Active Insights Podcast – Advisory Research Investment Management: “It's insightful to appreciate that growth companies are solution companies”

Diane Merritt:

Welcome to North Square Investments Active Insights podcast. North Square Investments is dedicated to bringing differentiated active investment strategies to financial advisors and investors through our multi-boutique asset management platform.

Today, Mark Goodwin, Chief Executive Officer of North Square Investments will discuss the approach to building high-conviction equity portfolios of Advisory Research Investment Management with Matt Swaim, Managing Director and Executive Chairman, and Andrew Cupps, Managing Director and Portfolio Manager. Advisory Research is a partner firm in the North Square platform and subadvisor to North Square Advisory Research Small Cap Growth Fund, ticker ODGIX. Mark, Matt, Andrew, we look forward to your discussion.

Mark Goodwin:

Thanks, Diane. As you mentioned, at North Square we seek out best-in-class* active managers for our platform, and our partners at Advisory Research have a long history of success with their approach to fundamental equity investing. Matt, Drew, thanks for being with us today.

Andrew Cupps:

Excited to talk to you.

Matt Swaim:

Thanks for having us, Mark.

Mark Goodwin:

Matt, I'm going to start with you. Advisory Research has managed equity portfolios for over 30 years, primarily for institutional investors. Many financial advisors and retail individual investors may not be as familiar with the firm. Can you give us some background on the firm and your investment team?

Matt Swaim:

Sure. Advisory Research has primarily worked with institutions in that we have a very research-intensive investment process that produces specialized, more concentrated portfolios for our clients.** And institutions have always liked that in that it adds some diversification to their index-type portfolios or their broad-market portfolios. So we're able to add something different to our research process and our portfolio management skills.

Also, we have kind of been under the radar to some degree in that we are employee owned. We are partner driven. We've served our clients well in the institutional space. But we just see an opportunity today to partner with North Square to bring that institutional knowledge and research prowess to a retail product. And so we're excited about it.

Drew Cupps, who's on the phone with me today, joined Advisory to lead our growth team in 2016. You know, I had led another part of our firm on the value side where we were very intense in what we believed and what we did for our clients. Drew did that in his firm, and we were able to join forces in 2016 to bring a more diversified offering to the institution, our institutional client base. So it's been exciting for Drew and I to work together over the past five or six years. And we're both very excited to work with North Square going forward.

Mark Goodwin:

Drew, I'm going to turn to you. Your investment approach is very research-intensive with a strong focus on stock selection. Can you talk to us about the core investment philosophy of your team in managing growth equity portfolios?

Andrew Cupps:

Sure, Mark. I'm glad to be here. I'm glad to share some of my insights with you and the audience. I've been investing for nearly, well managing these portfolios for nearly 30 years now. And I adore the process of trying to appreciate and understand just what exactly drives stocks, what makes stocks go up and what makes stocks go down. At the philosophical level, we have quite a bit of conviction that the core driver is what I call dynamic forces. And we think that there's really four dynamic forces that are responsible for the vast majority of notable stock performance increases.

And so two of them are really company-specific. And they are competitive advantage and strategy shifts within the company. And then two of them are very much external in nature. And they would be thematic forces. And what we mean by that is we mean technological or behavioral shifts that occur in the world and really transform industries and transform behavior. So they're very powerful, thematic forces. And then the last, the fourth, would be the cyclical business conditions that do change and really can be tremendous tailwinds to more mature, more established businesses. So a lot of our work and our process focuses on these dynamic forces.

Mark Goodwin:

Drew, putting together portfolios, you have to filter through the universe of small-cap equities to develop a workable set of potential investments and including the range of the Russell 2000 or Russell 2000 growth indices. How do you get to that workable set, and in doing so is your primary focus here on identifying growth potential or historical demonstrated growth?

Andrew Cupps:

Yes, it's so important at the end of the day what a management team spends its time on. The decision around what to spend time on really dictates the ability to succeed or not. So how we do just as you say, how we filter through the universe is certainly very important.

