Q2 2024 - Mid Cap Value Quarterly Update

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Hi, I'm Evan Fox, one of the portfolio managers on Pzena Investment Management's Mid Cap Focus Value portfolio. We're now at the end of the second quarter of 2024. We came through a quarter that really continued some of the trends we've seen over the last year or two, where the mega-cap growth companies continue to do very well, leaving behind much of the rest of the market.

If you look at what happened in the second quarter, we saw high single-digit performance from the Russell 1000 Growth, while the Russell 1000 Value, but also all the small-cap and mid-cap benchmarks, were all negative for the quarter.

When you look at our mid-cap portfolio specifically, we've still outperformed over the last 12 months, but for this quarter, we underperformed in this challenging environment. When you look at what drove that, it really wasn’t any common theme. If anything, what we saw was aggressive sell-down when any stock seemed to miss earnings or lower guidance across a range of industries.

When you look at the sectors that did detract the most for this quarter, it was consumer discretionary, industrials, and basic materials. The biggest individual detractor was window and door manufacturer, JELD-WEN. This is a company we've owned for quite a few years. The door industry is a great industry with two players that have really created a global duopoly for interior molded doors, and windows is similarly a consolidated industry.

During this quarter, there were some weak volumes and guidance, really driven by macro, and the stock overreacted to it. There was also potentially some overblown response as, in the first quarter, the largest competitor to JELD-WEN in the door industry was acquired, and there might have been some takeover premium on hope that maybe JELD-WEN would be acquired as well. As that unwound, the stock was down pretty substantially, and we actually took an opportunity to add more of it during the quarter.

Another detractor was Lear, which is an automotive seat supplier. This is making seats for cars. This is an industry where there's a lot of turmoil in automotive generally, as we're seeing more electric vehicles and the transition from internal combustion, but seats are something that are needed regardless, so they're well-positioned to work their way through it.

What really drove some of the weakness this quarter was a lot of production disruptions, as many of the OEMs were assuming that we'd see much better adoption of electric vehicles, which hasn’t been occurring as much as expected. So, a lot of the suppliers have been building out supplies of EV seats and components that are needed, and as those didn’t take off, you had higher R&D expenses for some of these new products, as well as just inefficiencies based on the production patterns versus what was expected. Nothing changes in how we think about this business for the long term, but it was weak in this quarter.

When you look at what some of the top contributors were, I'll call out specifically CH Robinson and Humana, two very different companies. CH Robinson is a freight brokerage company. This means they’re not a trucking company; they will connect companies that are shipping things with the truckers themselves in order to help them figure out backhaul and where everything should go and who should carry it. The stock did well really on two things: one was that global freight rates were up from some of the Red Sea disruptions we saw because of some of the disruptions there. Pricing overall increased, and then also we saw early signs of some self-help on the North American Truck Brokerage business, which is part of the core thesis that they had made some mistakes strategically on this, and they’re working their way through them.

The other one, Humana, is a Medicare Advantage health insurer. This is an industry where Medicare Advantage has seen a lot of disruption over the last year or so, because after a couple of years of low utilization, we’ve seen much higher utilization than expected for the senior citizen population. So, there’s some mispricing really for the whole industry in this space. Humana is one that’s still profitable, while many of their peers are not. And what we’re seeing is that, as everyone’s facing these same challenges, everyone’s talking about raising pricing for next year, being more rational, and adjusting for it. So now, after a lot of negativity, we’re seeing more optimism on how the business should be able to adjust for this.

During the quarter, we added a new name, FMC, which is a leading crop protection chemicals company. So this is for farmers around the world who want to treat their crops with different chemicals to protect them. One of the leaders in this space is FMC, which makes a range of products that deal with critters and mites and other things that they’ll face.

Really, there’s been a lot of pressure in this space because of destocking, because there were so many supply chain disruptions in 2021 and 2022 that the whole supply chain bought more product than they needed, and then 2023 into 2024, they have not needed to order as much as they’ve worked down those inventories. That’s led to lower sales and lower earnings for FMC and inefficiencies in working capital. So, their debt load has increased.

As we come through 2024, what we’re seeing is that a lot of that should start to reverse, which will be very good for earnings and especially for free cash flow. There was also a short report last year that drove down the stock on some concerns around generic alternatives, but this is well more than priced into the stock. And generics in this space is very different from generics in human pharmaceuticals, where you see a lot of shifts overnight; it’s a more gradual process. And if you look at the history, the total amount of shifts is really actually not as much as you’d think.

So, overall, as we come into the rest of the year, what I’ll really say is we’re seeing a wide range of opportunities across different sectors that really haven’t been concentrated in different areas, and we continue to be excited about the opportunities set.

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