Active Insights Podcast – Strategic Income Solutions from a Portfolio of Best Ideas

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. My name is Diane Merritt. Today, we are joined by John Cassady, Chief Investment Officer, and David Withrow, Director of Portfolio Management, with Red Cedar Investment Management. Red Cedar is a partner firm in the North Square platform, and sub-advisor to North Square Strategic Income Fund, symbol ADVNX. John and David, we are happy to have you with us today.

John Cassady:

Thanks for having us, Diane.

Diane:

John, Red Cedar focuses on income solutions and has a highly experienced team. Can you give us some background on the firm and your investment team?

John Cassady:

Sure. In reality, the genesis of this firm really started almost two decades ago. And I say that because the vast majority of the team here has worked together, going back to 2002. In fact, this strategy, at a different spot has been managed in the same manner since 2002, with David being a part of that team. And really, as we move through the crisis years, this team saw this strategy through the great financial crisis year, so '08 and '09, and on. This team, in particular, has been together at a different firm managing this type of strategy, managed in the same way for the past 10 years.

Then as we moved into 2018, we had an opportunity to partner up as a team with Delta Dental Insurance Company, Delta Dental of Michigan, and become Red Cedar Investment Management and bring a team over here of 11 investment professionals and 14 employees total, to manage generically fixed income solutions, income-oriented investment strategies, which also does invest in some equities. The team has been together for quite some time, and it was a great opportunity for us to partner with a strong parent. Then I guess, I would also add that we do have some exciting news coming out very soon, regarding ownership for the investment team in Red Cedar Investment Management.

Diane:

David, your investment approach is interesting, in the scope of investments you consider when building income-producing strategies. What is your process to evaluate your investment universe to develop a workable set of potential investments?

David Withrow:

Thanks, Diane, really, it all starts with the three key tenets. When we look at the universe of potential investments, we're really looking at global flexibility, high income, and the low correlation effect between the different securities and asset classes. That whole process starts with, formally a monthly meeting between some of the senior portfolio managers and the senior team. In that discussion, we talk about a lot of the different components of what's going on in the world. So equity markets globally, and also in the US. Certainly, the fixed income market, interest rates, what's going on from a trade standpoint globally, what's going on in emerging markets. That team evaluates all those different sectors of the marketplace, and rates those in terms of opportunity sets, both short-term, three to six month time frame, and then over a market cycle, how we think that those different sectors will perform. That's all distilled down to what's our view of the world today in terms of the opportunity set.

John, I don't know if you want to talk about it, a couple of our themes right now, to be specific, are the weak dollar and the implications of that, and then European interest rates. John, I don't know if you want to just briefly discuss how those two components, to give an example of what that process might look like.

John Cassady:

Yeah, absolutely, Dave. As Dave mentioned, part of our process is to evaluate different global asset classes. So recently, thanks to the pandemic and the actions that the Fed has taken, as well as other central bankers, and then the fiscal stimulus, the world has just been flooded with US dollar liquidity, something that was very sorely needed, as the wheels were grinding to a halt. Clearly the dollar has softened, overvalued, no matter how you might apply your analytics to the value of the US dollar because of its status as the reserve currency. But we just felt that coming out of this pandemic, we're still actually in it, but we just felt that there would be some dollar weakness, then there would be some reflationary themes that come about, as a result of that.

That would mean that other parts of the world, there might be better opportunities, especially since US fixed income, the Fed has cut rates down to zero and promised to stay here for quite some time. Part of the dollar's strength over the past couple years has just been the interest rate differential, which the US does not have that advantage anymore. Of course, Europe is already cut to negative rates in many cases, but there are themes that we could play on, cheap dollar, maybe stronger Euro, with perhaps Europe handling the crisis a little better than the US has. Maybe they get back on their feet a little earlier. There are themes like that we can look to take advantage of, and it speaks to David's point about global flexibility, the ability to go anywhere in the world to source income, which is very, quite challenging right now, with real interest rates, even in the US, real interest rates, that is, interest rates after adjusting for inflation are negative.

