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Near-term Opportunities for U.S. Mid Cap Growth

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Recent Market Gains and Future Prospects

From the depths of the market's COVID-19 lows in March 2020, equities have shown significant gains. As vaccines became available and economic activity reaccelerated, the U.S. stock market climbed sharply:

Table 1: Returns from the COVID-19 Lows

	3/18/2020 – 5/31/2021	
Total Returns (%)	Cumulative	Annualized
Small Caps (Russell 2000 Index)	56.04	42.75
Mid Caps (Russell Midcap Index)	48.10	36.91
Large Caps (Russell 1000 Index)	47.57	36.52

Source: FactSet

Market sentiment—or relief—was not the sole driver of recent returns. Companies have reported significant sales and earnings growth, outpacing expectations by wide margins in the most recent quarterly reporting season (Jefferies 2021). Looking forward, sales growth is expected to climb in 2021, as well as in 2022, across all the U.S. market's size and style segments:

Table 2: Actual and Projected Annual Sales Growth (%)

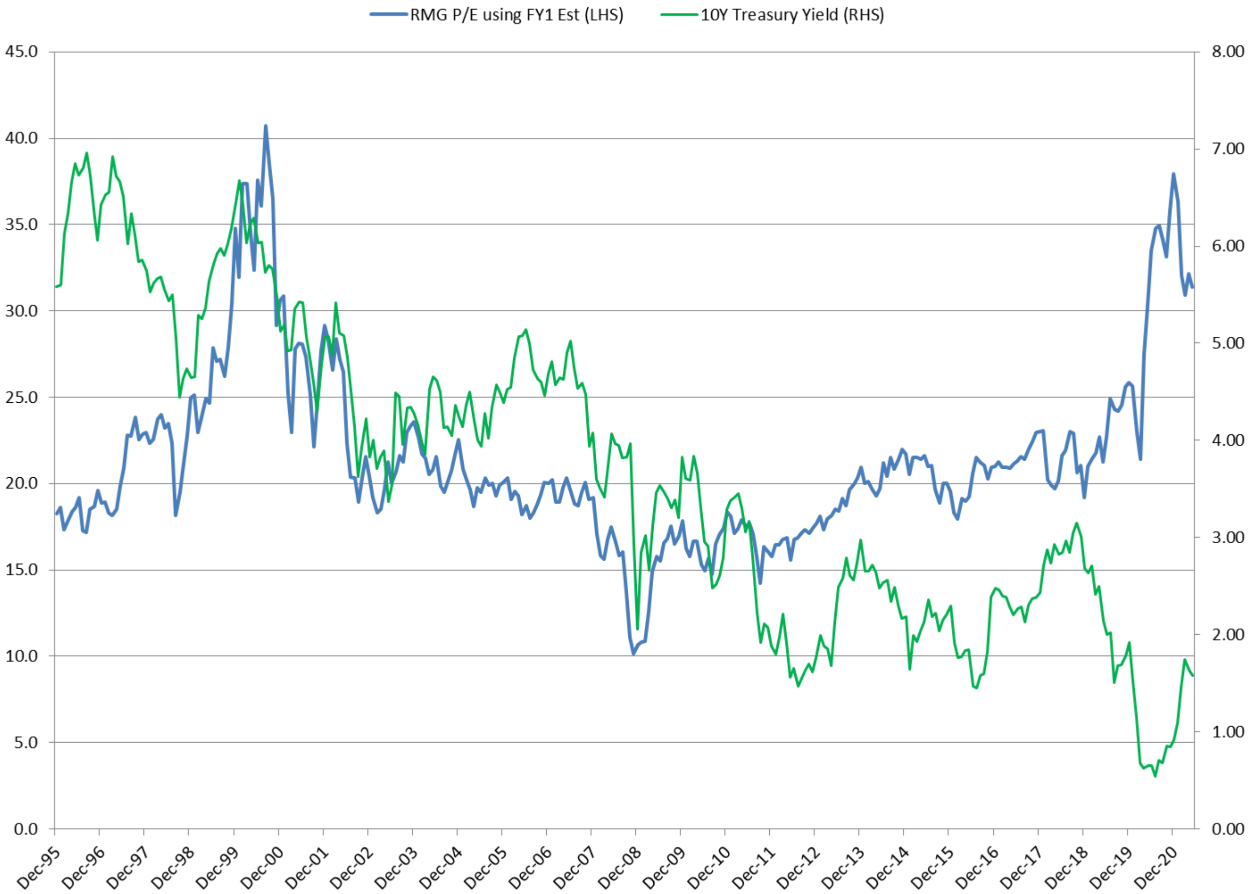
	Small Cap Growth	Small Cap Value	Mid Cap Growth	Mid Cap Value	Large Cap Growth	Large Cap Value
2018(A)	11.5	6.9	8.3	9.6	10.0	6.8
2019(A)	4.5	1.9	3.7	-1.0	7.5	2.5
2020(A)	-0.5	-4.8	-1.9	-7.3	4.6	-4.2
2021(P)	13.5	11.7	18.1	13.8	14.1	10.7
2022(P)	6.0	5.4	6.7	5.9	8.8	5.7

