Welcome to Conversations with Ken. A podcast where we discuss relevant topics in investing. I'm Ken Crawford, Portfolio Manager with Argent Capital Management.

Ken: Today I have the pleasure of being accompanied by Kirk McDonald, our Mid Cap strategist and Portfolio Manager. Kirk, how long have you been with Argent?

Kirk: I've been with Argent about ten and a half years Ken.

Ken: Ten and a half years. That's a good amount of experience. And as I recall, when you got here, the Large Cap team was full. So I guess you got stuck running Small Cap or Mid Cap and got the short straw. Sorry about that.

Kirk: Well, that's not true. And life in general, the word “middle” has all sorts of negative connotations, like you get stuck in the middle of nowhere, your career tops out in middle management. But that is not true when it comes to investing in the stock market because midcap stocks have been the best performing group of stocks in the US stock market historically. And that's why we started the Argent Mid Cap fund, to give our investors the opportunity to invest in this asset class. I'll give you an example, so since 1998, when Argent was started, the midcap group of stocks, as measured by the Russell Midcap Index is up over 800%. In that span of time, the small cap group of stocks, the Russell 2000, which are known as the best performers, they actually are up only a little over 600% in that amount of time. So a big 200% difference. And then large cap stocks, which get a lot of notoriety, especially on TV, that's what people generally talk about. They're up less than 500%. So once again, a big step down from the midcap stocks.

Ken: Hmm, well, that surprises me. And as you mentioned, large cap, that's where I live. So when I think of good stocks, and the stock market rising, I think of Apple and I think of Microsoft, and I think of Google and Target and you can’t own those in midcaps. So how can you generate performance like that?

Kirk: So an important thing to keep in mind about midcap stocks is these are not fly by night companies, they're actually quite large. So the average market cap of a midcap stock is $33 billion. So they're quite big. But the average market cap of a large cap stock, that's generally more of a household name is now $409 billion. So 12 times larger than your average midcap stock, but they are still plenty large to be very, very safe. And in fact, they've historically generated these good returns. They have management teams that are able to build the business and the processes, and discover the products that are interesting to people, that they want to buy and grow from a small cap to a midcap, and are able to keep growing that company and take advantage of their ability to go out and raise money and borrow money from banks, maybe sell more shares of stock to get capital to reinvest in the business and then grow to try to become a large cap stock in the future.

Ken: So I know, your team-you said you have ten and a half years at Argent and you've got Bill Weeks who is a PhD. But I did a little research, which is always a little risky and the universe as far as I understand in midcap is 1500 names. So firstly, how many stocks do you have in your portfolio on average?

Kirk: We are very, very selective. So right now we have 44 stocks in the portfolio. And it's designed to be between 40 and 50 stocks at any given point in time.

Ken: So 40 to 50 stocks out of 1500. How is it possible that just you two can narrow that universe to find those companies?

Kirk: So thanks for the question. And one thing we've come up with that's very, very different than what most other people do is this blended process of fancy quantitative models, mathematical models, and mixing it with fundamental research. So Bill, as you mentioned, has a PhD. and he has about 16 years of experience building these mathematical models to help pick stocks. And I have a little bit more experience than that- about 18 years. And all it means when you say quantitative is basically you're taking financial ratios, things that help describe what a good business is, so think- a business that earns high returns on capital. So they earn on average in our portfolio about thirteen and a half percent, so thirteen and a half cents of return for every dollar that's reinvested each year. Whereas the general market as a whole, it's more about nine cents of return on every dollar invested. So a good business to us is one that earns those higher returns on assets. Well we have a factor in the model that's called cash flow return on assets that measures that, and all that fancy word “factor” means is that cash flow return on assets is just statistically related to finding stocks that beat the market and outperform the market. So we've combined a group of these in a model. And then what we do is we're always seeking alignment between that and the fundamental research we do. So the basic, fundamental strategy at that company. So we want to hear management talking about how we're investing in higher return on assets, projects, and trying to grow that number and get bigger and more profitable over time. And when we can find that alignment between what the quantitative scores are telling us and what management is saying they're trying to do- that's nirvana for us. We get very, very good results and our best results that way. So we end up with a very small number of companies that meet that hurdle.

Ken: Well, that makes a lot of sense, focusing on the relevant metrics that drive stocks upwards, and then finding management that gives you confidence, both for the results that they've produced, but also results that they could produce going forward. So with that, are there any particular companies that you hold now in your 44 stock portfolio that intrigue you that you'd like to tell our listeners about?

