Active Insights Podcast – Looking at Creative Ways to Find Portfolio Income in the Current Fixed Income Marketplace

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 strategies Red Cedar Investment Management believes can enable income-oriented investors to navigate a rising interest rate environment.

John Cassady, Chief Investment Officer, David Withrow, Director of Portfolio Management, and Brandon Bajema, Senior Portfolio Manager, each with Red Cedar, will provide us with their insights. Red Cedar is a partner firm in the North Square platform and subadvisor to North Square Preferred and Income Securities Fund, symbol ORDNX[1]. Mark, John, David, and Brandon, 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 Red Cedar are well positioned to help income-oriented investors address the challenges presented by the current environment.

John, I want to start out by looking generally at the market today. Red Cedar focuses on income solutions and has a highly experienced team. What is your view of the market environment right now? Do you see the high rates of inflation continuing for some time? And will this force the Fed to be even more aggressive than what most people expected just a few weeks or months ago?

John Cassady:

Thanks for having us here, Mark. Market environment right now it's, having just been through the first quarter, one of the most challenging environments that we've experienced with some new challenges thrown in. As you mentioned, the inflationary outlook is not good. At first, the Fed thought maybe inflation was transitory. And they were slow to recognize that perhaps it was not transitory. And they only came to that realization in November of last year. And by that time, I think the market was now thinking, okay, they're behind the curve on inflation. And how is this all going to turn out?

Then you fast forward into January and you have some other challenges upon us that are further fueling maybe some inflationary flames. Number one, the Russian attack on Ukraine and what that might mean for food supply, energy, all that sort of thing with the sanctions put on Russia. And then number two would be the failed policy in China of zero-COVID. I think the world was wondering would China continue with this policy after the Olympics got through? And so far, they seem to be keeping in step with that zero-COVID, which could further exacerbate supply chain issues and add to inflation.

So those are the two wild cards I would say, with the inflation outlook would be does the Russian war in Ukraine escalate, deescalate, stay the same? And depending how that goes, inflation could go a certain direction. And then does China continue with this policy of zero-COVID? So those are kind of two wild cards we don't know. What we do know right now is that inflation is running 8.5%, headline inflation 6.5% year-over-year core CPI. And the market, I think, has come around to the realization that the Fed's going to have to do an awful lot.

And with that, I think that the market is pricing in quite a few rate hikes this year as well as next year. And where will that go? Many people think they're going to tighten until they break something. However, I just think there's too many external factors here. As I mentioned, the war going on in Russia, what happens there that could change that tune. Then I would also point out as well that the Fed so far has only hiked, what they've had one rate hike for 25 basis points. Clearly, that's not a ton of taking away the stimulus, and when they do take away stimulus there's a lag as well. So we might have a ways to go with that.

I do want to point out, though, that it's just not monetary policy at the front end of the curve. There's also credit rate, what's going on in the credit markets and what's going on with U.S. dollar, that sort of thing that can tighten policy. So if we take other things into account that impact financial conditions, if you look at the Goldman Sachs U.S. Financial Conditions Index, that was about as easy as it's ever been if we go back to November of last year. And so far, it's retraced about two-thirds of the way back towards neutral financial conditions despite the Fed only hiking one time. How have financial conditions gotten tighter? It has to do with the strength of the U.S. dollar. That has an impact there. Credit spreads for corporate borrowing have widened out. That has had an impact on financial conditions. And the other one would be just what's happened in the stock market. Obviously, stock market going down has also increased the tightness of monetary policy.

So some of the work is being done by the markets actually. So that's why it's tough to sit here today and say how aggressive is the Fed going to get with hiking rates? And then they also have their balance sheet, which they might start disposing of as well. So I'm probably still going to bet the under on what the market thinks in terms of the terminal Fed funds rate because I think there are other factors at work here that can force things to go in a different direction.

Mark Goodwin:

David, I'm going to turn to you next. Investors have had a long run of accommodative monetary policy and that has begun to shift with the pending rate increases that John referred to as well as the quantitative tightening as the Fed starts to unwind its balance sheet. What challenges does this situation present to income-oriented investors or investors seeking portfolio diversification from traditional fixed-income investments?

