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THE WALL STREET TRANSCRIPT

Connecting Market Leaders with Investors

Disciplined Mid Cap Growth Strategy Screens for Low Volatility First

KC MATHEWS, CFA, serves dual roles as the Chief Investment Strategist at Commerce Investment Advisors, Inc., adviser to the Commerce Funds, and Chief Market Strategist at Commerce Trust, a division of Commerce Bank. Mr. Mathews is a thought leader for the firm, speaking on a range of topics that include economic forecasting, market outlooks, and investment strategies. He also serves on investment and oversight committees within Commerce Trust and Commerce Investment Advisors. Prior to joining Commerce in 2023, Mr. Mathews served as the Chief Investment Officer at UMB Bank. Previously, he held positions of increased responsibility within the trust division of the Bank of Oklahoma. Mr. Mathews holds a bachelor's degree in economics from the University of Minnesota and a master's in business administration from the University of Notre Dame. He is a graduate of the ABA National Trust School at Northwestern University and completed an advanced investment management education program at the Harvard Business School. He earned the Chartered Financial Analyst designation, is a member of the CFA Institute, and is a past president of the CFA Society of Kansas City.

SECTOR — GENERAL INVESTING

TWST: Let's start with an introduction of sorts. What would you like readers to know about Commerce's investment and fund management business?

Mr. Mathews: The Commerce fund family was founded back in 1994. It is a family of nine mutual funds, currently has approximately $2.7 billion in the funds, and in separately managed account form there's an additional approximately $41.7 billion.[1] The current adviser is Commerce Investment Advisors, which was founded back in 2001, and prior to that, it was Commerce Bank.

TWST: How would you describe the investment philosophy overall, and what characterizes your approach to your mid-cap strategy specifically?

Mr. Mathews: If we focus on the equity side, it is more of a quantitative process. I want to make it crystal clear that it's not black box, meaning there are active decisions to be made, but we have a very disciplined screening process that we use to create these strategies. When it comes to mid cap, specifically, we have two strategies, a mid cap growth and a mid cap value.

With mid cap growth, this is a strategy that's quantitatively driven. What we look for is a low volatility strategy, which we think is somewhat unique in the marketplace. Our philosophy is, we believe that risk, defined as volatility, is not the driver of returns, and we believe in remaining disciplined.

We start with the Russell MidCap Growth index, and then we overlay our process, first by looking at low-volatile names. We stack rank the index into deciles, and what we've learned over the years is that the lowest four deciles, or 40% of the market, which has the highest volatility typically performs the worst. So we just want to stay away from those stocks.

Then once we have our low volatility universe, we do apply a proprietary quantitative scoring system where we will look at things like earnings estimates and free cash flow. Like I said, it's not a black box, we use it to assist us in our decision-making process.

The last step is in portfolio creation. We want to be virtually sector neutral, and equally weighted. We're going to create a portfolio with approximately 80 names, so 1.25% positions, and then we rebalance that portfolio every quarter so it remains very disciplined.

TWST: What's the thought process behind intentionally staying sector neutral and equal weighting? Some folks do, of course, choose to be over- or underweight certain industries relative to the benchmark.

Mr. Mathews: Correct. Our thinking is, we want to have a low-volatile product at the end of the day, and we never want to torpedo a client. By implementing those fundamental decisions, you just add risk to the portfolio.

TWST: With that as a backdrop, could you tell us about a couple of favorite names, whether top 10 holdings or recent additions?

Mr. Mathews: We don't like to have favorites, because, again, we want to remain disciplined to our process. As you know, this time of year the Russell indices go through their rebalancing. Perhaps some larger names that we've owned, if they moved up in capitalization, and/or names moved out of the low-volatile universe that we create, we have to say goodbye to them. We're not married to any name. We don't really have favorites. It's really predicated on the process that I just outlined.

And our top 10 holdings, we don't have large positions, we're not going to put 8%, 10% in one name. Again, this is a low-volatile product. We want to remain equally weighted. And when you look at our track record, I think it is proven to hold that we end up with decent competitive returns with low volatility.[2,3,4]

TWST: Clearly, as you've discussed, you wouldn't be intentionally over or underweight any areas, but are you seeing better or more opportunities in certain industries or sectors?

Mr. Mathews: I understand the line of questioning, but again, the process drives us to that, for the most part, plus or minus a couple of percent within the sectors. And that plus or minus percent sometimes can be market drawdowns or market lift.

At our quarterly rebalancing, we're going to rebalance the positions as long as they remain in our screening process. If for some reason a stock underperformed and it came down to 1%, we're going to rebalance, we're going to double down and buy more of that security. If it did well and it's at 1.5%, we're going to trim. Again, it's an extremely disciplined process.

TWST: You just mentioned the possibility of trimming, or adding to, a holding. Is there anything you'd add in terms of your ongoing risk management and ongoing portfolio monitoring?

Mr. Mathews: I don't know if I would add much. There are unique cases, unique situations, where we would take some active fundamental decisions. It could be due to M&A activity. In between our rebalancing, if we get some M&A activity, obviously we're going to look at the situation, look at valuation, and then either hold or trade the stock.

