Active Insights Podcast with Kennedy Capital Management: "We'd be excited to have you join our journey in uncovering returns in this under covered, less discovered niche of the public equity universe."

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 Kennedy Capital Management's approach to equity investing with Donald Cobin, President and CEO, and Sean McMahon, Portfolio Manager.

Kennedy Capital is a partner firm in the North Square platform and a sub-advisor for the North Square Kennedy Micro-Cap Fund.

Mark, Don and Sean, 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 Kennedy Capital specialize in the micro-cap to mid-cap range of equity investing. First, Don and Sean, thank you for joining me today.

Sean McMahon:

Oh, we're pleased to be here.

Donald Cobin:

Thank you.

Mark Goodwin:

Don, Kennedy Capital has managed equity strategies for over 40 years, primarily for institutional investors. Many financial advisors and individual investors may not be familiar with the firm.

Could you give us some background on the firm, the asset classes you focus on in your core investment philosophy?

Donald Cobin:

Sure. It's Don Cobin here. Let me start off with a little bit of firm background. So, we were founded about 44 years ago by two chemical engineers. We started off with a small cap product and we expanded from there. Decades ago, we began to focus our efforts more on return on invested capital-based approaches, which has set us apart a bit from our peers. We've been almost entirely institutional focused, as you alluded to Mark, for decades. Several years ago, we were asked to open up our strategies to the retail investor, and that's partly what has brought us to North Square. We were intent on finding a firm with roots in the retail world while they were intent on finding a firm with an intense research focus and a defensible niche. So, the asset classes that we focus on are actually fairly boring. We're a long-only equity manager, different flavors from growth to value and small to large, including core.

While this micro-cap fund that we'll be speaking about was just launched, we did begin our first micro-cap composite almost exactly 20 years ago in June of 2004. So briefly, our core investment philosophy. We live and breathe ROIC (return on invested capital), more specifically cash flow, return on investment. And rather than strictly discussing quarterly earnings trends, what we hone in on is really three questions. First, how does a company generate its returns? Second, how do they reward their people? And third, how do they allocate capital? As you'd expect, each of these should really be connected at the hip. So ultimately, our analysts should be sounding boards for the CEOs and CFOs of the firms we invest in. I encourage them to develop relationships so that the conversations around the strategic evolution of the firm we're investing in is a natural one. So, when something of note happens, I want our analysts and PMs to be the ones whose calls are fielded first.

Mark Goodwin:

Thanks, Don. Sean, we mentioned the North Square Kennedy Micro-Cap Fund, ticker NKMCX. I want to focus on your micro-cap strategy to begin. Your investment approach is very research intensive with a strong focus on stock selection. Can you talk about how you develop a workable set of potential investments from the broad universe of micro-cap stocks?

Sean McMahon:

Sure. Mark, I think it's important to understand a little bit about how Kennedy Capital Management is structured. So, unlike many of our peers that work in small teams, which can be anywhere from maybe a single PM (portfolio manager) to a PM and maybe a couple analysts, Kennedy uses a centralized research team. So, we have approximately 13 analysts here that support our strategies. So, you can imagine if you think about that in a few areas such as industrials and healthcare, we have actually upwards of three analysts that follow a single sector.

This kind of large analyst team gives us an ability, or I should say an opportunity, that we believe allows them to dig a little deeper into specific parts of their sector in greater depth. And so, we think that's very important, especially when you're looking at ideas that oftentimes may not have any sell side coverage.

So really there's nobody on the street that might not be researching or reporting on them. And so, it's important for our analysts to have that larger team, to have the bandwidth to go out and do the work on them. And not only that, it also gives them an ability to look at what's going on in the mid-cap and large-cap universe to help us give insights until the underlying dynamics that our particular industry might be having at the larger cap peers and how that might impact our micro-cap holdings.

Mark Goodwin:

What would you say are the key characteristics for a stock to ultimately become a position in your micro-cap portfolio?

Sean McMahon:

As my strategy, I employ what's called, I term it a bottom-up research process, which means that I look at each company independently rather than trying to use a top-down or macro viewpoint to determine what stocks get added into the strategy. But ultimately what I'm trying to find are companies that have an ability to generate positive change in their overall corporate performance, whereas Don, as he alluded to earlier in their ROIC, the return on invested capital. And so there's multiple ways to go about that and some can be improving in their operations margins, expense savings, maybe selling an underperforming business unit or even on the balance sheet if the companies are able to improve their working capital, reduce the amount of cash that they need to generate the returns that we think are possible in the business.

But ultimately, I think it boils down to two things. It's one, it's understanding the positive change in corporate performance, and two, finding opportunities where that change is not reflected in the current share price. And I say lastly too, I tend to be a little bit more contrarian. So, a lot of the ideas that get entered into or bought in the portfolio are sometimes ideas that maybe from an outsider's point of view don't have currently or not have tailwinds to them. But we think over time those businesses have an ability to improve their overall corporate performance.

