

## Active Insights Podcast with CS McKee – “As very style pure value investors, we're virtually always positioned with materially stronger value metrics than our value benchmark.”

### **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 large-cap equity investing with CS McKee Portfolio Managers Mary Jane Matts, Ted Moore, and Graham Harkins. CS McKee is a partner firm in the North Square platform and manages the Large Cap Value Portfolio, which is a separately managed account investment strategy offered by North Square.

Mark, MJ, Ted, and Graham, 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 CS McKee provide value-oriented equity strategies from micro-cap to large-caps.

MJ, starting with you, can you discuss the key elements to your approach to managing large-cap equity Portfolios and, also discuss the main driver of performance?

### **Mary Jane Matts:**

Yes, Mark. Thanks.

In the large-cap space, each of us on the team function as research analysts/Portfolio managers doing bottom-up fundamental research on our sectors. And at the heart of our approach is an assessment of fair value, which is driven by that fundamental effort. But to quickly and efficiently process a large amount of data and compare stocks across a wide variety of sectors, we utilize a toolkit of modern quantitative techniques. So in a way, our approach might be best described as quantamental, a marriage of bottom-up fundamental analysis with sophisticated quantitative techniques. The vast majority of the risk and return in the Portfolio is driven by stock selection as opposed to sector weight decisions or style deviations from the benchmark. That's where the bulk of our effort goes, and over time, that's the leading driver of performance.

**Mark Goodwin:**

Thanks for that. I want to focus on the large-cap value strategy right now.

MJ, there are almost 900 stocks in your benchmark Russell 1000 Value Index. What characteristics are you looking for in order for a stock to become a position in your Portfolio?

**Mary Jane Matts:**

Right, Mark. The universe is broad, but we're looking for an elusive combination of three factors that make a stock look attractive to us. First is statistical cheapness, second is undervaluation, and third is timeliness.

In terms of statistical cheapness, that describes us starting with a fishing pond of consistently underpriced stocks that represent neglected out-of-favor stocks that are trading at lower-than-average multiples of earnings, book value, cash flow, dividend yield. Those are stocks that are cheap on a price-to-pound basis, but many of those stocks deserve to be cheap, either because their growth prospects are so poor or their risk is so high that it isn't until we can do a valuation exercise that we can begin to distinguish between those that are merely cheap and those that are truly undervalued, that being the second leg of the stool.

Thirdly, we know the chief pitfall of this style of investing is being right about the value on paper, but being too early and having to wait too long for the market to realize that value. So to endeavor to avoid situations that become value traps, we use a number of timeliness tools to identify a situation where investor sentiment is actually beginning to improve. So those are the three main elements, statistical cheapness, valuation, and timeliness that drive us to a 40- to 60-stock Portfolio of attractive names.

**Mark Goodwin:**

That's a great summary.

Ted, turning to you, your Portfolio is relatively concentrated with 40 to 60 stocks as we talked about. How do you consider risk management as you build a Portfolio?

**Ted Moore:**

Thank you, Mark. Yes, it is a concentrated Portfolio with roughly 50 names and no single position over 5%. Regarding risk management, we closely track our level of active risk versus the benchmark, as well as its composition, which typically breaks down to roughly 70% stock-specific risk, with another 15% each attributed to sector and style. We consciously budget our risk via position sizing such that our highest conviction holdings contribute most significantly to active risk. And we monitor the sector and style factor risks to make sure that there are no unintended unwarranted risks accumulating in the Portfolio.

For instance, we recently noticed that the momentum factor was starting to contribute more to risk than we believe is warranted and we've adjusted individual positions to bring it back into line. I should also mention that risk is built into our evaluation process of each stock, as it determines the rate at which we discount each company's cash flows and thus determines each company's intrinsic value.

**Mark Goodwin:**

Thank you for that.

Graham, shifting to sell discipline for a moment, can you talk about what would compel you to sell a Portfolio position?

**Graham Harkins:**

Of course, thank you. Our sell discipline is the converse of our buy discipline. There are really five main reasons we have for selling a stock. Firstly, the stock performs well and approaches our price target. Secondly, a more attractive stock is identified. Thirdly, a lower assessment of fair value results from a downward reassessment of the risk-adjusted future prospects of the firm. Fourthly, the timeliness of the stock deteriorates, rendering it untimely. And lastly, the integrity of financial reporting becomes suspect. In the first and second scenario, we may be more likely to scale out of the position over time. In the third, fourth or fifth scenario, the position is most likely to be eliminated in its entirety.

I did want to mention that one of the more common reasons we do sell a stock is due to a deterioration of timeliness. Our timeliness metrics look to identify stocks with positive momentum in investor sentiment as evidence that a positive catalyst is at work. The metrics we use are an earnings estimate revision, predicted earnings surprise, insider trading activity, price trend analysis, and short interest analysis.

All of these factors are back-tested, and consistent with that back-testing, stocks that have a poor timeliness consistently underperform their peers. And using this data, our weighting scheme penalizes significantly stocks with a negative timeliness. This way we believe we are working hard to avoid the value traps, a name that could appear for a long time to be cheap and undervalued, but without that timely catalyst, as well as to eliminate or trim names in our Portfolio that see a reduction in their timeliness rank.