In addition, we want to be tax aware. It could be that we bought a stock, and let's say it was successful and it falls out of the low-vol universe and we've got another month until it becomes a long-term capital gain, we're probably going to override the strategy in that unique case because it's in the best interest of our shareholders.

TWST: Broadly speaking, do you think investors pay enough attention to mid cap? Does it play an important role in a client's overall investments?

Mr. Mathews: It's probably an underinvested asset class. And I would say, in recent history, that's probably the case just because of the performance of the mega caps.

You can look at the mid-cap index data going back to the late 1970s, and what you'll find is mid caps outperformed large caps during that time frame, and significantly outperformed small caps over a long period of time.

As you and I both know, if you go back over the last year or short-term periods, it's all about domestic large caps and, you probably could even say, technology.

So, yes, I think mid caps play a role in portfolio creation. What we at Commerce like about mid caps is they have, we think, unique risk/return profiles. Using long-term numbers, empirical evidence, they have attractive risk/return profiles.

You can get returns in an expansion like small caps with lower risk, and maybe defensive natures like large cap with similar standard deviation. So we think it does have a unique risk/return profile.

TWST: Are there common questions or concerns that you hear from clients specifically around mid caps?

Mr. Mathews: In general, in the last year, it's performance related. Year to date, the Russell 1000 is up about 13%, and the Russell MidCap is up about 6%. So the common question is, why do I own mid caps then? But if you're a long-term investor, given the conversation you and I just had, mid caps play a role.

What I like to think about is, we've been in the business a long time, so we understand reversion to the mean, and if we believe that that will hold true at some point in time, mid caps will be an important part of the portfolio. Maybe Mark Twain said it best — maybe history's not going to repeat itself, but perhaps it'll rhyme.

As I just cited, mid-cap index data going back to the late 1970s — you would want mid caps in your portfolio.

TWST: Are there specific investment market signs of change or shifting taking place that you keep an eye on?

Mr. Mathews: I think you're going to see signals that may change coming up here. One would be, on the macro side, interest rates. We believe, and the market believes, that clearly you're going to see a change in the trend and level of interest rates. That could play a role when you think about the composition of these indices.

We know that large-cap indices, using the Russell 1000, that's 28%, 29% in technology. But what if lower interest rates have a positive impact on things like finance or real estate or utilities? Well, the mid-cap indices have a much higher exposure than large cap in those respective sectors.

We're in the camp that inflation will continue to subside, and at some point, probably closer to the end of the year, we're going to see lower interest rates, and I think that could be a signal where you see a leadership change in the market.

TWST: If you got your crystal ball out, is there anything else you might anticipate in the next six to 12 months or so?

Mr. Mathews: Our economic viewpoint is modest economic growth, but modest economic growth with lower inflation and lower interest rates still provides a decent backdrop for corporate earnings. So we're still positive on risk-based assets, not only mid caps, but large caps, because we think earnings growth will still be favorable.

I think in the next 18 months, like we talked about, you could see a change in leadership, whether that's mid caps or small caps, whether that's different sectors. I think the bottom line is, our view is that the macro backdrop will provide a decent environment for earnings growth and risk-based assets, so stay invested.

The market's been very, very narrow, and we've seen this before. I talked about reversion to the mean; eventually the market broadens out. We can definitely see that, and that's where we think our process, our discipline, and our sector-neutral and equal-weight portfolios should be interesting.

TWST: Do you want to wrap up with any final topics?

Mr. Mathews: I might leave you with a thought, and maybe I'm selling my own book, but it is interesting: We don't find many mid-cap growth funds with a low volatility bent. And when you think about where investors would use something like this, you think about all the qualified money, whether it's a 401k or IRAs, where you definitely want to grow your assets but you want to control volatility, I think the Commerce Mid-Cap Growth Fund (CFAGX) is a unique option.

TWST: Thank you. (MN)

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Footnotes and Disclosures:

[1]Assets are of 5/31/2024 and subject to change.

[2]This is the opinion of the speaker and not that of Commerce Funds or Goldman Sachs & Co. LLC.

[3]The returns represent past performance. Past performance does not guarantee future results. The Fund's investment return and principal value will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost. Current performance may be lower or higher than the performance quoted above. Please visit our Web site at: www.commercefunds.com to obtain the most recent month-end returns.

[4]The Commerce Mid-Cap Growth Fund returns as of 6/30/2024 are as follows for the following time periods: -1.79% for the quarter, 4.55% year to date, 12.93% for 1 year, 1.91% for 3 years, 8.72% for 5 years, 10.57% for 10 years

The expense ratios of the Fund do not have a fee waiver and expense limitation. The Net and Gross expense ratios are the same for Commerce MidCap Growth Fund at 0.80% as of 6/30/2024.

Standardized Total Returns are average annual total returns or cumulative total returns (only if the performance period is one year or less) as of the most recent calendar quarter-end. They assume reinvestment of all distributions at net asset value.

Please consider a Fund's objectives, risks, and charges and expenses, and read the prospectus carefully before investing. The prospectus contains this and additional information about the Funds. A current Commerce Funds prospectus or additional information regarding The Commerce Funds may be obtained by calling 1-800-995-6365, visiting our website at: www.commercefunds.com, or by writing to The Commerce Funds, P.O. Box 219525, Kansas City, MO 64121-9525

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