Active Insights Podcast – Oak Ridge Investments: On a Mission to Find High Quality Best-in-Class Companies

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 a multi-boutique asset management platform.

Today, Mark Goodwin, Chief Executive Officer of North Square Investments will discuss the approach to building high-conviction equity portfolios of Oak Ridge Investments with Rob McVicker, Executive Vice President and Senior Portfolio Manager. Oak Ridge is a partner firm in the North Square platform and sub-advisor to North Square Oak Ridge All Cap Growth Fund.

Mark and Rob, we look forward to your discussion.

Mark Goodwin:

Thanks Diane. As you mentioned at North Square, we seek out the best-in-class active managers for our platform and our partners at Oak Ridge Investments have a long history of success with their approach of fundamental equity investing.

Rob, first welcome, it's always great to speak with you.

Rob McVicker:

Thanks Mark, very much appreciate the opportunity.

Mark Goodwin:

Rob, Oak Ridge has managed equity portfolios for over 30 years, but there may be some financial advisors and individual investors who still might not be familiar with the firm. Could you give us a brief overview on the background of the firm and the investment team?

Rob McVicker:

Yes, absolutely. So we started Oak Ridge in 1989, a long, long time ago with very simple concept of buying high quality growth companies, companies that were the best. We had kind of seen through the eighties street research, of course everybody always wants to be smarter than the next guy recommending kind of the B and C kind of companies. And we realized that owning high quality, best-in-class kind of companies was a much better way for us to go. And that's really the thesis for how we started Oak Ridge, the investment philosophy right off the bat. And again, today I can tell you chapter and verse about what we look for way down into the weeds, but that really was our guiding principle.

As we moved through the 1980s, lots of opportunities for small cap stocks, big markets, little stock called Cisco Systems, which ultimately became the biggest stock in the market had a little area called networking. Those were the kind of opportunities that presented themselves in the early 1980s, as such, we had good out-performance in our large cap picks, but we also did very well in our small caps. As we moved kind of through the eighties, we ended up in the internet bubble. So we've seen quite a bit over the 30 years. And if we think about the way that the institutional markets were, we had something called the nine boxes, and what that was is you would be a growth manager or a core manager or a value manager, but you would be put into a small cap or a mid-cap or a large cap category. This was considered avant-garde back then. You bought a small cap, you had to sell it out of your small cap product into your mid cap out of your mid cap and into your large cap product.

We thought, well, wouldn't it be nice if we had a product that allowed us to buy names as small caps and really get the entire business cycle, the entire life cycle out of our companies, owning them all the way from small caps to mid-caps, to large caps and ultimately the Ciscos and the largest caps in the market.

So that was the impetus for why we started the all-cap strategy. We started that in 2001, and this is the product we're talking about right now. As we've moved through the decades, certainly there's been lots and lots of changes in different environments that we've had to deal with, but our investment approach is a natural approach. We think it's very practical, repeatable, disciplined approach we say, really all that is, is looking for the best names, the best in class, the best organic sort of sales kind of growth companies and making sure that we're constantly buying those names, causes natural rotations in the types of stocks that we've owned.

Certainly, as an all-cap manager, I would have always thought that we would own small and mid-cap stocks and that would be the way that we would outperform, little did I realize how impressive the larger cap stocks would be as we've kind of over the last five to 10 years, seeing their tremendous fundamental outperformance.

So just to give you some of the changes that we've seen our history as to what we've looked for in our investments and kind of give you a sense, as a practical sense as to how the portfolio maybe has changed over time, it's a dynamic portfolio. Your second part of the question there on analysts, I'll get into it in a second here, but the types of stocks that we have are a definite type of stock. I mean, we have an “ilk”, it's a very high quality type company.

Our analysts would be considered senior, so very much in depth knowing everything about the silos. So technology, healthcare, industrial, I pointed out that over time, their input is essential to our performance in that they have a lot to offer and to recommend. I also would point out and we're going to get into it that our disciplined approach, depending on the analyst, we're not going to be looking at Caterpillar tractor versus Pepsi as a for instance. Instead, and a different analyst might be Coke versus Pepsi.

