

Active Insights Podcast – “With so many attractive stocks within the investable universe, we don't want to speculate. We want to focus on investing for our clients.”

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 micro-cap equity investing with Eric Holmes, Portfolio Manager and Director of Micro and Small Cap Equities with CS McKee. CS McKee is a partner firm in the North Square platform and manages the micro-cap value portfolio, which is a separately managed account investment strategy offered by North Square.

Mark and Eric, 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 strategies from micro-cap to large-cap equities. Eric, welcome. Can you discuss the key elements to your approach to managing equity portfolios?

Eric Holmes:

Yes, thank you. Our disciplined approach has been consistently applied since 1998, generating attractive long-term results, which includes outperforming 60% of the time over my 20 years as lead manager. We look for statistically cheap stocks that are out of favor with low expectations and are earning below their normalized earnings power, with catalysts to regain their earnings power over two to three years or sooner. We combine those factors with financial strength to reduce volatility and provide downside protection.

Mark Goodwin:

Thanks, Eric. Focusing on your micro-cap value strategy, there are over 3,000 stocks with a market cap under \$1 billion and about 1,000 stocks in the Russell Micro-Cap Value Index. What characteristics are you looking for to include a stock in your micro-cap portfolio?

Eric Holmes:

Besides the typical value characteristic of statistical cheapness, we're looking for catalysts to reignite earnings growth. It could be a product cycle, new management, restructuring, or as broad as an industry supply and demand cycle, or an acceleration in the economy. Another important characteristic we look

for is financial strength. When a small company is dealing with a period of weak earnings, that has limited resources and could find itself unable to obtain adequate funding or liquidity to survive, a healthy balance sheet and cash flows are very important to reduce risk while the catalysts are developing.

Mark Goodwin:

Thanks, Eric. Your portfolio is relatively concentrated. How do you think about risk management and portfolio construction as you build up the portfolio?

Eric Holmes:

Even though our portfolio is concentrated relative to the benchmark, we use about 90% fewer stocks than the benchmark. Our portfolio has a lower standard deviation, that's a lower volatility of returns. This is because we invest in higher quality companies than average - financial strength - and a history of earnings. The benchmark is chock-full of non-earning companies, which are perpetually generating negative free cash flow. Those companies have higher volatility and perform poorly in market drawdowns. Our portfolio has downside capture of only 43% over the past three years, so we usually do much better than the overall market when things get ugly. We seek companies with financial strength to protect on the downside when there are large market drawdowns or company-specific negative surprises. We maintain reasonable position sizes of one-half to 2% typically to reduce volatility, but still large enough to contribute alpha. We maintain limits on the size of each sector's weight relative to the benchmark to avoid taking excessive risks, and we carefully monitor each stock's trading liquidity so that we can enter and exit positions within a reasonable time.

Mark Goodwin:

And that's a great summary. In pivoting to sell discipline, what would you say are the factors that would lead you to sell a portfolio position?

Eric Holmes:

Full valuation after significant price appreciation, which is our favorite reason to sell a stock. We would swap out a stock for another one that has a better risk reward profile, upgrading the portfolio, as you might say. Deteriorating financial strength or negative development with a company's catalysts would cause us to sell. And also, concern about financial reporting would definitely cause us to sell. That shifts the stock from investing to speculating. And with so many attractive stocks within the investable universe, we don't want to speculate. We want to focus on investing for our clients.

Mark Goodwin:

Eric, thinking about the broader economic environment, the Fed has begun to ease rates. Tax policy and a trend towards deregulation are generally positive for businesses. But the shift in trade and tariff policy, as well as the recent government shutdown, has caused some uncertainty. With that backdrop, where do you see the equity markets currently, and what's your outlook as we end 2025 and move into 2026?

Eric Holmes:

I'm looking for continued economic growth into next year, which should be supportive of market appreciation as investors have become more comfortable with the volatility around trade and tariff policy.

Companies have also been adjusting to the new environment and should get back to normal spending patterns next year as well.

Mark Goodwin:

In recent years, equity markets have been dominated by very large cap stocks. How are micro-caps positioned in this environment, and are there potential opportunities for these smaller companies to outperform?