We take two primary approaches. One is that we work quite hard to develop a thematic lens. You know, constantly our team and I work to identify groups of stocks that are connected to these thematic forces that I referred to just a moment ago. So one of them is a fundamental, kind of subjective identification of what is essentially in play or positioned in a beneficiary way now.

The second primary approach to how we work through and filter through the many opportunities is something that we call inclusive screening. So many managers do a version of what we think is accurately called exclusive screening where they identify multiple criteria and start with a large group and screen down to a very small group that fits all of those criteria. We have found that great stocks are rarely perfect stocks. There's often some of the greatest stocks that have made multi-year or even decade-long runs have something that's not quite right, not perfect about them. And so what we have done is create processes around identifying stocks and companies that exhibit very powerful traits, such as earnings, beats, technical breakouts, revenue acceleration, et cetera. And then we hand over those, as we identify those stocks our research team then does the deep dive to round out the rest of the equation.

So that's a little bit different, that we screen through inclusion, a little looser screen than through exclusion. And so between the thematic lens of identifying the most important parts of the economy in the market and then the inclusive screening, we do a pretty good job of focusing our efforts into where the highest profile stocks are "living" at a given time.

Mark Goodwin:

So to distill that down, Drew, what would you say are the key characteristics for a stock to ultimately become a position in the small-cap growth portfolio from either the sales growth or earnings growth, or are you dealing with some stocks that don't have earnings, like biotechs? But give us a sense of the snapshot.

Andrew Cupps:

Yes, it's a great question. So again, one of the things that we have done somewhat uniquely versus our peers is we've identified a number of traits that we believe are very important. However, we focus more on the disproportionate weight amongst the set rather than insisting on minimums across the whole set. And what I'm referring to, we've developed a proprietary approach that we call our “five perspective approach.” And what we do is our team judges every candidate across these five perspectives. And we ultimately have a weighting system whereby we score these and come up with a total score. I mean, not every perspective needs to be the highest score. But across the five, we have to have a strong enough score.

And the five considerations are, as we refer to them as perspectives will include valuation, technical behavior, thematic timeliness, the quality of the business model, and the confidence we have in the management team. Our experience has showed us that those are the five criteria that really matter. A company doesn't have to be perfect. It doesn't have to ace every one of those. But the majority of those in different combinations need to be strong enough to drive the company to add value through earnings growth over time.

Mark Goodwin:

That's helpful, Drew. Changing gears, many small-cap strategies, and looking at several of your competitors, may have many hundred positions while your portfolios are concentrated with high-conviction and more concentrated portfolios. As you're considering portfolio construction, what are your key goals and to what degree does risk management come into play?

Andrew Cupps:

Yes, another super important topic. I think there's really two of them there. One is the winnowing process down from the many, as you say, hundred or even thousands to a portfolio for us that typically is about 75 positions. So, well-diversified portfolio, though a little bit top heavy. So we do concentrate our capital in some larger positions.

You know, we handle that first step of the winnowing through that scoring process that I just referenced where we do quantify a number of inherently qualitative judgements. I've been doing this about 30 years. I have a team that's a special team where I've been working for about 23 years with one of my partners, nearly 15 with another. So we all have a lot of experience to bring to bear in that experience shoulder to shoulder looking at the same things. And so we are able to produce a similar translation from the qualitative to the quantitative and narrow the portfolios down.

And then in the second part, the portfolio construction, we do what many managers do, which is establish diversity across economic sectors. We think that's kind of table stakes. The thing that we have really focused on over the last five, six, seven years that we think has, in a lot of ways, really upped our game is that we add to that economic diversity a diversity in factor profile.

So for example, you could have a software company and a restaurant company. If they are both growing at 42% a year and they both have, pick your positive or negative margins, they both have, let's say 10% margins and their operating margins are expanding in both, by and large you really own the same security. That security is largely going to be treated the same way from a factor standpoint. So we work both on the economic diversification as well as the factor diversification in our portfolio construction. And ultimately, that produces a risk management profile that is the best that we can achieve while we also pursue opportunities.