So it's going to be the same sort of stock because we're going to have the same sort of discipline in the way that we're looking at our names. But just to say, we have senior analysts that are really in depth in their areas and looking for those opportunities where we have good organic sales growth, that's very visible and consistent and can be projected off into the future.

Mark Goodwin:

That's great, Rob, thank you for that background. The Oak Ridge Investment approach has been consistent since the firm began in that it's very research intensive with a strong focus on individual stock selection. How do you manage and work through the entire universe of equities to identify specific areas, to consider for ideas for further research?

Rob McVicker:

I know that we're going to ask in a second here, but if I take a half step back and think about our philosophy, so I just mentioned kind of in a raw sort of sense, what we've been looking for over the last 30 years to put that into a real finite form. What is our philosophy? What are we looking for? That'll help answer the question of how do we get a stock through our funnel to ultimately be purchased. I'll take a little time here because I think this is kind of the essence of what it is that we offer. Very simply our philosophy. We think stocks follow fundamentals over long periods of time. The best stocks over the last 20 years, the Apples of the world, what did they have in common?

Absolutely fantastic, consistent, fundamental performance. We consider it our job to find and invest in those kinds of companies. And we do so by looking for what we call “Oak Ridge names.” These are companies that have three characteristics. Number one, the best of the best. A company that's taking market share, forcing competitors to adjust to them, low debt, no debt. Organic sales growth, kind of a novel idea, actually selling more of your product rather than screwing around with your income statements, balance sheets, buybacks, whatever that might be. We don't like hope. Hope that some bad division turns around, that sort of comment. We typically have a secular growth rate that's helping us with our investment or the aging of America, something like that. So that's number one.

Number two, we're not real macro. We didn't know who's going to win the election. We don't know what GDP growth is going to be in China or the United States. We don't know if we're on the precipice of big inflation or deflation. If we have to know any of those kinds of questions, it's probably not our type of investment. So what is it that we're looking for? We're looking for consistency. If a company has been growing its earnings at 12%, the last five years, things are better today than they've been in the past, a little bit easier to predict that that might continue into the future assuming that the situation is better. So what I just said there is we don't buy a lot of deep cyclical type stocks, we buy a lot of recurring revenue, servicey type businesses. That's number two.

And then number three, what separates us from a lot of growth managers is ultimately, we think valuations count. Call this the rule of reasonableness perspective, whatever you'd like to call that. We try not to forget that the S&P 500 over time only grows earning 6 - 7%. It's not real fast. Growth managers just like to throw around big numbers. It's fun while it lasts. We've been through internet bubbles, we're in something now I don't know what is, but we want to always keep that as a perspective. So if we put all of that together, what we think we're buying is “A” management executing “A” business plans and then paying attention to the valuations.

If I gave you a mental picture, if you think about this consistency of fundamentals. If we took a ruler and drew a line from the bottom left hand corner to the upper right, that would pretty much be our earnings, our sales, our cash flows, very straight line. What we wouldn't be able to predict very well would be the stock price. That stock price would probably dance around that line, but if we called that long-term kind of uptrend, we would expect the stock to follow that over time.

If our stock is underperforming, but is continuing to fundamentally be superior, then we're strong holders. The idea here is that we're not going to be buying and selling every squiggle on a chart and so on. We're really trying to get the full investment cycle. Most of the stocks in the market are too cyclical for us to invest in, too hard to figure out. And so in looking at and getting to the question, the visibility that we would need, ultimately, we're probably getting rid of around 70, 80% of the stock market so that we can focus on the names that have that consistency, low volatility on past earnings that we want in our investments.

So if we think about the types of stocks, so we've already got a filter off the front. We have a quantitative sort that we're looking for companies that are coming in on or above the earnings estimates, estimates rising, good organic sales growth, low debt, no debt, and this is very important, low standard deviation on earnings. So very consistent earnings type growth, and then paying attention to valuations to growth rates. When we do that, we come out with a relatively short list. So that's one way that we start our sort.