Kirk: I think one that people might find interesting that they've never heard of- so it's a good example of a midcap stock- but it's all around us. It's is Entegris. And you mentioned Ying Ko did your last podcast with you about a month ago, and you all talk about the big shortage of semiconductor chips right now.
Those chips go into everything from automobiles, to ovens, to your cell phone, and your Apple watch. Well, Entegris makes these very highly engineered materials that go into every single one of these chips. And now that the chips are in such demand that they're selling those materials, like as fast as they can possibly make them. And there's only about three companies on the planet that really make these highly engineered materials that go into all the chips. So Entegris, I guarantee you, there's some of their product in my phone, and the watch I'm wearing on my wrist right now. And same thing for most of the people listening to this. So it's all around us every day, but we haven't heard of it. And it's doing phenomenal business right now.

Ken: Great. Any others?

Kirk: Another one that's kind of interesting, and it's a good example, because they do something that's much simpler than what Entegris does, is Cintas. They're the largest uniform rental company in America. And they're also around us every day, but we don't notice. But if you've taken your car into the auto repair shop, most likely the people in that shop are wearing uniforms provided by Cintas. Same thing with hospitals, most of those uniforms are provided by Cintas these days. And it's just growing around us a little bit faster, roughly twice as fast as the overall economy. Because more types of businesses are finding that it's useful to supply their employees with the uniforms to wear so they look good every day, it's easier for the people to have nice clean clothes provided for them by a company like Cintas. Start looking as you're driving around the streets. And you'll see Cintas trucks all around you now. And every time you think you see a Cintas truck, think of Argent Mid Cap.

Ken: Well, I will certainly keep my eyes open. And those are two very interesting companies. So if you buy these companies, because they have good metrics, because they have good management, because they're doing well-at some point, the midcap companies that you own are going to appreciate and pretty soon they'll be in the large cap space. So you have to sell them and then and I would imagine your turnover must be pretty high.

Kirk: Actually, our turnover is very, very low. So over the long run, our turnover is about 28% a year, and in the past year, it's only 24%. It's been gradually coming down over time. And to put that in perspective, most of our competitors turn over their portfolio 100% every year. So every single stock comes in and goes out during a 12 month period. We're very different than that. So what we do is we will grandfather a stock in. When we buy a midcap stock, we want nothing more than to see that grow and become a large mega cap stock and have it on TV every single day and people talking about it and how great their products are. So we will grandfather that in and continue to own it as long as it meets our investment criteria. But we take an overall portfolio approach. So looking at all the 40 to 50 stocks in the portfolio as a whole to make sure on average, our market cap stays solidly in that midcap range. And we don't grow out of that because it's a very, very good place to be.

Ken: So explain to me more. If you've got these companies that are growing and becoming large cap, and you're holding them and we do that as well in large cap - hold on to your winners, how do you not have a mid cap portfolio that becomes a large cap portfolio?

Kirk: Because over time some of these stocks will meet our sell discipline. So a good way to think of the stocks in our portfolio is really like hogs at the trough. So imagine a farm, and you've got a bunch of hogs at a trough, and they're all lined up there, they're eating and growing just as fast as they possibly can, behind them is a group of younger, hungrier hogs a little bit smaller, trying to force their way in and get their turn at the trough. And every now and then one of those hogs at the trough is satisfied with how big and strong they are. And they stopped eating quite as fast and they stopped fighting as hard for their spot at the trough. And one of those younger hungrier hogs, smaller hogs behind them, is able to push them out of the way and get their turn up the trough. So think of those hogs at the trough as the stocks in the Argent Mid Cap portfolio, every now and then one of them tells us that they're satisfied with how big they are and they stopped growing quite as fast as they had historically. And that to us, that's our sell decision, that then it's time to move them out of the way and give another younger, hungrier smaller stock, a chance at the trough and to come into the Argent Mid Cap portfolio.

Ken: And through that process, then you get good growth with your portfolio as a whole and stay within the midcap space?

Kirk: That's exactly right.

Ken: Well, that sounds like a very interesting strategy. I like the blend of quantum fundamental and your results have certainly been impressive. I should look at the strategy.

Kirk: Well actually Ken you are a long term investor in the Argent Mid Cap strategy right now.

Ken: Oh well, then I guess I’m a better investors than I thought. So with that, I wanted to say thank you Kirk McDonald.

Kirk: Thank you very much, Ken, for having me on your podcast.

Thank you for listening to conversations with Ken. For now, stay safe, stay well and thank you for investing your time with us.