The ability to source ideas globally and take into account our overall world view and where we might want to go in the world, that might mean maybe some of the cyclical themes are going to start to play out here in the very near future, and that would mean different things for different countries that maybe have more of their economy tied to manufacturing raw materials, that sort of thing. Those are the kinds of ideas that I think we try to flesh out of our monthly meeting in our global view of the world. Right now we're, I think dollar has had a little bit of a bump here in the last few days, but it's probably just back-filling. But longer term, our view is that dollar weakness could be what could serve other parts of the world better, or have more investment flows, portfolio flows going to other parts of the world. That's how we try to look at it.

Diane:

How do you develop an overall portfolio strategy from that workable set of investments?

David Withrow:

Well, as I mentioned before, we kind of have to put all those ideas and that asset allocation framework through the framework of global flexibility, income, and low correlations, income being a primary driver. For instance, there might be certain investment opportunities in the global marketplace that aren't income producing. It's not that we can't buy those securities, but we don't want that to be a primary driver. It's not a primary driver of performance in this strategy. So it's boiling it down to what really fits, and achieve those three goals. The nice thing about this strategy, one of the real strengths of it is, we're not stuck into an area or a sector of the marketplace if we don't find that sector of the marketplace attractive. We can go up and down the capital structure, while we do have risk limits on that, we can go up and down the capital structure and really find not just the specific sector or the specific security that makes the most sense, but we're in the capital structure that we end up buying that particular issuer of that debt or equity in a company.

And then we create our toolbox of, here's the different sectors. And we meet again as a team with each of the portfolio managers having a depth of knowledge within a specific sector or area of securities. And then we go through and we determine of all those buckets, what bucket creates the best opportunity for the investment in this portfolio? One of the things we pride our team in is the fact that while we do have an in depth knowledge within each sector and look down in security evaluation, we also have a broad knowledge, we're a best idea shop, so any portfolio manager can convey any idea. And if that idea has merits, they can run with that, and potentially add it to the portfolio. But again, all of it, through that filter of, does it meet those three primary goals?

John Cassady:

And let me just add one thing on here about trying to maybe winnow down our opportunity set. But going back to Europe, for example, as I said, rates are negative in Europe. They wouldn't make much sense in an income fund, certainly in a fund where that's one of the major drivers, what we're doing here. But, there are other countries in Europe, I'll call them Central, Eastern Europe, emerging market sovereign debt over there that actually investment grade bonds that do offer positive yields, and quite a bit of pickup over US Treasury yields. Those are the things that we can look at and get into the opportunity set for a sense of Poland government bonds, the five or six year bond. You could get that to close to 1%, you got a US five year treasury at about yielding 25 basis points or so.

You can get income producing opportunities like that. And then if you really have a view on the currency, of course, Poland is not the Euro. We think Euro is going to be stronger. Poland has their own currency, the Zloty, but it's fair to state that the currency exchange rates are going to be somewhat correlated between Euro and Zloty. That's a way to look at correlation, and look at maybe parts of the world we'd like to be in. And maybe it's not a perfect match because of income constraint on a lot of European bonds, but it's a way to get creative about how we're going to put things in the portfolio.

Diane:

How do you then make specific security selections and then allocate to build your portfolios?

David Withrow:

Well, let me go back to the overall team and the depth of knowledge. Let me give a specific example first. Once we decide what our allocation is to the different sectors, and let's talk about corporate credit or the preferred sector, where we're literally looking into the credit structure of some corporate entity. We're really fortunate as one of the investment team is Michael Martin. Just to give you some background on Michael, his history is in loan workout, his degree is in geological engineering. This man has an exceptional way of digging into the numbers and the details of these organizations. Mike Martin starts digging into these. So we've decided we want to go to credit. We have to decide if we want to go to the corporate credit senior debt, or we want to go into the preferred, more subordinated debt of the security, and that fundamental analysis of: is this credit stable, are we being compensated appropriately for the risk in that credit?