David Withrow:

Well, as investors have been experiencing basically three decades of declining interest rates, and there's been some volatility in that. But you talk about kind of the post-stagflation period of 70s and early 80s, we've had interest rates coming down. And as investors have gotten used to that, there really has not been any consequences to going, extending out on the curve, buying longer-dated maturity securities, taking interest rate risk, and clipping the coupon, clipping the income from taking that risk in the portfolio.

But prior to that three-decade period or longer, there actually was the reverse correlation between that and the equity market. So whereas fixed income kind of hedged out your equity risk for the last 30 years, prior to that it wasn't hedging out and you saw those move in tandem. And we could be entering a period where that's going to be similar. Certainly we've seen that the beginning of this year where you've taken a hit both to your fixed-income portfolio and your equity portfolio.

So I think it's really crucial to think about increasing your income prior to this rise in interest rates. I think it's important to do, continue to do so to kind of diversify away your risk, look at creative ways to find income in a portfolio as we look at kind of a shifting paradigm in the fixed-income marketplace.

Mark Goodwin:

Today, we're focused on the North Square Preferred and Income Securities Fund, ticker ORDNX. This fund can invest across a broad range of securities, across several sectors. Can you talk about Red Cedar's approach to allocating among the various segments of the fixed-income space within this fund?

David Withrow:

Sure. First and foremost, the fund invests in really an attractive part of the capital structure. And we're talking about kind of the preferred space, some call it junior subordinated. But if you think of senior securities down to equity where it's right in the middle there. And that's attractive for a lot of reasons. One is, typically it's issued by companies where their senior debt is investment-grade. So the company itself from a balance sheet, from an income statement, from a cash flow basis is a solid investment-grade company. But because of where they're issuing this debt in the capital structure, it tends to offer a little bit more yield with a very different risk in kind of your traditional high-yield types of securities.

So starting with that is the premise. And within that, there's a variety of ways to take this risk. And we're seeking ways to diversify across sectors. Preferreds are traditionally issued in the banking sector, some in the insurance sector, but also energy and utilities are common issuers. And occasionally, you'll find some in a different sector of the marketplace. But the nice thing about those particular sectors is many of those sectors tend to be regulated. And regulation says that there's eyes from Washington and other areas looking at them making sure they don't get in too much trouble. Certainly post the '08 crisis, the regulation increase, which may not have been a great opportunity for the equity investor, but from a debt investor standpoint, that creates significant opportunity to invest, pick up significant yield, and to reduce the risk of the overall portfolio.

And then a third really important component of this, is within this sector, this preferred junior subordinated sector you can diversify by the structure. So they have a lot of optionality in these securities. You're looking at some with floating-rate opportunities, callability. And so looking at the opportunities to take, whether it's a $25 retail preferred or more of an institutional $1,000 preferred, and looking at the inefficiency of these markets and being able to trade in between those two markets to take advantage of those and provide not only income opportunities but total return opportunities for the investor.

Mark Goodwin:

David, how important do you see active management as you look across the range of potential investments in working through the current environment?

David Withrow:

Well, as I mentioned, there's the variety of different structures, and it's fairly inefficient. So being nimble in the marketplace is, I think, crucial. We have examples where preferred securities will trade at a negative yield to call. So if an investor buys it and it gets called away six months later, they're actually losing money on that security. When things are trading exceptionally cheap, we want to be a buyer of those. We're happy to be selling those securities to those entities which need to buy them.

Market cycles are becoming, at least the most recent one has become more compressed. So you're looking at very different markets, from 2020, 2021, and 2022 so far have been extremely different market environment. So this compression means that you have to make decisions quicker, more quickly in order to take advantage of the next opportunity, and only through active management can you take advantage. If you just buy and hold a security, you miss opportunities to add total return alongside of your income because that creative approach means you can enhance your overall performance over time.

Mark Goodwin:

John, I'm going to turn back to you. You and your team are known for having particularly strong expertise in preferred securities. How would you expect preferreds to perform in an environment of rising interest rates?