The other way is the analysts themselves. Once they're here for a while, they certainly understand that what we're looking for is a history that we can then base a future projection off and being very conservative. When we think about that, they are deep into their industries and understand a lot more than I'm ever going to understand about tech, healthcare, et cetera, et cetera, and will naturally be following and looking for this “ilk” of stock. As we move through the process, what are we looking for? Well, everything I just said, looking for consistency of past earnings that we can predict into the future.

What do we want to know? If it's a stock that looks like it's got a big product cycle or something that's very positive catalyst-wise coming, great underlying growth rates, so on and so forth. We want to do a fundamental deep dive on that stock. Fundamentally deep dive, what do I mean? Well, everything, I mean, we'd like to know what the industry is like, the size of the market, how the management views their businesses, so on and so forth. Again, there's a checklist here of 20, 30 long we just cut through it on just say everybody in the street research, every analyst, everybody wants to tell you what can go right. They want to tell you how fantastic a stock is, what the upside is. We absolutely focus on the downside. We want to know before we purchase a stock, what our downside risk is.

We like the reward, but we've got to understand that it's a cultural thing for us. Having lived through the internet stocks and all the rest. It does not bother us to miss a stock that goes up and doubles and triples. It keeps us awake at night if we buy a name and it goes down. So everything that we do in our investment process to really try and stable down our understanding of that business, the management, what their incentives, et cetera, et cetera, are, and then to pay attention to the valuations and ultimately to put it on a buy list or execute them and purchase

Mark Goodwin:

Rob, to interject as you go through the vetting process, how important do you think it is to interact with company management as opposed to just reading 10-Qs or 10-Ks?

Rob McVicker:

Well, it's very important for us considering that we're long-term holders. We're a very strange, a very unique growth manager. Most growth managers have a hundred plus percent kind of turnover ratios. Ours is 20 to 30%, meaning that our holding periods are three to five years, which is kind of the story I just gave you, kind of our proof statement. Because of that, and because of our deep dive work into the stocks, we're going to be able to understand and know our managements very well. So we're already dealing with a high quality group of stocks from our sort, from the analyst's kind of initial looks at the markets.

I often get a question, well, how do you know they're “A” managements? It's a valid question. What I know is that the stock has already had superior fundamentals. Now, what I want to do is, I want to match that superior fundamentals with a story from the management and an understanding that they're doing something. They're influencing and they're not just getting lucky. They're actually an active ingredient in the functioning of the company. It doesn't have to be rocket science. It can be simple, but it just has to be a differentiated view of the company. So yes, managements are very important to us and we're going to be hopefully fast friends for a number of years.

Mark Goodwin:

Thank you, Rob. When you think about portfolio construction, given you're investing in a variety of industries and sub sectors of those industries, you might have healthcare or consumer stocks coming into play. How does portfolio construction work? And is it more of an outgrowth of the individual names or do you have some higher level themes that drive the construction of the portfolio?

Rob McVicker:

Yeah, so we're not super macro. If it's germane to the investment, then I guess we have to think about it like a bank and yield curves, et cetera, but generally speaking, we're bottom up. So I mentioned when we talked about the history of the firm that we're looking for areas that have superior fundamentals, et cetera, et cetera, that is not a top-down sort of way to think. And it naturally leads us into areas that we should invest in, maybe be over-invested in.

So if you think about the Russell 3000 Growth, which is our index. Again, like all growth managers, it's a lot of technology, a lot of telecom and healthcare. And so we will of course have very good exposure to those three general areas. And back to your question, there's going to be areas inside of each of these that are going to be much better than other areas. To take a reverse as a for instance, an area that we have no interest in and haven't had interest in 15 years would be department stores, constantly losing market share. Everybody wants to tell you how cheap they are so on and so forth. We've got no interest in that.

Conversely, inside of these investments, we're doing this call during Coronavirus, the number of doctor visits, et cetera, has been way down. But as you look forward, there's rays of sunshine. It looks like maybe we're through the peak here, would not be surprised to see lots of pickup. And I always point out whether you're in a recession or in a good environment, you're probably going to continue to take your life-saving medications. And those are our kind of investments. And so on a bottom-up basis, we will be buying those names that are taking market share, have a little tailwind, and maybe even overweighting them slightly.