And then from a deal specific standpoint, are there any covenant structures in the prospectus or cash flow issues from just the structure of the deal that would make us either find this deal desirable, or find this specific security undesirable within the overall sector of framework. But we certainly have other members of the team who really do a deep dive on different sectors. Jason Schwartz does a great job on securitized, looking at mortgage-backed securities, commercial mortgage-backed securities, and other asset-backed securities. And then Julia Batchenko does our dividend growth strategy. And she's the one who gives us the best ideas of the dividend growth strategy. So we're looking at equities, which in many cases are paying a higher dividend yield on those securities than the corporate credit of the same issuer is paying in interest. So we're able to add that piece in, and if it's better to own the name from an equity standpoint, we have the flexibility up to 10% of the portfolio to invest in the equity of the portfolio with a dividend stream coming off that equity security.

And we would really prefer to take equity risks with the upside potential, than in many cases, not totally, but in many cases buy a high yield security, which has high equity correlations, why not take the upside and just buy the actually equity of that particular issuer? And I think that speaks to the depth of our team. Really one of the strengths of Strategic Income is it's a place where the best ideas from the overall shop, we manage fixed income, we manage equity, we manage preferred strategies. The best ideas from all those portfolios can come together in one strategy.

John Cassady:

Dave, if I could add just a good example of that best ideas, and this goes back to a quite a few years, but nonetheless, it was the same team managing this same strategy. And at that time, I was working a lot on mortgage-backed and asset-backed securities. This was during the financial crisis years, and we were coming out of the financial crisis.

Everyone hated the housing market, rightfully so. It was very difficult times, but as I was sitting there analyzing a lot of the distressed mortgage-backed securities in the universe there, and saw what was going on in say 2009, 2010, 2011, seeing that, look, we weren't building any new houses in this country. And I got to the point where I was very positive on home builders. So even though I wasn't working in the credit area, per se, I was one of the main portfolio managers on fund. We took that idea, to credit Mike Martin and the team, and said, "Hey, we think you guys ought to start to take a look at home builders," which at the time they were all below investment grade, but that's the genesis of an idea coming from maybe a different part of the firm, and then it got handed off to the credit team, and then they did a great job of digging into the credits, and making security selection.

Diane:

Now, as you find new opportunities, do you typically add these to your portfolio, or do they replace existing positions?

David Withrow:

Typically, we're largely invested. We hold a very small cash position. Typically, I'd say the cash position is between 1% and 4%. So by definition, there has to be a replacement. It's not that we couldn't add a specific security where it's just an outright purchase, but that's where the evaluation of, does the new opportunity replace the existing portfolio holding? And I think many portfolio managers will tell you, and I think our experience has taught us, you look at your portfolio every day, and if you wouldn't buy the security you're holding today, you shouldn't own that security. So that's the evaluation process we go to. If we find a new opportunity, are there any securities in the portfolio that are not adding value that we wouldn't buy today? And if we find a security that we wouldn't buy today, then that becomes the obvious replacement. Now it has to again pass through our filters.

And there are, given the risk constraints, we can't necessarily sell a credit instrument to buy an equity instrument if we're already our max on the equity side, but certainly on an ongoing basis, that evaluation allows us to substitute securities for better opportunities. We've seen that in the last, since the pandemic started, and credit markets and everything started deteriorating in market value. And there were lots of opportunities, and really it was a rising tide lifted all boats. And as long as you had the right macro view, you could perform well. Now it's become more of a... If you will allow the analogy of stock pickers market, it's a security pickers market. It's not necessarily a rising tide lifts all boats. It's does security A fair better over the next six to 12 months, given our view of the market, than the security we're holding in our portfolio?

Diane:

What are the key factors or events that would lead you to sell a portfolio security?

David Withrow:

Well, there's a couple things. Certainly a deterioration in a credit or in equity fundamentals. Essentially, did the story change as to why we bought the security? And if the story changed, then we have to reevaluate the fundamentals, or the story of the security still merit its holding. And then the other piece is, did it reach its valuation target? In other words, has it run as far as it can? And if that's the case, then we look for opportunities to replace it. And that might be a situation where we sell a security without immediately having a replacement security, or we find something that may be a treasury or a lower risk securities as a parking spot until we find a security with more upside potential on it. And let me give you a great example of some opportunities that existed in the past, prior to the great financial crisis.