Source: Jefferies (projected growth rates are consensus estimates)

Historical Context for Current Valuations

As the markets rose, valuation levels also increased. Optically, the Price/Earnings ratio for the Russell Mid Cap Growth Index—the segment with the highest projected sales growth for 2021 and second highest for 2022 in Table 2—has recently been at levels not seen since late 1999. While that may indicate concern, as investors in this segment at that time, we recognize that the interest rate environment is significantly different currently than 20 years ago. With the 10-year Treasury currently yielding less than 2% compared with over 6% in the late 1990s, we can understand why today's investors are willing to pay more for corporate earnings.

Chart 1: Mid Cap Growth P/E Ratios and Treasury Rates over Time



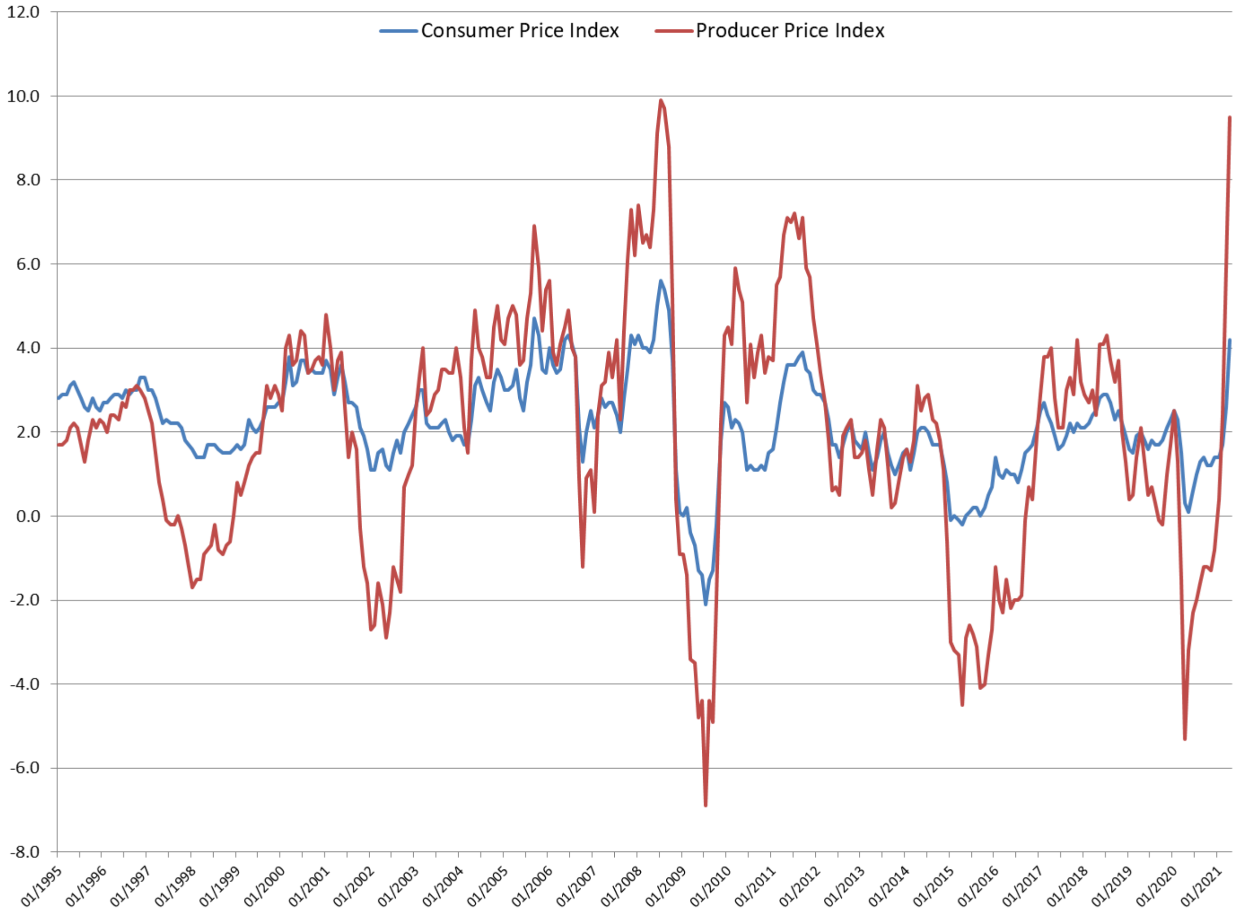
Source: FactSet

Still, when evaluating different investments we must be mindful of relative valuations. While historical comparisons may not be as relevant given the significantly different interest rate environments, contemporaneous peer-relative measurements can be useful.

Lurking Inflation Worries

Heightened demand stemming from an accelerating economy raises inflation concerns by many investors. That is with good reason as the Producer Price and Consumer Price indexes have seen their respective 12-month changes sharply increase recently.

Chart 2: Consumer and Producer 12-month Inflation Rates over Time



Source: U.S. Bureau of Labor Statistics

As an active manager, our evaluation of companies includes many aspects. It is particularly important during inflationary periods to consider the business's respective clout with suppliers and vis-à-vis customers. Meaningful pricing power enables a company to maintain its margins and have stable growth prospects. Where that exists, we believe higher valuations may be warranted.