John Cassady:

So historically, Mark, preferred securities have not had a very high correlation to interest rates if you go back and look at correlations for 5, 10 and 15 years. Now, that analysis kind of goes out the window with what we witnessed during the first quarter of this year, as there was not too many places to hide in fixed income. What the challenge was first quarter when you had that violent move in interest rates where interest rates rose so quickly. Ordinarily, if you have a rising interest rate cycle say over the course of the year, maybe rates go up by 50 basis points or so, over the course of a year you have a whole year of excess coupon to help cushion the blow of prices going down in something like a preferred security. So when you have a very quick movement like that, that's when it's not a very good environment. So that's the bad news.

The good news, though, is that while we do think that interest rates are still going up, we think that the violent move that we saw in the first quarter is probably behind us and it'll be a more gradual movement from this period on. And when you do get more gradual moves in rising rates, two things. That coupon that you can collect over the entire year can cushion that blow when it's a more gradual move. And then the other piece of it is that we as active managers can actually navigate around that by structuring the portfolio in such a way that it won't be as sensitive to rises in interest rates, or we look for different structures in the securities, that we'll get into I'm sure in a little bit here, that can help navigate the rising rate environment.

Mark Goodwin:

In a prolonged low-rate environment, investors have often looked for enhanced yield in different areas, such as emerging market debt and high-yield securities. Given the recent shift in interest rate trends, how would you expect the market for preferreds to perform compared to high-yield or EM debt?

John Cassady:

So if you think about the rising rate environment, historically as the Fed's been embarking on tightening cycles, usually they tighten until they break something, causing recession and creating stress, basically stress in companies and stress in banks and so forth. So if you take that, as that's kind of the path we're on potentially, then you could see more stress in high-yield securities than you would see in preferred.

So taken at face value there, I'll say a couple of things. Number one, high-yield securities by definition have a very different balance sheet than a lot of the preferred universe. The high yield by definition is a below-investment-grade balance sheet. They might have more leverage. They might have not very good debt service, coverage ratios, that sort of thing. Whereas in the preferred space, a vast majority of preferred securities, some of them might be rated below investment grade, but a lot of them are rated below investment grade. But at the senior unsecured level, they are investment-grade companies, meaning that they have an investment-grade balance sheet. That type of balance sheet should be able to weather a storm better than high-yield securities.

And then going back to what David said earlier, a lot of the issuance is in the banking sector. And I would say that thanks to having come through the financial crisis and Dodd-Frank and all that, bank balance sheets look as good as they've looked, in some people's opinions would say going back to just the post-World War II period. Just due to the amount of capital that these banks have at their disposal now and all the regulations, that they are solid. Now, they're not all going to be that Jamie Dimon fortress balance sheet like they have at JPMorgan, but by and large they all are following the same regulations and their balance sheets look great.

So I think compared to high yield, yes, they should be able to weather the storm better in a stressed environment. And I'd say in the high-yield universe, you might look at the yield on a high-yield security, but you should probably think about that in terms of a default adjusted yield. When there are times of stress, the most two recent episodes of stress and high yield, if you go back to the COVID, when COVID hit, I think default rates in high yield peaked at around 8%. And if you go back to 2016 where we had the energy debacle, they also peaked at around 8, 9%. Then of course, in the financial crisis, high-yield default rates spiked up to 14%. So you have to take that into account when looking at the returns on these securities and preferreds. Our estimates, there's nothing that's been really published, but our estimates show that preferred securities, default rates have been historically right around 1% or so. So when you take that and look at kind of normalizing the returns, you can expect preferreds should perform better than high-yield securities in a stress environment.

Then if I turn my attention to the second part of the question about emerging market debt, that's a tricky one. And I'd say that's country by country. For sure, you have commodity prices rising right now. So if you're a commodity exporter, you could be doing okay. But the other piece of emerging market debt is the currency piece. And if it's in local currency, the dollar has been strong lately, so emerging market debt, this denominated in local currency. That's been a drag to many of those issues, the currency on that. And then even if it's dollar-denominated EM debt, that local currency is depreciating. It makes it difficult for those emerging markets to service dollar- denominated debt.

