NORTH SQUARE INVESTMENTS

Evanston Capital Podcast – “We see a bunch of very specific opportunities across hedge fund strategies today.”

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 and Kristen VanGelder, Partner and Deputy Chief Investment Officer with Evanston Capital, will discuss alternative investment strategies and Evanston's experience in identifying and accessing leading hedge fund managers to build diversified alternatives portfolios.

Evanston Capital is on the North Square platform and is subadvisor for the North Square Evanston Multi-Alpha Fund.

Mark and Kristen, we look forward to your discussion.

Mark Goodwin:

Thanks. As you mentioned, at North Square we seek out best-in-class active managers for our platform and our partners at Evanston Capital provide differentiated access to a portfolio of managed alternative strategies.

Kristen, Evanston has managed portfolios of alternative strategies for over 20 years, primarily for institutional and high net worth investors, so some financial advisors and individual investors may not be familiar with the firm. Can you give us some background on the firm and your core investment philosophy?

Kristen VanGelder:

Absolutely, and thank you so much, Mark, for having me here today. Evanston Capital was founded in 2002. We trace our roots to the endowment world. One of our founding partners was the former Chief Investment Officer of Northwestern University. So, the vision was really to bring an endowment-like approach to investing in alternatives and institutional quality portfolios to investors that might not have the scale, time, or resources to build their own direct portfolios in that portion of the market. Today we manage over $4 billion in multi-manager portfolios, predominantly in hedge funds, and we are a fully independent and employee-owned firm. We have been at this a long time, over 20 years as you mentioned, but I would say our core investment philosophy has really remained steadfast throughout that time. So first and foremost, we approach investing in hedge funds with a healthy dose of skepticism. We think that markets are generally efficient, investment skill is scarce, and the average hedge fund adds no value on a net of fees basis.

So, we think selectivity is really key to results within hedge funds. Second, we are firm believers in the lifecycle of a hedge fund. So, we think we can add value by identifying talent early and investing when managers are smaller and hungrier, when they have a lot of investment flexibility, and when our incentives are highly aligned around performance. I'd say there's also an added benefit of investing early, in that we can often negotiate preferred fees and terms on behalf of our investors.

Then last, I would say, if we think that there's truly a limited number of top-tier hedge fund managers out there, it would stand to reason that we build relatively concentrated portfolios. So, the Multi-Alpha Fund is typically 20 to 25 managers. When we bring a new idea to the table, the first question that's asked is, which manager would you fire, or what investment would you fully exit in order to pursue that idea? So I think that's just been a great discipline for our team. It's kept the bar really high, the standards really high for making a new investment, and it's encouraged this sort of constant competition for capital within our portfolios.

Mark Goodwin:

Kristen, as you develop your asset allocation for the portfolio, are there core investment strategies that you build around and how are those strategies complementary?

Kristen VanGelder:

Yes, the hedge fund universe is pretty diverse, but we divided into sort of four strategy categories, long-short equity, event driven, global macro, and relative value. So long-short equity, just as it sounds, these are stock selection strategies where managers are buying stocks that they think should go up in value over time, and likewise short selling stocks that they think should decline in value over time. Managers operate with varying degrees of net market exposure based on their own individual styles. Event-driven strategies, they really span both equity and credit markets, but the commonality there is that they're trying to capitalize upon some corporate transformation or corporate event. So these are big hard catalysts typically, like merger and acquisition activity, spinoffs, recapitalizations or refinancings, bankruptcies and restructurings. Global macro, these are strategies that are focused on forecasting macroeconomic outcomes, so things like growth, inflation, monetary policy, and then managers express those views globally across asset classes including equities, fixed income, currencies, and commodities.

Then lastly, relative value. These strategies are generally designed to capture mispricings between two related or highly correlated securities. So for example, playing two different parts of the capital structure of the same company. Trading debt versus equity or trading the securities of two different companies, but that operate within the same industry or that are close peers to one another. We have strategic asset allocation ranges that we typically operate within, across those four buckets that I would say have served us really well over 20 plus years and in very different market environments over time.

But where we are within those historical allocations definitely evolves given first, our bottom-up assessment and confidence in our individual managers, but then also given our top-down views on the market environment and the opportunities for different hedge fund strategies. I would also say long-short equity and event driven, those strategies typically do have some directional exposure and modest correlation to markets over time. While relative value and global macro, those tend to be more defensive strategies, tend to be negatively correlated or even uncorrelated to markets and other hedge fund strategies. So having all four together in one portfolio gives us some nice balance.

Mark Goodwin:

Thanks for that. Are you finding any differentiated or innovative strategies that may be less well known, but warrant a modest allocation in the portfolio?