Holdings with Different Growth Opportunities

Within our Mid Cap Growth Strategy, we build our portfolio with businesses that benefit from various drivers of growth. Some are more cyclically positioned and will benefit from near-term market trends. A larger portion of the strategy is primarily focused on secular growth and long-term trends. Then there are those holdings that blend aspects of both. Examples among our largest positions include RenaissanceRe, CrowdStrike, Catalent, Waste Connections, and O'Reilly Automotive.

Cyclical Growth

RenaissanceRe (RenRe) has been owned in this strategy since 2008. This reinsurer offers property and catastrophe policies as well as other specialty reinsurance. Over the many years we have owned RenRe, we have seen it exhibit a sustainable competitive advantage, driven by superior customer relationships, risk assessments, and capital management. Aside from its primary reinsurance operations, RenRe has been a pioneer in its industry by managing third party capital for institutions, which generates an additional stream of income. However, reinsurance is a cyclical industry as capital ebbs and flows, and the risk levels change, which affects supply and demand. RenRe has been very disciplined by increasing the gross value of premiums written when reinsurance pricing is high, and reducing activities when pricing is poor (and as a long-time investor we have adjusted our position size accordingly over the years). In the company's most recent fiscal quarterly report, RenRe noted an increase in the total value of premiums written, which came from new business and higher pricing for existing lines.