When we think about the weightings of the index, we generally think that the Russell indexes have looked kind of at what the United States does well and has exposure to those areas. I asked the question, what's the biggest European biotech or internet company that you can name? They pretty much don't exist and they're everywhere in our index. And hence, we expect to have really good exposure to those areas. So what we've said is that we'll always be at least 50% exposed and could be up to 150 although, certainly technology is too big, but we might be slightly overweight from time to time and or overweight in healthcare. But everything we do is driven on a bottom up sort of basis.

Mark Goodwin:

Great. Thank you, Rob. You had mentioned that you're naturally a lower turnover manager, but eventually you do need to sell some securities to buy other securities. What's the typical sell-discipline driven around? Is it their realization of full value? Or how do you think about the sell-discipline for Oak Ridge in general?

Rob McVicker:

Yeah, so there's probably four main ways that a stock ends up out of the portfolio. I guess I could give you examples of each one, but the best scenario is that you have a better alternative. We're seeing kind of a transition in the market here. We're not going to change the core of our portfolio, but on the margin, does it make sense to maybe sell a name here or there inside the portfolio that may be a little more mature in favor of rotating towards, again, on the margin, names that are a bit more organic growthy, a bit better futures, even if they happen to be in this case, maybe a little bit more cyclically oriented. Certainly not cyclical, but recurring revenue maybe with a little cyclical taste would be the way that we would think about it, I give an example.

So if we have a name that's done well, that may be more industrially oriented and you have a new president and he's going to introduce a $4 trillion infrastructure program. It would be icing on the cake. So we already have a company that's doing well, if and when that infrastructure program is passed, then it's just benefit for us on the ownership. That's the way that we would think about that. So that's the best, the best ways that I have to sell a name, to buy a name. Sometimes we have an unbelievably successful investment. So that's a wonderful problem to have. We bought a company called Waste Connections at a 17 P/E about a decade ago. The stock is around a 40 P/E today. So very expensive, still a fantastic company, growing, it's a waste company. They pick up garbage on Tuesdays, Thursdays, and Saturdays.

Again, whether you're in recession or not back to visibility, that diagonal line that we talk about. It's not super cyclical, so we may underperform if the market's a bit more cyclical, but in this case, we've got a lot of real good consistent growth, market should come back to us. But with that valuation makes sense to reduce the exposure. So we took some money off the table because of valuation. Another can be that we just, back to what your other question was, maybe you have too much exposure in a certain area and that area kind of rotated out. I give you an example on that. We owned Stryker, hips and knees. Well, nobody's going to go visit a doctor or the hospital during coronavirus, and maybe pulling your horns in there makes some sense. So we reduced our exposure, still have a very good active investment there, but just to give you an example of reducing based on the sector and or the area that we're invested in.

And lastly, which is probably the most used of our investments, something material is happening with the company, our investment thesis has been penetrated. Another example, we've enjoyed owning Yum Brands. This is again, Taco Bell, et cetera, et cetera, we like them because it's a management company. They really don't own a lot of stores, they just make cash flow.

If you wake up, and by the way, so in the fourth quarter of last year they had kind of a so-so earnings release. One thing we don't worry about is our fundamental releases. Pretty much every quarter, our companies are going to be taking market share, are going to be better than everybody else. That's what we expect from our companies. In this release with a little so-so, Kentucky Fried Chicken, which had been doing pretty well, actually kind of had a clunker of a number. And so it wasn't purely an Oak Ridge. It was kind of spotty.

And so then, again, we're not real macro, but if something's slapping you in the face, I guess you pay attention to it. Looking around and seeing not only South Korea, but Italy, once you see the streets and everything, the restaurants closed in Italy, made you think it was coming to the United States. We had a fundamental issue with the stock. Here's a bull market, we should have had better earnings and now we've got a kind of a push to get us out, so we sold the position. But those were the four main ways that we exited the name and the best one of course is to have a better alternative.