Kristen VanGelder:

Yes, we do have some exposure today to the carbon markets, specifically California carbon allowances. So that's not really a strategy per se, but it is certainly a niche market. There are government-mandated limits on the participation from financial speculators in the physical allowances, but there is also an active and pretty liquid futures and options market in California carbon allowances. So, we believe it's still a niche space. We see some potential changes to the state's cap and trade program that could further restrict supply of allowances in the future. We think that could be a positive catalyst . So, we do have some exposure, modest exposure to that through one of our existing managers today.

Mark Goodwin:

That's great. Well, what would cause significant shifts in your asset allocation, either among the broad categories or within them?

Kristen VanGelder:

Historically the biggest shifts to our asset allocation really tend to be tied to the credit cycle. So, when credit spreads are wide, yields are high and defaults are prevalent, you will see us lean into those opportunities by increasing our allocation to event driven strategies. That would be primarily credit-oriented event managers. So those that have expertise in stressed and distressed debt, for example. Likewise, the reverse is true. When credit spreads are tight, yields are relatively low, there is very little in the way of default activity, we will lean away from the event-driven allocation. So that's probably the biggest shifts that tend to occur in our asset allocation really tied to the credit cycle.

Mark Goodwin:

Kristen, evaluating managers across sophisticated investment strategies requires specialized experience in a disciplined due diligence process. Two-part question for you, A), how do you work through the universe of hedge fund managers to identify those to consider for more detailed due diligence? Second, what is the decision process for a manager to ultimately be allocated assets in your portfolio?

Kristen VanGelder:

Yes, it's a big universe, but we do try to cast a wide net. We want to give full consideration to managers of all shapes and sizes, different strategies, different stages in their lifecycle. We meet with hundreds of managers every year and we make on average three to five new investments. So, it's turning over a lot of rocks to find a very small handful of gems. What are we doing to filter down that universe? We're really focusing on, I'd say several factors, manager pedigree, so their experience and the applicability of that experience to the strategy that they're now pursuing, their articulated economic edge and the process that would lead us to believe that's repeatable over time, their portfolio construction and trading acumen,

their risk management discipline. Then we're thinking about how diversifying or what kind of correlation characteristics that strategy would offer relative to other investments that we have.

I'd say there's some general preferences we've developed after doing this for a couple of decades and some real patterns that we look for. As I said before, we definitely believe in investing early. So having a rich pipeline of new launches has always been important to us. We look for managers that have some degree of specialization, so something that really narrows their investment universe, or where they've developed a real specific skillset. We also look for managers that can add value from trade structuring, position sizing, and exposure management. I think there's a much larger universe of managers out there that can add some value from security selection, but those that actually can also add value from the way they put together a portfolio, you end up with a much smaller number. So we really look for that.

Then we look for some softer things, like just a true passion for investing. We want to see that a manager is somewhat addicted to doing this and would do it no matter what, isn't just driven by the financial benefits of success, but that they love investing. Then there's also, likewise, there's some things that we avoid. We avoid strategies that are opaque or that we can't really fully understand. We definitely also avoid strategies that rely upon very high degrees of financial leverage to generate optically attractive returns and worse yet, strategies that combine both illiquidity and high degrees of leverage, which can be a dangerous combination. So, when we're going through the process, it's a really multi-step process for us. Investment due diligence is at the front end. So, we really want to thoroughly vet the investment equation first and foremost.

There are quantitative elements to that process. We're analyzing any prior data that we can get our hands on, track record, prior examples of prior investment successes and failures. We're comparing them to a high-quality group of their peers, but then there's also a lot of judgment that goes into that process. I think in that we're really aided by our team's deep experience and networks within this space. We can talk to a lot of other hedge fund managers and investors to vet a manager's prior experiences. Then once we're fully convinced on the investment side of the equation, we have a separate team that focuses more on operational due diligence. So, there's definitely clinical elements to that process, making sure the manager has the right checks and balances, works with high quality service providers, et cetera. But there's also some real soft considerations that we give close attention to. So just trying to understand the firm's character and culture, the degree of transparency that they give to us.

We want to get a sense that these are really good business partners and that they would treat their investors fairly both in good times and in bad. So, there are senior members from both the investment team and the operational due diligence team that are represented on our investment committee. That committee meets together on a monthly basis. That's where all of our investment decisions are formally ratified, and we require unanimous approval to actually move forward with a new investment and allocate assets to a manager. I think it's pretty special, because (on) our investment team, we have a lot of experience. We have on average over 20 years of experience, but we've also been working together on average over 16 years. So, there's both that knowledge base, as well as just the stability of working together, I think that really aids in this process.

Mark Goodwin:

Kristen, that's an awesome background. Can you talk about access for a minute? I know that skilled hedge fund managers can often be difficult for the average investor to gain access to. Has this created any issues

for Evanston and how have you been successful in accessing investments with these managers that you believe are best in class for your portfolio?