So either way, you just have to be careful. There's another added piece to it on the currency side for emerging markets that could be troublesome. And then the inflation piece, historically, emerging markets have a more difficult time dealing with inflation than G7 countries, let's say.

Mark Goodwin:

John, Red Cedar's known for its success as an active manager. Are there nuances to the preferred space that give an active manager an advantage? And I'm thinking everything from trading in the secondary markets, navigating liquidity of smaller-issue sizes, dealing with callable aspects of the securities. What can you share that active managers have an advantage with here?

John Cassady:

Yes, I think that's very true. And you can look at the universe of ETFs out there that are maybe betrothed to a certain index or something like that that might be a very long index. Whereas as an active manager, we have the latitude to really move around and we can decide, well, what kind of risk do we want to take in the portfolio? Do we want take a ton of interest rate risk? And right now, the answer is currently, no, we do not.

We can choose the types of risk we want to take and structure the portfolio accordingly. And that includes keeping maybe duration on the lower end of the range, maybe taking certain kinds of credit risk, and then looking at the structure of the individual security, analyzing that structure. We have the expertise to look at structures that maybe are fixed to floating and have a shorter duration in that regard.

And then as David alluded to earlier, some of these sectors, so to speak, are not very efficient, particularly the $25, we call it the retail preferred sector, where we can trade in and out of that and buy them when they're at cheap level, so to speak, or higher yields, and then sell them when yield to calls get towards zero or in some cases negative.

I'd also say that the market for preferred securities is about, we'll call it just about a trillion, maybe a little bit less than that. And so the behemoths out there can't necessarily take advantage of this and really move the needle on their portfolios in terms of adding value. So we're in a nice space where we feel that we can really take advantage of the inefficiencies and the active management that can produce potentially superior returns.

Mark Goodwin:

Brandon, I'm going to turn to you. Can you talk about how the current portfolio for ORDNX is positioned?

Brandon Bajema:

Yes. So on the more macro side, the fund's pretty cautiously positioned in terms of credit risk and interest rate risk. As the Fed begins its tightening cycle, we're already starting to see the impact that's having on liquidity, spreads, and yields. So consequently, the fund has less duration in its index, less spread risk, but more importantly than that, it's got a lot larger than normal amount of dry powder available in the form of treasuries and cash and sort of getting ready to deploy that as valuations continue to look more and more attractive.

On the more micro side, we're finding a lot more value sort of across the Atlantic and the European additional tier-one space, which are very, very similar securities to the U.S. domestics. But we're finding better value there. That's in general to the U.S. domestics, but in particular relative to the fixed-for-life structures here in the U.S. So the AT1s pay more from a spread perspective. And given the flatness in the yield curve, that translates to a higher total yield as well. While at the same time, your duration's more manageable with most of the AT1s having a rate reset within five years. So you get more spread, more yield, and less duration for credits there that are very similar from a credit risk standpoint.

Mark Goodwin:

Do you feel the exposure to preferred securities provides a degree of diversification that investors may not get from more traditional fixed-income offerings?

Brandon Bajema:

Well, preferreds as an asset class provide diversification in the context of a traditional 60-to-40 portfolio with perhaps having low but positive correlations to both equities and fixed income sort of broadly defined. There's also diversification benefits within fixed income with the correlation between preferreds in both the Bloomberg US AGG index as well as the high-yield index also being low but positive.

And this diversification exists because the type of risks that you're getting paid for owning a preferred are largely structural in nature. So I think Dave talked about that earlier, as did John in fact, the fact these are large, highly rated banks in most cases, that they have some embedded call options that you sold, et cetera, et cetera. Whereas if you look at a high-yield fund, the nature of the risk is very fundamental in nature. Or in the case of a government, it's very much interest-rate driven. So empirically, preferreds as an asset class have meaningfully less default risk, but given the structural risks embedded in the products, you still get paid similar spreads over treasuries.

Mark Goodwin:

For income-oriented investors that may be new to the fund in Red Cedar's approach, how would you see this preferred strategy best positioned in their investment portfolio?