Eric Holmes:

Quality micro-cap stocks are trading at very attractive valuations relative to large caps. After periods of strong growth stock performance, like we have had the last few years and particularly over the last three months, There is often a powerful counter-trend revision to the mean, where the out-of-favor group performs very strongly. Examples include the periods after the dot-com bubble in the late 1990s and after the meme stock mania of 2021. Smaller value companies performed very strongly following those periods, and we're expecting a similar result after this period of growth stock performance comes to an end.

Mark Goodwin:

Thanks, Eric. How do you see value stocks positioned compared to micro-caps that are more growth-oriented?

Eric Holmes:

Similar to my answer regarding the large-cap stocks, value micro-cap stocks have very attractive valuations relative to growth micro-caps with the added support of financial strength and much fewer non-earners. We're expecting a mean reverting outperformance from value micro-caps relative to growth micro-caps too.

Mark Goodwin:

Are you finding the best opportunity to put new capital to work in certain sectors at the moment?

Eric Holmes:

We haven't had a particularly strong tilt to any one area, but the recent market softness has provided some opportunities to put money to work in industrials, technology, and financials.

Mark Goodwin:

How would you say your micro-account value strategy is currently positioned?

Eric Holmes:

We have a pro-cyclical tilt with overweights to industrials, technology, materials, communication services, and consumer discretionary. All of those sectors should do particularly well in a moderately growing economy, which is what we expect for next year.

Mark Goodwin:

Thanks, Eric. Do you have any concerns that would cause a significant shift in your outlook and the way you position the portfolio?

Eric Holmes:

Not currently. We are expecting continued economic growth into next year, which is supportive of positive market returns. We proactively monitor economic and industry trends to stay ahead of changing conditions so that we can make a change of the portfolio as necessary.

Mark Goodwin:

That's great. Eric, micro-cap equity is an area that lends itself to professional active management. How do you see a concentrated micro-cap value strategy, like the micro-cap value portfolio of CS McKee, being best positioned in the diversified portfolio of an investor.

Eric Holmes:

Our portfolio provides exposure to the higher long-term returns generated by micro-cap stocks that investors desire, but with less volatility and risk than the index. Index fund exposure is popularly believed to provide diversification and reduced volatility. However, in the micro-cap space, professional management actually provides lower volatility due to avoiding the junk companies that don't earn money and burn cash. Our more concentrated portfolio has lower volatility and a lower downside capture ratio than the index, providing investors with a greater margin of safety due to our focus on higher quality companies with financial strength. That has enabled us to outperform 60% of the time over the last 20 years.

Mark Goodwin:

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

Eric Holmes:

Thank you. It has been my pleasure.

Definitions of terms used in this podcast:

The Russell Microcap® Value Index measures the performance of the microcap value segment of the US equity market. It includes Russell Microcap companies with relatively lower price-to-book ratios, lower I/B/E/S forecast medium term (2 year) growth and lower sales per share historical growth (5 years).

Standard Deviation measures an asset's volatility or risk by showing how much its returns typically vary from the average return; a high standard deviation means bigger price swings and higher risk, while a low one indicates more stable, consistent returns. The Standard Deviation metric assists investors in determining their risk tolerance.

The **Downside Capture Ratio** measures how well an investment manager performs relative to a benchmark index during periods of market decline. A ratio below 100 indicates the manager outperformed the index during downturns.

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.

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

Important Disclosures

- **Past performance is not indicative of future results. Investment return and principal value will fluctuate, and it is possible for an investor to lose money. There is no assurance that any strategy will achieve its objectives.**
- **The strategy is benchmarked to the Russell Microcap® Value Index. Indexes are unmanaged and do not incur fees; investors cannot invest directly in an index.**
- **Risks associated with the strategies include, but are not limited to, equity risk, value investment style risk, liquidity risk, and risks associated with small- and micro-cap companies. These securities may be more volatile and less liquid than those of larger companies.**
- **For additional information - including composite performance, characteristics, and methodology - please refer to the official strategy fact sheet available at www.csmckee.com.**
- **CS McKee claims compliance with the Global Investment Performance Standards (GIPS®). Composite characteristics, including the number of accounts, assets under management, and dispersion measures, are provided in the GIPS® Composite Report. Please refer to the report for additional important information or to view a list of composite descriptions by visiting: <https://csmckee.com/gips/>**
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