Mark Goodwin:

Thanks, Sean. I imagine that the micro-cap arena could be a volatile space to invest in. How do you think about incorporating risk management into your process of portfolio construction?

Sean McMahon:

Yes, for me it is not just understanding what happens if our investment thesis works out when we enter a security, but it's also important to understand what happens if it doesn't. And that's part of the process when I work with the analyst team is trying to understand both sides of the view. So, what I would tell you fundamentally as a bottom-up investor, we're looking at the balance sheet and I think number one, really trying to get comfort with the liquidity position of the company that we invest in. And having a large analyst team I think helps in that regard. But also we do additional work. Outside of just listening to corporate conference calls, we ask our analysts to go do site visits, investor conferences, industry conferences to get better insight into what's happening in that particular industry.

And then I'd say another kind of unique characteristic of this product might be is I'm fairly well diversified with more than 120 positions invested currently in the strategy, which helps reduce the impact or risk from any singular company in the portfolio. And maybe lastly, I'd just like to highlight that I typically won't overweight any single sector by more than 10% as an additional risk management tool.

Mark Goodwin:

Thanks, Sean. Can you also share what resources may have uniquely shaped your journey into the micro-cap stock arena?

Sean McMahon:

For me, the firm has been here for, as Don alluded to, I think a little over 40 years. I've been at the firm for 20, and I started as an intern. And so, I believe I've been very fortunate, let me say, to have worked with Dick Sinise, one of the co-founders of Kennedy Capital. And to me, probably one of the greatest small cap investors that have ever been in our space. And so that often we would work together, I'd be in here on Saturdays and Sundays, we'd be discussing stocks, and I'd go back from a conference and he'd break out his notebook and we'd go through every meeting I'd have.

So, if I had 20 or 25 meetings in the last few days, we'd literally go through every one and decide which ones should be bought and sold. And so, I'm a big believer in mentorship, and those are things you can't just learn in a book. And so now that he's since retired, I kind of believe it's my job to kind of pay that back to our newer analysts here that we've hired at the firm over the last few years. So, I feel very fortunate to have the mentorship with Dick over the last few decades.

Mark Goodwin:

Sean, that's great perspective. Equity markets have had a great run since November of 2023, and the Fed has held rates steady, but seems inclined towards easing at some point. The rate of inflation has improved, but still a persistent issue while economic growth has been resilient. Where do you see the equity markets currently and what's your outlook for the rest of 2024?

Sean McMahon:

Yes, obviously the last week or so has been pretty exciting here with the move in small and micro-cap. But overall, my personal belief is that the economy is going to be very resilient. I'm not expecting a recession, though I do believe inflation will remain near current levels and likely potentially for at least one, maybe two interest rate cuts later this year. However, I'd still highlight that we're still finding good investment opportunities where companies have an ability to improve overall corporate performance and so very excited at what the current market is giving us today.

Mark Goodwin:

Sean, for some time the driver of equity performance has been a narrow group of large cap stocks, primarily in technology. In fact, I think back to 2022, and I don't think anyone even knew what AI was at that point in time. Where do you see the micro and small cap space today and what catalysts may provide advantages to these asset classes?

Sean McMahon:

Yeah, just to highlight, I think it's been remarkable how narrow the performance has been within large cap. Obviously it's been well reported in the news about the "magnificent seven" stocks (Microsoft, Apple, Tesla, "Amazon, Meta, Alphabet and Nvidia). And however, I do think micro and small cap offer some unique advantages. Specifically, if you think about the sheer number of names within my universe, unlike large cap that might have several hundred ideas to choose from. And within the small and micro, I have several thousand to choose from as I build our strategy, which typically incorporates anywhere from 80 to 125 ideas. The other thing I would focus on is that typically small and micro-cap ideas have significantly less focus from the sell side. So, if you think about large cap ideas, they may have a number of analysts following them. In my case, I may have none. Sometimes there may be no analyst following or maybe just a couple.

So, I think that's a unique part of investing micro-cap. It's this kind of undiscovered nature of ideas. And then secondly, I would highlight that a unique opportunity, especially within micro and small, is sometimes if you think about a mid-cap name, maybe they run into an issue or so for the next, there's some problem in the business and it might take a year or two to fix. Oftentimes we talk about it like a fallen angel. They may fall down from a mid-cap to a small to a micro-cap. And by the time that happens, it might take a little while, but that business can often heal. And when that happens, it gives us an opportunity to buy a business that was once operating at very high returns that fell and now has kind of, what I'd say, re-accelerating or improving the rates of returns.

And I'd be remiss not to highlight this, but a recent holding in the fund that we exited early this year at a significant gain was Root Incorporated, an auto insurance company. And if you look back over the last four years, they've kind of struggled with inflation on their policies and to generate profitability on their current underwriting processes. However, if you see that they've kind of been fixing their underwriting processes. And in Q3 of '23, we saw that their actual policies grew substantially and at much improved margins versus the last 12 months. And the market didn't actually even recognize it, Mark. I mean, the stock barely moved and reported fantastic results in Q3. But again, what happened Q4, they reported the similar strong results. The market started to believe and buy into it, and the stock moved from low teens to, I think it actually peaked over $80 at one point in time.