Brandon Bajema:

It can replace or complement core credit strategies like high yield or even investment-grade, or could take the place of alternative fixed-income strategies, like private credit or CLOs. But the easiest comparison is obviously with high yield. So in a nutshell, if I was allocating to a broad fixed-income mandate, I would look at the preferred securities fund as a high-quality, high-yield alternative.

Mark Goodwin:

A last question. As we start the year, many investors might find themselves uncomfortably overweight equities, but still uncertain about diversifying with traditional fixed-income investments given the performance of the (Bloombergg US) AGG year to date in response to anticipated rising rates. How do you see ORDNX better positioning them for a rising rate environment?

Brandon Bajema:

So investors not focused on the preferred space in the detail, they see the words perpetual and/or preferred, and they very understandably hear large interest rate risk with infinite duration. But the reality is the vast majority of the investible universe are either floating rate securities or securities that are fixed for a short period of time, five to seven years, and then they float thereafter. Only a small portion of the investible universe of preferreds are fixed for life. And the fund currently owns exactly zero of those.

So this is in stark contrast to the Bloomberg Investment Grade index, which are predominantly fixed for life bullet structures and consequently has about twice the level of interest rate risk, or as you mentioned the Bloomberg US Aggregate, which I think has about two and a half years more interest rate risk than the fund currently has.

Mark Goodwin:

Thank you. John, David, Brandon, thank you all for joining me today. This has been a great discussion.

John Cassady:

Yes. Thanks a lot, Mark.

David Withrow:

Thank you, Mark.

Brandon Bajema:

Thanks, Mark.

John Cassady:

Enjoyed it.

Diane Merritt:

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[1] On January 11, 2022 the Fund's name changed from North Square Oak Ridge Dividend Growth Fund to North Square Preferred and Income Securities Fund. Also, on January 11, 2022, the Fund's Principal

Investment Strategies changed and performance prior to January 11, 2022 represents a different fund strategy.

*The determination of "best-in-class" is solely the opinion of the Fund's Adviser, and such opinion is subject to change. Those companies that hold leading market share positions, strong growth potential, historically good probability, and management teams known or integrity and good corporate governance are generally considered to be "best-in-class."

North Square Preferred and Income Securities Fund Characteristics as of March 31, 2022

SECTOR DIVERSIFICATION (%)

Banking	55.4
Specialty Finance	11.2
Sovereign Government	17.5
Oil & Gas Producers	4.1
Automotive Manufacturing	4.1
Diversified Industrials	3.8
Other	3.9

[1] Source: Bloomberg

COUPON STRUCTURE (%)

Fixed to Float & Variable Rate Sec	80.85
Fixed for Life $25 Preferred	0.00
Floating Rate Sec.	3.79
Other Fixed Rate Sec.	15.36

[1] Source: Bloomberg

BOND QUALITY RATING[1, 2] (%)

AAA	15.4
BBB+	10.4
BBB	24.0
BBB-	27.8
BB+	10.2
BB	12.1
Cash & Equiv	0.2

[1] Source: Bloomberg

SECURITY TYPE[1] (%)

Inst Pref	42.8
AT1s	29.6
Corp Hybrids	12.0
US Treasuries	15.4
Cash & Equiv	0.2

[1] Source: Bloomberg

[2] Quality ratings are based on Moody's, S&P, or Fitch, as applicable. Securities rated by all three services are assigned the median rating; if a bond is rated by only two agencies, it is assigned the lower rating; if it is only rated by one agency, that rating is assigned.

The Portfolio is actively managed and current holdings and characteristics may be different. The holdings listed should not be considered recommendations to buy or sell any particular security listed. The holdings identified do not represent all of the securities purchased, sold, or recommended for the adviser's clients. Actual portfolio investments may vary when actually invested. A complete list of holdings is available upon request.