And we've seen it also again recently, as markets have rallied. We do a lot of investing in preferred securities, which we've done again, for the last 18 years, and they provide great opportunities, but some of the ETFs, which buy preferreds, are very large ETFs, and they'll start buying these preferred securities because they just have to put cash to work. That might make the yield, the income stream that you get on that security, be a negative yield, kind of like we talked with international interest rates. I don't want to hold a security that has a negative yield. That makes a technical situation where I can sell to these large ETFs at a negative yield. And then when you have a great financial crisis or a pandemic, or just more typical disruptions in the market like a recession, and they have to start selling those securities just because they have to raise cash because of outflows from their portfolio.

We're able to opportunistically load back up on those securities at disproportionate yields than what the risk of the security might merit. Until recently, we've been taking advantage of that, selling $25 preferreds, which is a type of preferred security, at negative or very low yield to call, and buying what they call hybrid securities, which is more of an institutional preferred security, and getting those at substantial yield pickups because of the technical flow in the market. And it really is an anomaly that should not exist, but because it exists, and it's a fairly inefficient market, we're able to take advantage of those situations.

Diane:

John, you and your team have particularly strong expertise in preferred securities. What are the characteristics that you find compelling, and how do preferreds to add value to your portfolios?

John Cassady:

As was David just mentioned, one of the things is, it is an inefficient market. For our standards, the market where we can take decent positions and make a difference in the overall value of the fund. We took this strategy in a former life to just about a billion dollars in this strategy. We can play in that market. Some of our larger brethren out there, they're too big for this to make a difference. So we liked that fact. We also like the fact that we do the capital structure analysis, and this does get very nuanced when you're dealing with preferred.

It sits in that part of the capital structure clearly beneath the senior secured or senior unsecured debt and in between that in what I'll say is common equity. It sits in that spot where you can take a look at the company, try to understand its business, try to understand its financials, and make a determination as to whether or not they'll have the debt service coverage, or the debt service paying ability to get it done. And then that's where our credit team comes in to play there, and they can really tear it apart.

The other thing about preferreds, which plays into our wheelhouse, is they do have complicated call features on them. Different features to the security, that you have to be aware of. And analyzing callable securities is part of this firm's DNA. Myself, David, and Jason Schwartz all started in this business a long time ago, working with mortgage-backed securities, where you do have to understand the callability of different securities. Preferreds are just another way, they have another way of looking at preferreds. We'd look at that to try to determine the cash flows and get an idea of how they'll perform.

And I guess one of the other big factors, clearly is the correlation benefits, or the lack thereof, when it comes to correlation with other securities. They don't necessarily give... You can actually calculate a duration on these securities. A lot of them do have maturity dates. A lot of them have call dates. They have a lot of fixed income characteristics. In fact, many of them are categorized by regulators as fixed income. So the idea that it is fixed income, and there's duration, but it doesn't always trade with the same correlation as other fixed income instruments. And that's what we like. It's one of the main tenets of this strategy, is the fact that they do tend to be uncorrelated to other assets and sectors that we might invest in.

David Withrow:

I can give a quick example of one of the other ideas we're talking about, is the banks coming out of the great financial crisis, and the fact that the regulatory framework put around the banks really made them more stable, and that actually bore itself out during the pandemic. The regulatory environment doesn't work great if you're an equity holder. It limits the growth potential of bank issued equity, but it bolsters the balance sheet. In other words, it bolsters the ability of them to pay income on the preferred securities. Part of the analysis we've looked at to avoid the equity potentially, and buy the preferred, you want to go down as far in the capital structure as you can, if you're getting paid extra income in order to own lower in the capital structure. And that's where the preferred fits in very nicely.

Diane:

John and David, thank you so much for taking the time to join us today.

John Cassady:

Thank you, Diane.

David Withrow:

Thank you very much, Diane.

John Cassady:

Enjoyed it very much.

Diane:

And we want to thank you for tuning into our North Square Active Insights podcast. For more information on North Square Investments, our partners and investment solutions, please visit our website at www.northsquareinvest.com.

