients get in and out of strategies. We hire and fire managers at different times. The more time periods we can look at, we're really looking for that repeatable process.

And lastly, Malcolm, any recent purchases or any good stories that you'd like to share with us?

Lately we've tended to find companies that have a bit of controversy. So for instance, GameStop we've owned for a long time. There's a huge bear case against it, the position being it's another Blockbuster. Blockbuster went under because their business was being cannibalized by Redbox, amongst other things.

But what people don't understand is the business model that GameStop uses, they don't have the same long-term lease issue that Blockbuster did. There's no natural competitor to the secondary market that GameStop creates. They've done a great job of diversifying their business with a technology business that they've added onto it, which is growing very rapidly. And management has been kind of holding off the shorts, to a certain degree, by buying back stock. They've generated huge amounts of cash flow that they can't adequately reinvest in the business, so they've been giving it back to us as shareholders by buying back their stock.

It's a wonderfully run business. The capital returns are fantastic. And so we've done a good job of playing off the shorts, if you will. Comfortable with the risk, understanding the issues that people think are behind it. But we know that they're wrong because they're not looking at it correctly.

So I'll give you an example as well, and it's actually related to GameStop. It's a company named NVIDIA, and they actually make graphic cards that go into the video games that people are renting at GameStop. And so what we like about NVIDIA, tremendous balance sheet, great returns on capital. They have a very nice market opportunity both in serving the video game market, and so they are the leader by far in that market. And there's just a lot

more video games being played that require more advanced graphics, and so they're serving that particular need.

At the same time, their one competitor is a company that's under financial distress. AMD is the name. And they're really able to capitalize on that, so they're in a very nice competitive position.

And then we see some very new growth opportunities emerging for the company. One is in virtual reality type of applications, which is becoming a hot topic in Silicon Valley, and we think that there is a reasonable chance that that's going to be a big market. And they're also serving the auto market in terms of the newer technologies like self-driving vehicles and sensors and the ability to navigate without a driver at the wheel. And so they're making the chips that go into these systems that enable these cars to be manufactured.

And so that's a new growth opportunity for them as well.

Those are all the cool parts of technology now, right? Self-driving cars, virtual reality. Wow. All right. Well, great insights. Before I let you go, I'd love to get everyone's final takeaways. And let's start with you, Derek.

So I think the biggest takeaway from my perspective is that the viewers should really make sure that they understand the type of manager that they're buying. And so from our perspective, high quality is really incredibly important when investing not just in the midcap space, but across the market.

And I think the evidence that proves that these types of companies do better over time is very clear. We have a gap between high quality and low quality of roughly 700 basis points on an annual basis, looking back historically all the way to 1965. We see no reason that gap should not continue out into the future, especially after going through a period of time when high quality did not do well, a short period of time.

So we feel very good that companies that have great balance sheets, high returns on capital, good free cash flow generation. Management teams that allocate that capital effectively are the ones that are going to win in the long term. And I think your viewers will be well-served to focus on managers that identify and invest in these types of companies.

Bryce, your final thoughts.

Yeah. So at the end of the day, we believe that midcap has been an important area to be and we think that will continue. We want investors to have that exposure however they need to get that exposure, whether they have a manager that can dip down into that area, or they utilize SMID or a dedicated midcap manager. But at the end of the day, it's a growth area that we think is attractive. And so we want to make sure that people get access to that.

At the end of the day, though, you can tell it takes a lot of research to identify those companies. So they do need

to make sure that the managers have deep analysts and really understand those companies because they're not as widely followed. So it's an area that we think is attractive, and we think that people should continue to look at it.

Malcolm.

We really think that investors need to think like business owners because that's what you're buying when you're buying a stock is a fractional ownership interest in a business. And so from our perspective, it's always made sense that you think like a business owner when you're buying a share of stock.

So as investors, we really think you should be focusing on managers that think like business owners. High free cash flow, high return on invested capital, management that make smart decisions with their money and concentrates their bets so that they're not investing in businesses that are bad businesses because they happen to be represented somewhere. We think that will serve investors very well going forward. Do your homework, just as we do.

All right. Great insights. Thanks so much, gentlemen.

Thank you.

Thank you.

And we want to continue this conversation about midcaps. Follow us on our social media on Twitter, LinkedIn, and Instagram. From our studios in New York, I'm Courtney Woodworth.