Principal Risks of Investing: Risk is inherent in all investing, including an investment in the Fund. There can be no guarantee that any strategy (risk management or otherwise) will be successful. An investment in the Fund involves risk, including the following principal risks, among others: Credit and Subordination Risk, Preferred Securities Risk, Hybrid Security Risk, Additional Tier 1 Securities Risk, Optionality Risk, Foreign Investments Risk, Rule 144A and Regulation S Securities Risk, Currency Risk, Emerging Markets Risk, Derivatives and Hedging Transactions Risk, and LIBOR Risk. Summary descriptions of these and other principal risks of investing in the Fund are set forth in the Fund's prospectus. Before you decide whether to invest in the Fund, carefully consider these risk factors and special considerations associated with investing in the Fund, which may cause investors to lose money. There can be no assurance that the Fund will achieve its investment objective. An investment in the Fund is not a deposit of the bank and is not insured or guaranteed by the Federal Deposit Insurance Corporation or any other government agency. Please see the Fund's prospectus for additional information.

An ETF is a type of investment company whose investment objective is to achieve the same return as a particular market index. An ETF is similar to an index fund in that it will primarily invest in the securities of companies that are included in a selected market index. An ETF will invest in either all of the securities or a representative sample of the securities included in the index. ETF's are subject to specific risks, depending on the nature of the underlying strategy of the fund. These risks could include liquidity risk, sector risk, as well as risks associated with fixed income securities, real estate investments, and commodities, to name a few.

A mutual fund is a company that pools money from many investors and invests the money in stocks, bonds, short-term money-market instruments, other securities or assets, or some combination of these investments. Mutual funds have risk, you could lose money on your investment. The value of most mutual funds will change as the value of their investments goes up and down. The level of risk in a mutual fund depends on what it invests in. Usually, the higher the potential returns, the higher the risk will be. Common types of risk include market risk, liquidity risk, credit risk, interest rate risk, foreign investment risk and currency risk.

Before investing you should carefully consider the Fund's investment objectives, risks, charges and expenses. This and other information is in the prospectus, a copy of which may be obtained by calling 855-551-5521. Please read the prospectus carefully before you invest. Distributed by Compass Distributors, LLC.

Definitions of terms used in this podcast:

CPI: The Consumer Price Index (CPI) is a measure of the average change over time in the prices paid by urban consumers for a market basket of consumer goods and services. Indexes are available for the U.S. and various geographic areas. Average price data for select utility, automotive fuel, and food items are also available.

Basis points: A basis point (bp) is a standard measure for interest rates and other percentages in finance, representing one-one hundredth of one percent. 100 basis points = 1.0 percent.

The Goldman Sachs U.S. Financial Conditions Index is a widely watched index which takes into account of the value of the dollar and interest rates to provide a gauge of U.S. financial conditions. One cannot invest directly in an index.

Quantitative tightening: For two years after the onset of the COVID-19 pandemic, the Federal Reserve bought over $4 trillion in assets, mostly U.S. Treasurys and mortgage-backed securities, to help stimulate the economy. The Fed finally stopped purchasing bonds in March 2022 as it began to pivot toward slowing inflation. Fed officials have “generally agreed” to selling $60 billion in Treasury securities and $35 billion of mortgage-backed securities each month, according to recent Fed Policy meeting minutes, a process known as quantitative tightening.

Duration: indicates the years it takes to receive a bond's true cost, weighing in the present value of all future coupon and principal payments.

AT1s: also known as contingent convertible securities, are debt or preferred securities with loss absorption characteristics that provide for an automatic write-down of the principal amount or value of securities or the mandatory conversion into common shares of the issuer under certain circumstances. A mandatory conversion might be automatically triggered, for instance, if a company fails to meet the capital minimum described in the security, the company's regulator makes a determination that the security should convert, or the company receives specified levels of extraordinary public support. Since the common stock of the issuer may not pay a dividend, investors in these instruments could experience a reduced income rate, potentially to zero, and conversion would deepen the subordination of the investor (worsening the Fund's standing in a bankruptcy). In addition, some AT1s provide for an automatic write-down of capital under such circumstances.

Bloomberg US AGG Index: The Bloomberg U.S. Aggregate Bond Index, or the "Agg," is a broad base, market-capitalization-weighted bond market index representing intermediate term investment grade bonds traded in the United States. Investors frequently use the index as a stand-in for measuring the performance of the US bond market.