Kristen VanGelder:

Yes, you're right. Some of the best managers eventually close to new capital and it can be difficult for the average investor to gain access. So, it's important for us to make sure that Evanston has a great reputation. I think that we do have that. So, there are cases of course where managers are closed to new capital, and we would love to access them. In those instances, we just focus on building a relationship with the manager, making sure they really understand who we are as an investor and our investment philosophy, hoping that in the instance where they do reopen or they have redemptions that they want to replace, we would be sort of at the top of that list.

Then investing early is important because we can gain...in some instances, we can negotiate capacity agreements, but then you also have this goodwill with the manager, as you've been one of the few investors that kind of help them get into business. So down the line, they'll remember you as an important partner and maybe you would be the first call in many instances if they were to reopen to a limited amount of capacity. Then I think on top of that, I would just say that Evanston, I think we're kind of at a sweet size, in terms of our asset base. At a little over $4 billion, even relatively small managers can be meaningfully sized positions in our portfolios and matter to performance. We don't need to deploy 500 million, a billion dollars to a single manager for them to move the needle. So, it's really all those factors combined. I think that has led to success for us when it comes to access.

Mark Goodwin:

Kristen, I know you have a robust monitoring process for your managers. Can you talk about what issues or changes among them would result in your replacing a manager or substantially lowering an allocation within the fund?

Kristen VanGelder:

Yes, there's lots of reasons why we would exit or reduce the position size. I think the most common is probably strategy drift. So, when you see a manager start to broaden out from their core competencies or the characteristics of their portfolio really start to change. I'd say most often that is tied to growth that goes beyond the manager's likely capacity or growing just far too fast. So, we're highly attuned to both of those things when it comes to monitoring our managers. But there's other common factors too.

Sustained subpar performance, either relative to what we view as their market opportunity set or relative to peers, significant organizational change, both incoming and outgoing and then a little bit softer, but I'd say kind of any breach in our confidence of them as a true business partner. So maybe becoming less transparent or certainly any material adverse change in their fees and terms, that would definitely lead to potential reason to exit. I would just say there's thousands of hedge fund managers out there. We're investing in 20 to 25. Our view is that when the facts change, we are not afraid to move our feet. So, this is a very actively managed portfolio, typically it has 15 to 20% turnover per year.

Mark Goodwin:

That's great. Kristen, going macro for a minute, The Fed has been holding rates at current levels, inflation has seemingly improved recently but remains a concern, economic growth has been resilient but deficits are challenging. We have also have significant geopolitical tensions and US federal elections are coming in November that could potentially impact markets. Another two-part question for you. First, where do you see investment markets currently and what's the outlook for the rest of the year? Following on that, what's your positioning of the portfolio given your thoughts on the broader market?

Kristen VanGelder:

Yes, Mark, I couldn't agree with you more. There are just so many cross currents to consider today. I look at markets, we have high interest rate volatility, relatively high equity valuations in the US, high-yield credit spreads that are nearing historical tights. Then just all of this uncertainty as you mentioned. I think that it's precisely these types of environments where risk assets are relatively richly priced and you don't really know what will happen, in terms of monetary policy or some of these geopolitical concerns. It's precisely these types of markets where the flexibility of the hedge fund model can be most valuable. Our high-level view is that The Fed is likely to remain patient. Maybe we do see them start to ease towards the end of the year, but inflation remains a concern, as you say. So far, the economy has remained really resilient.

So, I think that higher interest rates are a tailwind for hedge funds, that really has not existed for the better part of the last decade. That's for several reasons. Managers are earning higher rebates on the collateral that they post for short positions. They're earning higher interest on their unencumbered cash when they're investing on margin through futures or when they're using other derivatives like options to express their investment views and they're earning higher yields on credit-oriented strategies. Plus, there's these second-order effects of higher interest rates, which you see both higher market volatility, which we have had in the past couple of years, and the potential for higher dispersion between individual securities. When there is a real cost of capital again, there is more differentiation between businesses of different qualities. Both of those, higher volatility and higher dispersion, have generally been precursors for better results from hedge funds, broadly speaking.

So, we're super excited about just this general picture, but then looking deeper, peeling back the onion, we see a bunch of very specific opportunities across hedge fund strategies today. So, one area we're really excited is fundamental long-short equity. I see far less competition for stock selection strategies with a multi-year horizon today than I've seen in years. We all know about the trend toward passive investing in the long only world, but even within active management, we've seen allocations become more and more barbelled, with a lot of capital flowing into very short-term trading-oriented strategies at one end. Similarly, a lot of capital tied up in ultra long duration private equity venture capital at the other. Meanwhile, there has actually been outflows from fundamental long-short equity, which sits in the middle. So, we think if you can find real skilled stock pickers, especially those with real skill on the short side, they've got an incredible opportunity with far less competition today.