Mark Goodwin:

Drew, I know you look to hold positions for the longer term, but you are also continuously evaluating the portfolio. Can we talk about sell discipline for a moment? And could you comment on what issues or catalysts would result in a change making you sell a particular position out of the portfolio?

Andrew Cupps:

Sure thing. The nuts and bolts of how or why we sell a stock, or at least the function is the score that I referred to earlier. We have the five perspective research that produces a quantitative score made up of our team's insights. But then the reasons that a company would experience a lower score and therefore be pushed out of the portfolio really fall into three buckets.

One reason we would sell is we simply have opportunities to upgrade the portfolio with new holdings that are even stronger, even more attractive than some of the current holdings. So that's the, in many ways a very positive way and reason to push out a position from the portfolio. The second reason that we would make a sale would be a series of ads and trims. In a given holding, as that holding, as that stock rises and falls, maybe makes a notable advance, it becomes a little less attractive, and we may choose to trim that holding, although maybe not totally push it out of the portfolio. So the second bucket would be what I'll call ads and trims around varying levels of attractiveness. And the third reason for a sale would simply be a thesis that was not satisfied, a negative development at a company that takes it from something we deemed attractive to something we deem unattractive by the five perspective score. So those are the reasons that we would make sales in the portfolio.

Mark Goodwin:

Drew, I'm going to change to the macro environment for a minute. Equity markets have had a more volatile start in 2022. The Fed is on track to be less accommodative, inflation remains a growing challenge, and geopolitical tensions have also increased with the Ukraine war. As we move towards the end of the first quarter, where do you see the equity markets currently? And what's your outlook for the remainder of 2022?

Andrew Cupps:

Yes, it's interesting. There's as so often is the case, we often find ourselves referring to the currents under the surface. And I think that that is true here. There's almost a tale of two or even three markets. One group of stocks would be the kind of core growth stocks, the secular growth stocks, and they have declined in price quite dramatically versus say November or late October of '21. It's really notable, in a lot of cases we have 30% to as much as 60 or even 70% declines. And so what that does is that does a tremendous amount of discounting of these challenges that you just mentioned, whether it's inflation or higher rates or geopolitical turbulence. A lot of the positive expectations that those stocks may have included just five months ago has been removed. And so we are very cautiously or in the early stages of having a lot of enthusiasm for reengaging in some of those great secular growth stocks.

The second group I would call out would be the inflation beneficiaries. Right now, that's some metals companies, commodity companies, aerospace defense companies, et cetera. We can kind of map the geopolitical instability and inflation to the groups that would be beneficiaries. Some of those are interesting as well. And we often work around the idea of a core secular growth portfolio complemented by companies that have those different profiles, those different factor profiles. And so that second bucket would include some of those stocks that we're enthusiastic about and have in the portfolio.

And then the third group that I'd call out would be just the mature companies that haven't had a lot of love for quite some time. They have been cheap and largely remain cheap. Some of them also may be positioned to kind of grind out growth in a more inflationary environment. So we appreciate that there are these three groups of stocks under the surface. And we think there's a really nice opportunity to pick the most attractive across those three groups and we think put together a portfolio that really can perform even in an environment that has some challenges as you referenced.

Mark Goodwin:

You answered my next question about talking about some of the groups that have been oversold and perhaps presenting some great opportunities in the short run. Can you talk about perhaps particular sectors amongst small caps where you're finding great relative value today, or maybe even the spectrum between microcap to the higher end of small caps? Are you seeing any relative valuation advantages, either sector-wise or market cap-wise?

Andrew Cupps:

That's a good perspective that you offer there with market cap. We have found that most of the stability has occurred as you move larger along the market cap. And the inverse is true. As you move down the market cap, you have not seen as much stability. You've seen those prices give way more aggressively, and therefore they represent, in our minds and to the best of our abilities from a research perspective, they represent opportunities. So we do think there's an opportunity in the smaller-cap spectrum of small-cap growth.

