NORTH SQUARE INVESTMENTS

C.S. McKee: A Team Approach Focused on High Quality, Liquidity and Downside Protection

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Mark Gensheimer, President of C.S. McKee, and Brian Allen, Senior Vice President and portfolio manager recently discussed taxable fixed income investing in a podcast conversation with Mark Goodwin, Chief Executive Officer of North Square Investments, and more specifically the investment approach that C.S. McKee has utilized for institutional investors for decades. Mark Gensheimer and Brian Allen shared their insights and outlook for this sector, which is transcribed below.

Interview Highlights:

C.S. McKee aims to approach the market in ways that allow them to consistently outperform. They believe they add value in risk avoidance and downside capture minimization—adding up to a very consistent stream of performance, lower volatility, and generally, higher liquidity than an investor would find in a passive portfolio.

One of the strengths of C.S. McKee's credit approach is that they can share the firm's inventory with most of the street, and as their collective balance sheets have shrunk over the post great financial recession timeframe, they quite often are looking for liquidity themselves—and C.S. McKee can provide it to them at the right price.

C.S. McKee is very active in the government sector, looking well beyond the types of securities that appear in the benchmark. They find a very unique world where liquidity and flow is more than meets their standards and yet there are structures that are fundamentally mispriced.

In economic terms, C.S. McKee's outlook for GDP growth this year is about 4%. They see inflation ticking higher, and expect a spike in inflation in the second quarter of the new year, largely due to just the year-over-year base effects. They do think that inflation will drift higher through the course of 2021.

Mark Goodwin:

At North Square, we seek out best in class active managers for our platform. And our partners at C.S. McKee, have a proven repeatable approach to taxable, fixed income investing.

Mark, your firm has primarily worked with institutional investors. So, financial advisors and individual investors may not be so familiar with C.S. McKee. Can you give us some background on the firm and your investment team?

Mark Gensheimer:

C.S. McKee, which is headquartered in Pittsburgh, has been in business for almost 90 years. We've managed assets for institutions since the early 1970s. About 50% of our clients are public entities, which includes States and counties and municipalities and fire and police. And the rest are split pretty evenly between endowments and foundations, Taft-Hartley plans, hospitals, religious organizations, and insurance companies. About $6 billion of our over $7 billion of assets are investment grade fixed income portfolios. And our three senior portfolio managers, Brian, Brian and Jack, have worked together for over 20 years, which as you know, is pretty unique in our industry.

Mark Goodwin:

Brian, taxable fixed income is a pretty broad range of investments that you and your team consider when building income producing strategies. Can you tell us how you develop an overall portfolio strategy with an objective to both deliver performance, and manage risk?

> "But we really add value in risk avoidance and downside capture minimization… It all adds up to a very consistent stream of performance, lower volatility, and generally, higher liquidity than you'll find in a passive portfolio."

Brian Allen:

Certainly. Our process is largely bottom-up. We spend the vast majority of our time working on security selection within our individually defined sectors. But we do start the process with a view towards the macro-level environment. We are not economic forecasters and we don't attempt to define a single most-favored forecast, but we want to get an idea of which way the market's leaning, what the macro-level factors point to, and help us frame the portfolio in terms of guidelines and basically guard rails when it comes to asset allocation going forward.

Once that's done, we began to implement our team approach with respect to duration, yield curve and sector allocation. And then, we move on as the individual teams focus on security selection. Portfolios are always at least the benchmark average in quality. We overweight credit to a small degree as our baseline approach. We are always underweight BBB Securities, and otherwise look to approach the market in ways that allow us to consistently outperform. One of our hallmark characteristics is we tend to outperform in up markets by about 110% of benchmark returns. But we really add value in risk avoidance and downside capture minimization, if you will. It all adds up to a very consistent stream of performance, lower volatility, and generally, higher liquidity than you'll find in a passive portfolio.

Mark Goodwin:

Brian, the market is a very dynamic thing, and we've seen that especially so in the first quarter of this year. How often are you looking at your investment process? And what general timeframe are you looking at as you consider how you build out your portfolio strategy?

Brian Allen:

The process itself has been in place the entire 22 years I've been with the firm. We spend about 80% of our time looking at security selection within our respective sectors. Portfolio turnover is higher than you'll see for most core-fixed income portfolios and tends to run about 130-150% per year on average. And as such, we tend to look at a three month to one-year timeframe with respect to some of the macro-level inputs. I call it a sector allocation and duration and/or yield curve bias, But at the individual security level, it could be as short as hours, if it's a new issue that comes with a steep discount, and then, prices outperform aggressively after the fact. In many cases, it could be six to nine months, depending on what our targets are at the time of purchase.

Mark Goodwin:

When you think about the broad fixed income universe and the array of securities that you can choose from, how do you go about distilling that into a workable set of potential investments to use in your strategies?

Brian Allen:

Here's where our approach tends to be most drastically different than your typical core manager. We implement an approach in both credit and in the government space that if anything is, diametrically opposed to what you'd expect. In the corporate space, we narrow the universe of several thousand securities down to the top 250 issuers. There we find higher than average liquidity, more dealer firms making a market, higher than average quality overall. So, we have price discovery in all markets.