**Mark Goodwin:**

Thanks for that.

Going back up to 30,000 feet, MJ, thinking about the broader economic environment, the Fed has begun to ease rates. August CPI was about 2.9%. Tax policy and a trend towards deregulation are generally positive for business, but the shift in trade and tariff policy has caused some uncertainty. Where do you see the equity markets currently? And what is your outlook for the rest of 2025 and into 2026?

**Mary Jane Matts:**

Right, Mark. Equity markets have been extraordinarily strong since the initial bearish reaction to the "Liberation Day" (U.S. tariffs) announcement earlier in the year. It hasn't all been irrational trading. Consumers and market participants have remained remarkably resilient in the face of the uncertainty that you described. And earnings and economic growth have come in better than had been expected, as the tariff implementation has been far less draconian than that first announcement. The 10-year Treasury Note has come down a bit as the Fed has begun to ease. And the earnings outlook has improved a bit as well. But at these levels, the equity market valuation is well above historical norms, which is obviously a concern. Now, despite the valuation, the technical setup for the remainder of the year looks quite favorable, with the GDP forecasted to come in just below 4% for the fourth quarter and earnings estimated to gain another 7% in the fourth quarter.

The market now is really counting on the Fed. The biggest risk here is the delayed impact from the tariffs that were announced earlier and the implementation that has been so sporadic throughout the year. Next

year will be the first full year effect, as well as the first full year effect of the labor market adjustment to lower immigration. So lots of cross-currents, but given that we see full valuations at this point, multiple expansion for the market from here is not to be expected. So maybe the best estimate for the following year, for 2026 is the earnings growth that's expected, about 10%. That might be the best estimate.

**Mark Goodwin:**

That's a great summary.

Ted, turning back to you. In recent years, a relatively small group of growth-oriented companies have dominated the large-cap space. How has the value segment been impacted by these mega-cap growth leaders?

**Ted Moore:**

Yes, I believe you're alluding to the "Magnificent Seven," which we would actually expand to eight or nine. Broadcom definitely deserves inclusion and Oracle's getting there. But certainly, the level of euphoria surrounding those names can impact the growth/value balance and flows in the market. More directly, those companies' spending decisions, notably their massive Capex (capital expenditure) increases in the quest for AI dominance, can impact suppliers like Cisco, which we own as a beneficiary of the trend.

As for our Portfolio, as very style pure value investors, we're virtually always positioned with materially stronger value metrics than our value benchmark. We won't buy the triple-digit PE names, the Teslas of the world, but we can seek out cheaper exposure to some of the exciting high-growth megatrends.

For example, five years ago we bought Oracle on the thesis that the market was underestimating its prospects in cloud computing. While consensus was so concerned about the existing oligopoly of Amazon, Microsoft, and Google, it was our position that Oracle, in fact, had the best technology offering and should become a viable fourth competitor. The shares have quadrupled and we finally eliminated our position in July.

Another example is IBM, which we bought three and a half years ago, partly due to its new mainframe cycle, but also as a very inexpensive call option on artificial intelligence and quantum computing. That one's doubled, working out well for us too.

And while we don't traffic heavily in Magnificent Seven names, we're not against buying them if they dip into value territory. And when we have owned even one, it's always been the cheapest and most undervalued. As it happens, three of them, namely Alphabet, Amazon, and Meta, came into our value benchmark at the end of June at a collective weight near 6% and we redoubled our efforts to evaluate their company-specific factors. This deeper consideration revealed a solid investment case for Google or Alphabet, easily the cheapest and most undervalued of the three, and with our timeliness model also suggesting there's reason for near-term optimism. Fortunately, it's risen 40% in that short time and we've already begun trimming.

This is our third foray into the Mag Seven. We owned Google once before from October 2020 to May 2022, with our thesis that the market was overestimating breakup risks and undervaluing its cloud opportunity and AI advantages. We overstayed our welcome a bit at the end, but it was still a nice outperformer.

And finally, we owned Meta very early in 2023 when it was down about 2/3 from its prior peak, but after the proverbial knife had stopped falling and it had stopped screening as untimely. Our thesis was that it was in the midst of cycling through its worst advertising comparisons and was dialing back what we considered to be its highly questionable Metaverse spending plan, so we expected investor sentiment to continue improving. It promptly went up 125% in five and a half months, before exiting the benchmark again, and we couldn't justify holding it any longer in a value Portfolio. Given our very slight overweight to the stock, it didn't give us a lot of Alpha, but it also didn't ruin our year by not owning it.

**Mark Goodwin:**

That's a great summary, Ted.

I'm going to pivot back to you, Graham. Can you talk about how the large-cap value strategy is currently positioned, where you find the best opportunities to put new capital to work either in sectors or sub-sectors, and maybe talk about any of the broader themes that are causing you to target certain areas?

**Graham Harkins:**

Of course. Yes, thank you. As Ted sort of mentioned, around 70% of the active risk in the Portfolio comes from our stock-specific risk, with concentrations in the financials, healthcare, and industrial sectors. Within the stock contributions themselves, Cummins, Delta Air Lines, US Bancorp, and Mosaic have our highest stock-specific contributions.