Mark Goodwin:

That's helpful Rob. Rob, you've done a nice job describing how Oak Ridge operates as a conservative growth manager or quality, growth or growth at a reasonable price manager to change gears for a minute as an all-cap manager, investing across the spectrum of market caps, you can go from mega caps to micro caps and everywhere in between, which is a bit unique as a portfolio manager. How has this been helpful to you over time? And where do you see the best relative values today within the variety of cap structure ranges?

Rob McVicker:

Yeah, so great. It's the same question as to what our weightings are and kind of way the index is set up versus the way that we think about our investments being overweight, underweight, et cetera.

The same is true with the market caps. We would like to have exposure, again, remembering that we're not super macro. We'd like to have exposure kind of across the market cap groups. Just like I said about sectors, there's going to be opportunity in each of these. I would only say that the larger caps have had a bit easier time over the last five to 10 years. It's been a strange market, the larger the market cap the better the performance, both stock wise and fundamentally, which is, I never thought I'd see that, but that's what's happened. Again, we don't try and out think ourselves, we just go where the earrings are telling us to go.

So after all of that time, the market had left all the small caps valuation wise kind of by the side of the road. The same would be said of cyclicals and certainly micro-caps. Being cheap is not a reason for us to consider investment. Remember, we're looking for trends, we're looking for visibility. And there was a lot of people talking about small caps over the last five years. I would just say that the area itself is inexpensive.

It's not, after the huge run that the stocks have had over the last three, four months, they're not as inexpensive as they were as a unit. They're pretty much in line with large cap stocks, but that's unusual too, because small caps are supposed to grow faster and have higher valuations pretty much typically. So that makes them attractive as far as valuations go. If we look at margins, there's a lot of headroom there.

So there's a lot of ways for a small cap company to make increasing profits as we move forward. Again, I say all of that, we're always comparing one stock versus another. And if I have two names that I like equally, well, one's a larger cap. It's probably growing slower, but it's also safer or conceivably safer versus a smaller cap, which is probably a higher valuation, but also is going to be possibly more erratic in their earnings. So we're always evaluating that. As a whole, however, you just heard me say that the area is attractive.

What we need now is Oak Ridge names in small cap land. We need good markets, we need good underlying growth rates. We need the “A” managements, all that stuff. In other words, we don't think about small caps as small caps. We think about businesses, that's what we're invested in. And so on the margin over the next six to nine months, assuming that we find some areas that our recipients are going to have positive catalysts from an economy that hopefully is going to recover as we move through this year, wouldn't be surprised to see us take a little bit more exposure into the smalls and the mids. Just to give you an example.

Mark Goodwin:

Thank you, Rob. The equity markets have sure had a great run over the past 12 months and valuations may be getting a bit stretched as we start into the new year. The past year's seen one of the largest relative spreads in performance between value and growth with value having one of the largest trailing gaps in history. Where do you see the equity markets currently? And what's your outlook for 2021? And any thoughts with respect to value, rallying back anytime soon?

Rob McVicker:

It was a pretty unbelievable three- to five-year run for growth versus value. I know it's a mathematical equation that you get reversion to the mean, I would just say that that's not really our cup of tea. I know it exists. I've seen it happen over the last 10 to 12 years. Value has rotated inter-year like two, three times and has outperformed anywhere from six months to two years. What is this one?

I don't know. It's been going now for three, four months. Wouldn't surprise me to see it continue for a while. I would only say that we're not interested. We've got a definite style of investment and we're not going to vary from it. If the market is going to reward inflation and in value stocks because of that or something like that, that's okay, again on the margin maybe we'll buy a name here or there that has a little bit more cyclicality, not much, but it's not going to change the fact that we own fantastic companies that are constantly thumping through with, again, that diagonal line sort of growth.

The market may find some other shiny thing that it wants to invest in today, meaning value stocks, something like that, but it's not going to change the tempo of the companies that we own. And so in that environment, and should it be inflationary, we have stocks too. They're going to price in that same environment, we may not have tip of the whip kind of performance, but we're going to have very solid underlying businesses.