Secular Growth

CrowdStrike has been owned in this strategy since 2020. This cybersecurity firm offers endpoint protection and a suite of solutions that enterprise customers employ to prevent damage from threats, detect and mitigate advanced malware, and monitor endpoints. We appreciate how subscriptions initially are sold to companies for a limited number of endpoints and security modules, with customers soon expanding their use of CrowdStrike's services. That "land and expand" business model benefits from CrowdStrike's software-as-a-service delivery, which leads to rapid and nearly frictionless expansion at existing customer sites. That gives CrowdStrike a competitive edge over legacy cybersecurity firms that have more cumbersome installation procedures. In the company's most recent fiscal quarterly report, CrowdStrike announced it added over 1,500 net new customers for a total of over 11,000 current customers. We believe the long-term power of that growing installed base should continue to produce significant expansion rates of annual recurring revenue for years to come as the company cross-sells additional endpoints and modules to current customers. For such a rapidly growing company with a vast market opportunity, one caution is that the near-term valuation may be lofty. Among our holdings, CrowdStrike does have the highest P/E ratio based on projected earnings for the next fiscal year, and that is double the level of the next highest valuation in the strategy. However, CrowdStrike's business is generating significant levels of free cash flow with net client retention levels over 100% and increasing profit margins. That gives us the confidence to look several years further into the future to support CrowdStrike's current valuations.

Catalent has been owned in this strategy since 2019. This leading contract development and manufacturing firm provides advanced delivery technologies and development solutions for drugs, biologics, and consumer health products. Its primary driver of growth is biologics, followed by softgel packaging. Recently, Catalent collaborated with Moderna for the latter's COVID-19 vaccine. As the vaccine demand wanes, we believe Catalent's capacity utilization will remain stable because the majority of its biologics contracts are for development-stage treatments, so activity should continue through their commercialization. In addition, Catalent benefits from the significant sums that early-stage biotechnology firms raised over the last decade. Those small companies lack the internal manufacturing capabilities of large cap pharmaceuticals, and will need to outsource that function to firms such as Catalent. In the company's most recent fiscal quarterly report, Catalent noted that high demand for COVID-19 vaccines and treatments led its management to increase its guidance for near-term revenues and earnings.

Blend of Both

Waste Connections has been owned in this strategy since 2017. This integrated municipal solid waste services company provides solid waste collection, transfer, disposal and recycling services in the U.S. and Canada. As the third largest solid waste collection and disposal company in the U.S., Waste Connections focuses on the stable municipal sector with long-term contracts (as opposed to short-term contracts with commercial businesses where volumes can vary significantly). A limited supply of waste treatment and disposal locations provides the company significant pricing power. In the company's most recent fiscal quarterly report, Waste Connections reported benefits from that pricing strength, and that recent increases in economic activity should lead to increased volumes, especially for the company’s oilfield waste treatment operations as drilling activities resume in earnest.

O'Reilly Automotive has been owned in this strategy since 2011. This specialty retailer of automotive aftermarket parts serves both do-it-yourself customers (DIY) and commercial service providers. As a distributor with a significant number of suppliers and customers, O’Reilly sits in an optimal negotiating position for prices and has limited threats from ecommerce because of the complexity of specific auto parts and the requirements of fast delivery from its commercial customers. As people begin to travel more, and vehicle miles driven increase, demand levels should increase for O’Reilly. In the company’s most recent fiscal quarterly report, O’Reilly reported that both segments of its business—DIY and commercial—were growing with the strongest quarterly same-store sales growth in the company’s history. That led its management to increase its guidance for near-term revenues and earnings.

Conclusion

Though many areas of the U.S. market have returned to pre-pandemic levels in terms of prices, sales, and earnings, we believe significant potential remains in the near term, especially for the Mid Cap Growth segment. Higher valuations and the specter of inflation are concerns, though often those businesses that control their pricing are justified with above-average multiples. Opportunities exist for active investors, and vary across different business models and sectors. For example, the preceding examples cover Financials, Information Technology, Health Care, Industrials and Consumer Discretionary. They also represent a broad perspective of our current investment views.

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