The remainder of the active risk derives from style and industry deviations from the benchmark. Among style effects with an overexposure to earnings yield, dividend yield, and book-to-price, the Portfolio maintains its positioning as deeper value characteristics than the benchmark. The Portfolio also has an overexposure to the momentum factor at the moment, and with overweights to energy, healthcare, communication services, and financials, and underweights to industrials, information technology, consumer discretionary, and materials, the Portfolio's positioned moderately defensively at the moment.

**Mark Goodwin:**

Thank you. After an extended period of underperformance, do you think that value-oriented stocks may be positioned with some potential advantage to outperform vis-a-vis their growth sisters?

**Mary Jane Matts:**

It's a good question, Mark. If we look back at the very long term, like back to 1927, value had a multi-decade, many, many decades of outperformance versus growth. And it wasn't up until about 2007 when we hit the Great Financial Crisis that the pendulum began to swing strongly the other way, and it has been an extended period where value has lagged growth.

When we consider the outlook from here for value versus growth, we look at the Russell 1000 Value Index versus the Russell 1000 Growth Index on measures of statistical cheapness, valuation, and timeliness. Again, the same way that we look at stocks from the bottom up, we're looking at value versus growth in that way. Statistical cheapness measures currently favor value over growth, measures of valuation favor value over growth, but timeliness metrics favor growth over value. So kind of a mixed bag there, but if

indeed we do have a pause that refreshes, if we have a recession in the early part of next year, value may indeed be poised to outperform given the more deeper ties to a cyclical rebound.

**Mark Goodwin:**

And thanks for that.

MJ, your team applies a very disciplined approach to managing equity Portfolios. How do you see a concentrated large-cap value strategy like the McKee Large Cap Value Portfolio being best positioned in the diversified Portfolio of an investor?

**Mary Jane Matts:**

As a result of the disciplined implementation of the approach that we've described here today, we do have a very long history of maintaining stronger value characteristics, and we do have a tendency to be deeper value than the benchmark and many of our peers. In other words, we stay in our style box and we tend to perform best when value is in favor. Because of those tendencies, our Portfolio tends to be an excellent counterpart or complement to a disciplined large-cap growth Portfolio.

**Mark Goodwin:**

Thank you for that.

MJ, Ted, Graham, thank you for joining me today. This has been a great discussion.

**Graham Harkins:**

Thank you.

**Mary Jane Matts:**

Thank you.

**Ted Moore:**

Thank you.

**Diane Merritt:**

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#### **Definitions of terms used in this podcast:**

The **earnings multiplier** is a financial metric that frames a company's current stock price in terms of the company's earnings per share (EPS) of stock, that is very simply computed as price per share/earnings per share. It's also known as the price-to-earnings (P/E) ratio.

The **book value** of a company is the difference in value between that company's total assets and total liabilities on its balance sheet.

**Cash flow** refers to the movement of cash into and out of a company over a specific period, indicating its financial health and ability to generate returns. It is used to assess a company's liquidity, profitability, and investment quality.

The **dividend yield** is the amount of money a company pays shareholders for owning a share of its stock divided by its current stock price. It is expressed as a ratio.

**Momentum** is the rate of acceleration of a security's price—in other words the speed at which the price is changing. In stock investing, the **momentum factor** describes the tendency of winning stocks to continue performing well and losing stocks to continue performing poorly in the short term.

**Intrinsic value** refers to the innate or fundamental features of an asset, as opposed to the fluctuating price assigned by traders in the market. In equities markets, the intrinsic value of a stock is calculated from its cash flows

**Short interest** is the total number of a company's shares that have been sold short but not yet bought back to cover the position. Investors sell borrowed shares hoping the price will fall, and this creates short interest until they repurchase and return the shares. Short interest is often expressed as a percentage of a company's outstanding shares and serves as an indicator of bearish (negative) sentiment toward a stock.

**Earnings growth** is a financial metric that measures the increase in a company's profitability, such as net income or earnings per share (EPS), over a specific period, typically expressed as a percentage. It serves

as a key indicator for investors to assess a company's financial health, operational success, and potential for future growth.

**Alpha** represents the excess return of an investment strategy compared to its benchmark index, after accounting for risk.

**Earnings yield** is a financial metric that represents a company's annual earnings per share (EPS) as a percentage of its stock price, indicating the return from earnings for every dollar invested in the stock.

The price-to-book (P/B) ratio is a financial metric that compares a company's market value to its book value, which is the value of all its assets minus its liabilities, helping investors identify undervalued stocks.

**Book-to-price** refers to the Book-to-Market Ratio (B/M ratio), which is the reciprocal of the more common Price-to-Book (P/B) ratio. The B/M ratio measures a company's book value per share (the net asset value of the company) relative to its market price per share, indicating if a stock is trading at a discount or premium to its underlying asset value. A B/M ratio less than 1 suggests the stock may be undervalued, while a ratio greater than 1 indicates it might be overvalued.

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