The bottom line here is we don't know when the music's going to stop. We don't know when the next bear market or recession is going to hit, but we do know that you have got to have fundamentals. There's nothing worse than waking up and questioning your companies when you definitely have to have those and that's what we've invested in.

Mark Goodwin:

Thanks Rob. Passive investment strategies have increased to take a larger share of investors wallets over the past several years or decade even. Can you talk about how Oak Ridge's particular style of active management provides advantages over passive strategies, particularly in the current market environment?

Rob McVicker:

Yeah, so it's pretty impressive, pretty unbelievable that the rise of the index fund, it's kind of uncanny that the largest market cap stocks would happen to have the best growth. I mean, these are monopolies, right? If they have a competitor, this is back to kind of what I was talking about with small caps. If they had a competitor, they bought them. Facebook bought Instagram and WhatsApp and so on and so forth. So when we think about the indexes, they just happen to have all kinds of tailwinds when they started. And that's led to their pretty unbelievable performance.

As far as Oak Ridge is concerned, we've lived through a lot of different types of markets. Certainly the portfolio today is completely different than it was 20 years ago and will be different again in the next 10. Right now we have a good solid weighting in many of these, the “FAAM” or “FAAMG's”—Facebook, Amazon, Apple, Microsoft Google, just to give the acronym and know from the internet bubbles and from just general rotations in stock markets and bear markets and everything that happens, that there will come a day in which these names will become mature or heaven forbid there'll be knocked off by a competitor or whatever might happen.

Then these indexes are going to be loaded with these super large cap stocks. When we started Oak Ridge back in 1989, 1990, the bellwether back then was IBM. Had we had index funds back then, it would have been 3% or something like that of the index, and it was the gift that kept on giving for over a decade. So I envisioned that day happening off in the future and as an active manager will again, look to have a dynamic portfolio where we're constantly moving towards those names that have the better growth prospects and away from those that are becoming more mature.

Mark Goodwin:

That's helpful Rob. As we mentioned earlier, you're one of the portfolio managers on the North Square Oak Ridge All Cap Growth Fund, ticker “ODGIX”. Can you tell us a little bit about the fund? I know it's a clone of the strategy that you run $700 million worth of assets in both SMA and UMA formats, and give us a sense of how the fund is positioned today with respect to sectors or any particular market cap weights.

Rob McVicker:

So everything that I said pretty much goes for the mutual fund. Yes, very similar. We started that in 2016 and again, we're going to have nice weightings in healthcare, technology, et cetera, et cetera. It's again, the same general concepts buy the best, let the best at executing whatever environments we have and really outperform by being long-term holders and getting fundamental compounding greater than the stock market itself.

Mark Goodwin:

Great Rob. Last question, how do you see an actively managed high conviction, all-cap equity strategy being positioned in the diversified portfolio of an individual investor?

Rob McVicker:

There's lots and lots of allocations, a lot of planners allocate to value to emerging markets, to all of that. Certainly the all-cap is a fantastic investment in growth in general. Just as a word, the Russell 3000 Growth is really kind of a large cap index, but what's nice about us is being larger cap, we also get to have a bit of space by going down to the mids and the smalls.

And again, to your prior question, there will come a time in which the mega caps will rotate out. And that will be an area where we can add a tremendous amount of hopefully alpha through our smalls and mids, but as a general exposure, I think we definitely offer a good, full rounded growth allocation, and we do so without hopefully taking a lot of the risks, the stress out of what could be a very aggressive sort of portfolio.

So we've got a very stable, visible, consistent, organically driven type of a portfolio. So it would match what a general investor in large caps or in growth stocks would look for. Conversely or another option that I know that we're used for back to having allocations to value stocks, et cetera. A lot of managers will make us, pair us up with the value kind of compliment a general value manager. And then you run the risk reward kind of statistics on that. Apparently it looks very, very positive. So those are the two main things that I think might be of interest to the average manager.

Mark Goodwin:

That's great, Rob, thank you so much for joining me today. This has been a great discussion as it always is with you.

Rob McVicker:

Great. Well, thank you very much, Mark.

Diane Merritt:

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