Within credit, we think that if rates remain relatively high for a longer period of time, that is eventually going to cause some problems for certain leveraged borrowers as maturities start to near and the prospect of refinancing at much higher cost of capital becomes reality. So, within that theme, we're most interested in leveraged loans. As floating rate instruments, these borrowers are already starting to feel the pinch

from higher interest expense, and there's both a higher volume of loans coming due in the next couple years, as well as a higher proportion of that is lower rated. So, we think that provides for a pretty attractive setup for our credit-oriented hedge funds. Then finally, we think that all this focus on central bank policy action creates a really rich backdrop for macro managers. Just look at the interest rate volatility that we've seen this year and how dramatically the probabilities that were priced in for how much the Fed would cut this year have changed, as we've gotten incremental data points with respect to growth and inflation.

All that volatility creates so much trading opportunities for our managers. Compare that to the decade or so post global financial crisis, when all central bank action was very highly coordinated, we held interest rates at zero, there was very low volatility, and it was kind of a steady up and to the right market for the most part. There's just so much more going on today that creates trading opportunities for those managers. So, when I look at the way our portfolio is positioned, given those views, I'd say we're pretty close to home base in terms of what our historical average asset allocation is. Long-short equity is the largest allocation. That's partly driven on our positive view of fundamental long-short as I articulated.

But it's also very typical for us, because our view is that equity markets are broad and deep and there's generally a pretty consistent opportunity set within that space versus some hedge fund strategies that are just more cyclical by nature, especially event-driven strategies. There are periods where there's a lot of events to capitalize upon and periods when there are less so. But then when I look across the other three strategies today, the allocations are pretty evenly divided. I think that's reflecting this feeling that there's a good opportunity across so many different hedge fund styles simultaneously, and that, that doesn't always happen.

Mark Goodwin:

That's great insight. Just focusing on risk for a second, do you have any key concerns or risks that you're monitoring? Thinking that we really haven't been through a full credit cycle in a very, very long time, and maybe that's coming with rates ticking up and perhaps consumer defaults and other defaults rising. But how do you think about macro risks that could cause a significant change in your market outlook and how you position the portfolio?

Kristen VanGelder:

I think the biggest potential surprise would be a non-anticipated and significant slowdown in economic growth. I think sort of waiting for growth to catch up to the very significant move that we've had in rates, and it just kind of hasn't come as anticipated. So, as you mentioned, we're very closely monitoring the credit markets. Sometimes that's the first place to start to move. In many ways, we're looking for opportunities to lean in. If you do see credit spreads start to materially widen or you do start to see a pickup in defaults, that historically has been a very rich opportunity set for hedge funds and our distressed debt managers. So that is probably the key macro thing that is top of mind. Then as it relates to hedge funds, I'd say we're monitoring parts of the hedge fund universe that have grown just really rapidly in recent years.

So, the multi-portfolio manager platforms, pod models, they've grown a ton. On top of that, they amplify their market impact with very high degrees of leverage. So, while we don't have any direct exposure to those strategies, they do in their trading style create a decent amount of volatility, especially in the short term, that other managers need to adapt to and learn how to navigate. Then we think that just given their

size and the amount of leverage, they could pose some potential contagion risks if they were to hit a rough patch in terms of performance. Those managers that pursue very similar styles would be forced to undo leverage at the same time. So, we want to just make sure that that's top of mind for our managers and ourselves as we manage the risks in our portfolio.

Mark Goodwin:

That's great perspective. Kristen, NSEMAF has a $50,000 minimum investment and some limits on liquidity, so not all investors may be eligible. Understanding this, how do you see a strategy like the North Square Evanston Multi-Alpha Fund being best positioned in the diversified portfolio of an investor?

Kristen VanGelder:

This fund is really designed to provide a source of returns that's different from and less correlated to traditional long-only investments. So, it's designed to protect capital in market sell-offs, while still participating and hopefully to an even larger degree in the market's upside over time. Reducing volatility, we think, and protecting your downside in market sell-offs matter in practice, because it allows an investor to better plan for their spending needs and to really stay the course with their more directional and more volatile investments through bear markets. So, for our investors, they're using this portfolio either as just an outright diversifier or as a substitute within their traditional stock and bond portfolios.

Mark Goodwin:

Kristen, thank you for joining me today. This has been a great discussion.

Kristen VanGelder:

Oh, it was my pleasure, Mark. Thank you, and I look forward to talking again soon.

Mark Goodwin:

Likewise.

Diane Merritt:

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