



The Case for Wedgewood's Focused SMID Cap Strategy

Our proof statement to launch a Focused SMID Cap strategy is three-fold. First, the consistency of our Large Cap Focused strategy in outperforming the Standard & Poor's 500 Index over the past 5, 10, 15, 20, 25, and since inception time frames. Second, in launching a SMID strategy, we are simply institutionalizing a key element of our research process; that of identifying, researching, and building a bench of smaller than large cap stocks to feed into our Large Cap strategy. Third, in an investing world dominated by indexation within large cap, we view SMID Cap as open-field running for active managers – particularly for focused managers.

Results matter. At Wedgewood, our investment strategies must be unique in order to outperform our active peers and benchmarks over the long term. Our nearly 30-year-old investment philosophy of investing in our focused portfolio of only our best, most convicted ideas is a simple, yet powerful means to differentiate ourselves in the highly competitive investment management industry – in both active and passive investing. Focus is our edge. Our focused edge is repeatable. Our long history has been investing in large cap stocks where we typically own between 18 and 22 holdings. According to Informa Intelligence PSN Enterprise database¹, there are nearly 900 strategies in the U.S. Large Cap Equity universe, and just 61 – or about 7% – of the strategies have fewer than 22 holdings. There is little doubt that managing a focused portfolio the Wedgewood way is uncommon.

As capital markets have dramatically expanded over the past few decades, we have witnessed market cap ranges expanding wider and higher. Consider, a decade ago the largest market cap companies in our investment universe were Apple along with Exxon Mobil, at about \$330 billion each. The median market cap of the same universe was around \$5 billion. Today, Apple continues to be the largest company by market cap at nearly \$2.5 trillion – almost 8 times larger – and the median market cap of our investment universe is \$15 billion – about 3 times larger.²

As we maintain our market cap investment discipline, our Large Cap Focused portfolio typically carries very few holdings under \$20 billion in market cap. However, we believe there is a tremendous opportunity for our focused investment philosophy and process to add value at market caps of \$20 billion and below. Wedgewood's Focused SMID Cap portfolio aims to extend our core competency in focused investing by constructing a portfolio of 25-40 stocks with market cap ranges between \$500 million and \$20 billion. Further, there is

¹ PSN Enterprise as of 6/30/2021. Wedgewood Partners contractually subscribes to Informa Investment Solutions (PSN) on an annual basis.

² Source: Factset

the distinct possibility for the Wedgewood SMID Cap portfolio and Wedgewood Large Cap portfolio to both generate significant value-add in their portfolio overlap. Importantly, the Wedgewood Investment Committee has followed many of the holdings in the Wedgewood SMID Cap portfolio for many years as a byproduct of the team's analysis and due diligence efforts on the Wedgewood Large Cap portfolio. For example, First Republic Bank was on the potential buy list for Wedgewood Large Cap for many years. First Republic Bank's initial public offering was in December of 2010 at a market cap that was around \$4 billion. The Company spent the next 5 years below \$10 billion market cap. In mid-2018, Wedgewood incepted its SMID Cap portfolio with a weighting in First Republic Bank. While it was appropriate for the SMID Cap portfolio at the time, the investment team was still not convinced the Company maintained the characteristics necessary to outperform in large cap. However, by the summer of 2020, First Republic Bank was on the cusp of \$20 billion market cap and was also sustaining very attractive growth levels even when compared to tech-laden large cap markets³. Subsequent to adding First Republic Bank to the Wedgewood Large Cap Focused portfolio during the third quarter of 2020, the Company's market cap has increased to \$32 billion as of June 30, 2021. Wedgewood's unique philosophy and process often uncovers attractive opportunities that can add value for clients across the SMID Cap and large cap market spectrums.

Our SMID Cap portfolio of 25 to 40 holdings is slightly less concentrated than our Large Cap Focused portfolio quite simply because the universe of SMID cap companies is much wider than our Large Cap universe. In fact, the SMID universe, nearly two to three times broader than Large Cap⁴ with more business models that exhibit the characteristics we look for in our investment process. Despite this, and according to Informa Intelligence PSN Enterprise database⁵, there are 204 products in the US SMID Cap universe, and just 18 – or about 9% – of the products have fewer than 35 holdings. Again, we find that our practice of focused investing an uncommon strategy compared to both passive and active options. To reiterate, in order for a strategy to add value in any competitive industry, it has to be structurally different and repeatedly executed.⁶

In order to maintain a focused portfolio, investment managers must make tradeoffs, particularly related to capacity. For example, an equal-weighted portfolio of around 30 holdings would be able to scale assets under management to around \$1.5 billion to \$3 billion⁷. In contrast, the vast majority of investment portfolios carry 100 or more holdings⁸ and could scale from \$5 billion assets under management to \$10 billion (and above), generating significantly more revenue for the investment manager. At Wedgewood, our investment professionals maintain nearly 95% of the equity of our Firm and have made the conscious decision to trade lower potential firm revenue for a higher probability of value-added outperformance. The concomitant expense structure to support that revenue base must also be lean and scalable. Rather than rely on a large, fixed cost base of marketing and distribution professionals, Wedgewood has partnered with excellent third parties. Our

³ FRC 5yr compounded asset growth of 19% compared to 4% revenue CAGR of S&P 500

⁴ Ibid

⁵ Ibid

⁶ Source: Magretta, Joan (2011-11-22). Understanding Michael Porter: The Essential Guide to Competition and Strategy

⁷ Assume stay below 10% ownership of outstanding equity and portfolio holdings have a minimum market cap of \$500m to \$1 billion

⁸ Morningstar Premium Fund Screener: Fund Category = U.S. Equity; Number of Holdings in Portfolio

focused approach to investing has been made at the ownership level in order to align ourselves with customers seeking to find truly differentiated active management.

In conclusion, active management is a perfect example of an industry that is crowded with a vast array of highly competitive players, discerning customers, large and commodified suppliers, and passive index substitutes. Active managers need more than just an informational advantage to sustainably add value over time, considering these competitive pressures. Our long-term track record of success using a focused approach has differentiated us since 1992. As capital markets have dramatically expanded against this competitive backdrop, we have extended our philosophy and process in launching the Wedgewood Partners Inc's Focused SMID Cap Strategy and have managed to generate a 21% compounded return over the past 3 years, which places it in the top 1 percentile relative to the PSN SMID Cap Core Universe⁹. We think our superior performance is a byproduct of Wedgewood's unique and sustainable approach to focused investing.

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⁹ 6-30-2018 Inception through 6-30-2021 – net of fees. Returns are presented net of fees and include the reinvestment of all income. "Net (actual)" returns are calculated using actual management fees and are reduced by all fees and transaction costs incurred. Past performance does not guarantee future results. Additional calculation information is available upon request.