And so, you get these opportunities. And by the way, that stock was a mid-cap stock a couple of years ago when it came public. And so, it fell all the way down from a multi-billion dollar to sub $300 million market cap. And we found it actually on their earnings, their improvement and so believed in their ability to improve corporate performance, and it was a huge winner for our clients. So those are types of ideas that we think you can find in micro-cap and small that may be a little bit more difficult in the larger cap arena.

Mark Goodwin:

Thanks, Sean. Are there particular sectors among micro caps today where you're finding the best opportunities?

Sean McMahon:

Yes, I mean, it clearly feels like you can't get through a conversation with a client without discussing AI. However, as a bottom-up manager, I look at each stock on its own merit. I don't have a favorite sector, but I tend to underweight areas where you probably think that you see less of an opportunity for change. Areas that come to mind are utilities and even some parts of consumer, specifically retail, where I see micro-cap is less advantaged compared to some of their larger cap peers. I am though particularly bullish still in healthcare, especially within biotechnology. I believe micro-cap and small cap biotechnology companies will continue to be a place of significant focus, an area of M&A interest from larger cap pharma. So also, within MedTech, I expect to continue to see consolidation as these companies oftentimes have an ability not only boost revenues for larger cap peers, but also generate significant cost synergies. Just here recently, for example, one of our holdings, Silk Medical, announced they were being acquired by Boston Scientific at a significant premium.

Mark Goodwin:

Thanks, Sean. Do you have any key concerns or risk you are monitoring that could cause a significant shift in your market outlook? And likewise, the way you position the portfolio?

Sean McMahon:

Mark, there's always events happening in the world, unfortunately, as we know. And I have a large screen that helps me monitor them. For example, the impact on cargo shipments through the Red Sea, the ongoing war in Ukraine, port closures, cyber attacks here as we've seen here recently, but even the potential largest probably being the administration change and how that will impact our holdings going forward. So, there are items that I say that we're constantly evaluating and watching, but while some of these are risks, I would highlight that some are also opportunities. Some of these risks as they change and unfold can create new investment opportunities, and we look to always capitalize on them.

Mark Goodwin:

Thank you, Sean. Don, back to you. The North Square Kennedy Micro-Cap Fund is newly launched, but your firm has a long history of applying a consistent investment process to micro-cap equity investing. How do you see a strategy like this fund being best positioned in the diversified portfolio of an investor?

Donald Cobin:

Well, ultimately, we are investors, not asset allocators. However, we believe it's important that financial advisors help individual investors determine a comfortable degree of risk in their portfolios. Microcap investing does tend to generate higher returns, higher alpha over time, but that also comes with volatility. Though we all know that there are no guarantees in this business, when we started a micro-cap composite a couple of decades ago, we brought it that same rigorous discipline that we use in our other equity strategies. Over the long term, so let's think of a decade or so, our micro-cap composite has outperformed its benchmark by more than any other strategy that we run, over 350 basis points after fees in excess of its benchmark. So micro-cap stocks can have large movements up or down. Historically speaking, for an investor seeking higher after fee returns with somewhat high volatility, this could be a suitable asset class. So, as you've undoubtedly sensed from Sean here, our passion for this area is virtually unmatched. We'd be excited to have you join our journey in uncovering returns in this under covered, less discovered niche of the public equity universe.

Mark Goodwin:

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

Donald Cobin:

It has.

Sean McMahon:

Thank you. We appreciate it.

Donald Cobin:

Thanks, Mark.

The North Square Kennedy MicroCap Fund's date of inception is June 10, 2024.

Past performance does not guarantee of future results. Please click here to view standardized performance for the Fund.

Principal Risks of Investing: Risk is inherent in all investing, including an investment in the Fund. An investment in the Fund involves risk, including the following principal risks, among others: Equity Risk, Preferred Stock Risk, Convertible Securities Risk, Sector Focus Risk, Portfolio Turnover Risk, Market Risk, Micro-Cap and Small-Cap-Sized Company Risk, Growth-Oriented Investment Strategies Risk, Value-Oriented Investment Strategies Risk, Reliance on Technology Risk, Cybersecurity Risk, ETF and Mutual Funds Risk, Real Estate Investments Trust Risk, Liquidity Risk, Currency Risk, Foreign Investment Risk, Emerging Market Risk, Limited Operating History Risk and Management and Strategy 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.

Definition of term used in this podcast:

Return on invested capital (ROIC) assesses a company's efficiency in allocating capital to profitable investments. It is calculated by dividing net operating profit after tax (NOPAT) by invested capital. Return on invested capital is a calculation used to determine how well a company allocates its capital to profitable projects or investments. Comparing a company's ROIC with its weighted average cost of capital (WACC) reveals whether invested capital is being used effectively.

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.

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