And then I think the other one that we would have to call out, it won't be any surprise, is that the technology sector or certainly elements of the technology sector have indeed been revalued lower in a real substantial way. And we think there's a lot of very compelling growth franchises. In other words, companies that are differentiated and are adding a lot of value or set to add a lot of value in terms of growing their company, growing their earnings power over the years ahead. And we think now is a very good time to start the systematic building of positions in those companies. So again, we really appreciate the spectrum of different types of opportunities.

I'll add one other comment here, and that is that I think it's insightful to appreciate that growth companies are solution companies. So the reason a company grows rapidly is they solve a problem that the world has and it's a dire need. It's a need. And so we can kind of turn those challenges that you referred to of our current world and redefine them not as challenges but as problems that need solving or as opportunities. And it really is growth companies that will be solving many of those problems. And I think we would position our process on top of that as a process that seeks companies that are solving problems.

And so the markets have been challenging for three or three and a half months here, but we're pretty fired up about some of these new challenges to be solved, problems to be solved, and the tremendous technological tools that companies have today to solve those problems. So we really have quite a constructive viewpoint in the next three to five years for stocks and certainly for growth stocks.

Mark Goodwin:

Thank you for that upbeat perspective. Changing gears for a minute. Many investors have increasingly looked at passive investment strategies for their equity exposure over the past several years, both retail and institutional investors. Can you talk about how the Advisory Research particular style of active management for growth equities has the ability to provide advantages for investors, in particular for small caps?

Andrew Cupps:

Sure. I mean, we've appreciated that movement to passive that has taken place over many, many years because it really does make our job as active managers an easier one. There really are companies that are more special than other companies. And the more dollars that are kind of sitting in the passive portfolios, the better opportunity we have to have a more focused portfolio that is really having our investors dollars working harder in companies that have more value and are growing faster.

So whether it's opportunities in disruption in health care, in the green ecosystem, in new advances in medical devices, et cetera, not all companies are created the same and we believe our team is pretty good at identifying those that are best positioned for the stocks to appreciate, recognizing the difference between potential energy and kinetic or active energy. That's a lot of what our process has focused on over the last nearly 30 years. So we like that setup. We think there's a lot of differentiation out there, and we enjoy the hunt to find it and to build compelling portfolios that can outperform.

Mark Goodwin:

Drew, as we mentioned earlier, you subadvise the North Square Advisory Research Small Cap Growth Fund, ticker ODGIX. Can you tell us what the current investment strategy is and portfolio allocation for the fund as we head into the first quarter here 2022?

Andrew Cupps:

Sure. The fund is a small-cap growth fund. We're building portfolios generally in market cap ranging from a little under $1 billion into the low single digits, billions. Almost all are mostly in the small- cap growth benchmark. We are focused on dynamic forces, and we work very hard to recognize the difference between companies that really don't have the catalyst in place to perform versus those that do. We emphasize thematic forces. We include technical behavior in our analysis. And we work hard to have the discipline to keep the portfolios both diversified across both sector and factor profiles but also engage such the stocks are positioned to perform rather than the opposite. So that's what we're trying to do for our investors.

Mark Goodwin:

Drew, a final question. How do you see an actively managed, high-conviction, small-cap growth strategy being best positioned in the diversified portfolio of an individual investor?

Andrew Cupps:

It's a great question. It really is because so many of the companies that exist in small-cap growth land are these really special companies that many of which people haven't heard of, some of which are bringing products to market that seem exotic while others are more mainstream. But we really believe that the small- cap growth portion of the market is where the companies that shape the economy are born. And so we have a pretty strong conviction that everybody needs exposure to this market. And it's really a decision for the individual and their advisor to decide how big of a weight that exposure is. So we think it's less about yes or no, and more about the size. It's just too important a part of the economy, a part of the stock market to take a pass on.

Mark Goodwin:

That's a great summary. Matt, Drew, thank you again for joining me today. It's been a great discussion.

Andrew Cupps:

Thanks so much, Mark.

Matt Swaim:

Thanks, Mark.

Diane Merritt:

Thank you for tuning into our North Square Active Insights podcast. For more information on North Square Investments, our partners, and investment solutions, please visit our website at www.northsquareinvest.com.

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