Nothing contained in this communication constitutes tax, legal, or investment advice. Investors must consult their tax advisor or legal counsel for advice and information concerning their particular situation. This podcast contains certain statements that may include forward looking statements. Although Red Cedar Investment Management believes that the expectations reflected in these forward looking statements are reasonable, they do involve assumptions, risks, and uncertainties. And these expectations may prove to be incorrect. Actual events could differ materially from those anticipated in these forward looking statements, as a result of a variety of factors. You should not place undue reliance on these forward looking statements. This podcast reflects Red Cedar's views and opinions as of the date herein, which are subject to change at any time based on market and other conditions. We disclaim any responsibility to update these views. These views should not be relied on as investment advice or an indication of trading intention.

Important Risks: The Fund invests in equities which are subject to market volatility and loss. The Fund invests in equities of large-cap companies which may be unable to respond quickly to new competitive challenges. The Fund invests in equities of small- and mid-cap companies, which may be subject to more erratic market movements than stocks of larger, more established companies. The Fund invests in value equities which may not appreciate in value as anticipated or may experience a decline in value. The Fund invests in foreign securities which carry the associated risks of economic and political instability, market liquidity, currency volatility and differences in accounting standards. The Fund invests in preferred stocks which are relegated below bonds for payment should the issuer be liquidated. The fixed dividend may be less attractive in a rising interest rate market. The Fund invests in REITs; the risks are similar to those associated with direct ownership of real estate. Shareholders will indirectly bear the additional expenses of investing in REITs. The Fund invests in convertible securities which are subject to the risks of both debt securities and equity securities. The Fund invests in debt securities which can lose their value as interest rates rise and are subject to credit risk which is the risk of deterioration in the financial condition of an issuer and/or general economic conditions that can cause the issuer to not make timely payments of principal and interest also causing the securities to decline in value and an investor can lose principal. When interest rates rise, the price of debt securities generally falls. Longer term securities are generally more volatile. The Fund invests in investment grade debt securities which may be downgraded by a Nationally Recognized Statistical Rating Organization (NRSRO) to below investment grade status. The Fund invests in non-investment grade debt securities which are considered speculative with respect to the issuers' ability to make timely payments of interest and principal, may lack liquidity and have had more frequent and larger price changes than other debt securities. The Fund invests in U.S. government and agency securities which are neither issued nor guaranteed by the U.S. Treasury and are not guaranteed against price movements due to changing interest rates. The Fund invests in mortgage-backed securities and asset-backed securities which are subject to the risks of prepayment, defaults, changing interest rates and, at times, the financial condition of the issuer. The Fund invests in other investment companies such as closed-end funds and ETFs which are subject to substantially the same risks as those associated with the direct ownership of the securities comprising the portfolios; however, the price movements of the investment companies may not track the underlying securities or market index; the value of their shares may be lower than the value of the portfolio securities, and may be illiquid and shareholders will bear, indirectly, the additional expenses of investing in other investment companies. The Fund invests in derivatives such as forward currency exchange contracts, futures contracts, options and swap agreements. Derivatives can be highly volatile, illiquid and difficult to value, subject to counterparty and leverage risks and there is risk that changes in the value of a derivative held in the Fund will not correlate derivative may be much greater than the original cost and potential losses may be substantial. The Fund may experience higher portfolio turnover which may lead to increased fund expenses, lower investment returns and higher short-term capital gains taxable to shareholders. Current and future portfolio holdings are subject to risk. The advisor engages the sub-advisor to manage the Fund's portfolio; the sub-advisor's judgment may impact the Fund's performance.

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. Member FINRA.

Not FDIC Insured · May Lose Value · No Bank Guarantee

For Financial Professionals and Institutional Use Only.

North Square Investments, LLC is an investment adviser registered with the U.S. Securities and Exchange Commission. Registration does not imply a certain level of skill or training. More information about the companies' investment advisory services can be found in their respective form ADV, which are available upon request. Past performance is not indicative of future results. The investment strategy or strategies discussed may not be suitable for all investors. Investors must make their own decisions based on their specific investment objectives and financial circumstances. Nothing discussed herein constitutes and offer to buy or sell a particular security or investment strategy. No assurance, representation, or warranty is made by any person that any of North Square's assumptions, expectations, objectives and/or goals will be achieved, Nothing contained in the document many be relied upon as a guarantee, promise, assurance, or representation as to the future.