Q1 2024 - Mid Cap Value Quarterly Update

[Music]

Hello, I'm John Flynn, a portfolio manager here at Pzena Investment Management, and I'm here to give an update on our Mid Cap Value strategy for the first quarter. It's a pretty interesting quarter from a market standpoint where we saw both good economic data leading to cyclicals being strong and consumer stocks being strong, which is something we benefited from in the portfolio, and we'll talk a bit more about that. On the other side of what was driving the market is this AI boom, and as I'll talk about, we were a bit on the other side of that and it kind of weighed on some of the performance in the portfolio. So, lots to talk about, let's get into it.

Advanced Auto Parts was our top contributor. Advanced Auto Parts, if you remember, is an auto parts supplier and retailer, and their margins compared to peers have been lagging for quite some time. A new management team came in recently and kind of gave a strategic update with earnings after the fourth quarter and laid out their plan. Shortly thereafter, Third Point, an activist, announced they were coming in and taking three board seats. All of this was very positively received by the market, and the stock was quite strong.

Another top contributor in the quarter was Acuity. Acuity is a lighting distributor, a commercial lighting distributor, and their margins continue to hold up better than expected despite a weaker demand environment as we've gone through that with rising rates and kind of commercial construction pulling back a bit. With that continued margin strength, the stock was strong. Then, finally, the other big contributor in the quarter on the consumer side was Gap Inc. What's been going on here is a recovery in the Old Navy brand, where we've seen comps turn positive, margins be strong, and the stock react quite positively to that. I should say we trimmed both Acuity and Gap in the quarter on the strength. We continue to hold positions there but definitely took advantage of some of the strength to trim.

Moving on to the detractors, the biggest detractor in the quarter for the portfolio by far was Concentrix. Concentrix is essentially a call center outsourcing company, and the fear here has been around the impact of AI. It really came home in the quarter, and the stock was down significantly. We think the move is quite dramatic in the stock price. When we look at it, we think Concentrix is positioned to be an implementer of AI solutions at scale and should benefit over time, but the market obviously took a pretty draconian approach to this. We took advantage of that weakness to add to our position.

Another detractor in the quarter, though much less so than Concentrix, would be Forus. This is the kidney dialysis company. They actually put out guidance that was ahead of expectations for 2024 but struck a tone of caution around patient volumes and really what's been going on within their value-based care segment and the economics there. I think that spooked the market a little bit, so we saw a little bit of weakness there. We also saw some weakness in Magna as well. Again, really around their guidance, Magna's margins have slowly been improving. This is the auto parts supplier, and while they guided for margins in 2024 to be up again, they weren't up as much as consensus was expecting. So we saw a little bit of weakness in the stock there, and again, we added on that weakness as well.

It was also a pretty busy quarter for us on the new names front. Continuing the theme we've been talking about for the past couple of quarters, we're continuing to see a broadening out of the opportunity set. So, we added four new names in the quarter: Dollar General, Humana, CH Robinson, and Charter Communications.

Dollar General is the dollar store, the discount retailer, and really what's been going on there is they've been growing quite quickly for a number of years now, really taking share from the CVS’s of the world in front-of-store sales. They've had pretty significant supply chain issues that have really weighed on their margins. We think management has made pretty good progress in putting that behind them. It's a theme we've seen across a lot of different companies having margin impacts from supply chain disruptions, but we think longer-term the Dollar General concept remains well positioned and should continue to grow.

Humana is a managed care company really focusing on Medicare Advantage, and what we saw here was the medical loss ratio, so the amount of money that the company is actually spending on healthcare, spiked in the fourth quarter. This was an industry phenomenon, really, on higher utilization as people have gone back into getting elective procedures done. That, combined with inflation, kind of weighed on margins at Humana. It’s a multi-year cycle to get that pricing back because you've already priced next year's health plans prior to finding out that the MLR is elevated. We will see that come through over time, but generally speaking, Medicare Advantage has been a growth area within healthcare, and Humana has been kind of a pure play within that. So, they usually trade at a premium, and we were pretty excited to take a position in the company as they face what we think is a temporary headwind.

We also added CH Robinson, continuing the theme of diversification in the portfolio. This is a truck brokerage, so shipping around the country, primarily by truck. They do some ocean freight as well. What's gone on here is their margins have lagged peers. A couple of years ago, there was a big fear in the industry that Uber and other digital platforms would sort of put traditional truck brokerages out of business, where it's a very people-intensive business. That’s proven not to be the case. When you look at truck shipments, traffic happens, flat tires happen, changes to loading dock schedules happen, and the digital solutions have not really been effective. CH Robinson, a couple of years ago, panicked and invested in some digital solutions that they probably shifted too much volume to and upset some of their customers. Those were higher-margin customers. They're in the process of getting those back. We think that long term they remain a market leader in a growing market, and there is an opportunity to bring margins back as they kind of mix correct, I guess would be the words for that FAA a couple of years ago.

Finally, the last add I'd mention is Charter Communications. This is the cable company—internet, voice, data—though the real crux of this investment is around the internet and fiber to the home and cable to the home. The fear here is that you're going to see fiber overbuild, with multiple competitors to the house. Instead of having just one provider pass a given household, they have multiple choices, and that leads to lower pricing. There are tons of plans that have been announced, but when you look at what's actually been done, little has been done, and most of those plans were announced in a much lower interest rate environment. So, the economic feasibility of those plans has certainly been hindered. We think that Charter is well-positioned and that over time they will continue to grow. They're investing in capex, which we think is profitable. I think the market gets a little spooked when they invest in capex. The other thing that's been going on there is you've seen providers like T-Mobile provide what they call fixed wireless access via the cellular network. There's limited capacity to how much they can add, but they are adding that at a lower price. So, you see a lot of new ads coming into the fixed wireless space. Charter has been holding price in their markets and letting the T-Mobile of the world play out that excess capacity they're selling off. But short term, this is certainly a bit of a pain point that we're watching and monitoring.

So, those are kind of the new buys in the quarter. In addition to some of the trims I mentioned earlier on the strength, we also sold out of our positions in Reinsurance Group of America. This was the life insurance reinsurer that we bought in the depths of COVID. We sold out of Mohawk, really for more attractive valuation opportunities. We also sold out of Cardinal Health, the drug distributor, on valuation. That stock had done quite well.

So, that's kind of what's been going on in the mid-cap portfolio—a busy quarter for us. But we continue to be excited about the prospects and the valuations we're seeing in the portfolio, and look forward to joining you next quarter for another update.

[Music]