One of the strengths of our credit approach is that we share our inventory with most of the street, and as their collective balance sheets have shrunk over the post great financial recession timeframe, they quite often are looking for liquidity themselves and we can provide it to them at the right price. So, we're very active in swapping our holdings for something similar either by issuer, credit quality or maturity, and doing so at advantageous prices. In the government space, quite the opposite.

The government sector of the market is only about 1%, depending on the benchmark—between one and 4% of the total composite of the total benchmark. In our case, though, we are very active in that space. We look well beyond the types of securities that appear in the benchmark. They aren't in the benchmark because of the type of issuer or size to a certain degree or coupon structure, but we do find a very unique world where liquidity and flow is more than meets our standards yet, there are structures there we find to be fundamentally mispriced. So, one of the long-lasting features of our portfolios is an underweight to mortgage pass-throughs, which is a very large component of most benchmarks, Aggregate, Intermediate Aggregate in particular.

Those are sectors where the Fed has been involved and they can suppress the relative value opportunities that occur in that space. We can trade basically a government backed callable security, otherwise known as a mortgage, for others. We just need debentures that have similar credit quality and display some degree of negative convexity, but for the units of risk we're taking, we find much more advantageous valuations there. And frankly, with six-billion-dollars in fixed income investments, we can take advantage of opportunities, that firms 100 times our size simply can't.

Mark Goodwin:

That's great Brian, I know that being nimble is part of your DNA. And as you look through the wide array of securities that you can invest in, choosing the specific ones is important as you build out individual portfolios for your clients. Can you take us through how the selection process plays out in a practical sense?

Brian Allen:

Sure. At the individual security level, again, with credit, we're very active in the new issue market. We're working from a fairly concentrated buy list, which means we're very familiar with trading levels. We're very familiar with the relative value among the names in those industries and within that select group of total issues. And again, with various specific levels in terms of buys and targets for a sell, both positive and negative, we assess relative value.

> "..while consistent returns are certainly important, our risk adjusted performance characteristics are what we are definitely most proud of...particularly the downside protection, that we've always provided our clients."

Also we're very active in the secondary market. I mentioned relative value opportunities. Market liquidity needs present us with opportunities. Not to hit the proverbial home run trade, but a much more singles and doubles approach. Fairly consistent and is a key part of why our performance year in and year out is better than the benchmark. We've outperformed 12 of the last 13 years, I believe 18 of the past 20.

So, on balance, we are outperforming the benchmark net of fees, and doing so with less volatility. And within the government space there again, we focus on a wide array of securities. Most popular these days are intermediate and long maturity, callable securities. They are benchmark-included, but there again with spikes of volatility, much like we had in March of this year, they become unusually cheap.

That's driven, not only by macro-level factors like the move in rates and volatility spikes, but also, as you approach a quarter or a calendar year-end, we find that the street has very limited appetite to hold risk assets on their balance sheet. And therefore can be at times a little overly aggressive, if you will, when it comes to lightening up on balance sheet holdings. The security price markdowns look very attractive to us and with our portfolio, which is always steeped in liquidity and quality, we have the capacity to take on risk when it makes no sense.

Mark Goodwin:

As you look at new opportunities that arise, how do you shift your allocation to add these new securities to the portfolio? Do you sell out of existing positions or try to do trimming on the margins?

Brian Allen:

Really a combination of both. If it's a security trade which totals less than 1% of the total portfolio, if the sector manager decides it's a good relative value swap within their sector, those trades are done on their own volition. And if we're looking at trades that are beyond 1% of total market value or include a move from one sector to another, then the entire team's involved. A vote is taken after some fairly lively discussion on the relative value merits of both the buy and sell candidates. And that's coupled with updated scenario analysis. A review of our outlook for the market will ultimately determine if it's a swap candidate or we're actually going to increase or decrease total portfolio risk.

> "With a firm our size, we can build a more meaningful position while maintaining liquidity than someone that's much larger."

Mark Goodwin:

Sell-discipline is often one of the most important things to keep a manager out of trouble in managing their portfolio management process. Can you talk about sell-discipline for a bit? And how it works within the team?

Brian Allen:

Yes. For us, that's one of our most important factors, as we discussed recently, with respect to our performance characteristics and minimizing downside capture. Risk mitigation and risk management is really a key portion of our process. If you look at our process, you'll see the top-down view followed by security selection and then risk management is the third step. But it's really a very circuitous process or repetitive process where risk management is involved in every step of the process and is continuously applied whenever we take positions on anything active, relative to our benchmark, or to total returns in an absolute form. We identify both target sales and loss limits in terms of that exposure. And it takes frankly, an act of the entire team, a revision in our outlook before those guidelines are violated or the initial trade plans are somehow altered.

Mark Goodwin:

Thank you Brian. Turning to you Mark, C.S. McKee has been named a Top Gun Manager of the decade by PSN for 11 consecutive years.* That's really remarkable. First of all, congratulations. How have you folks managed to build this consistency, particularly given the volatility we have seen in certain periods over that timeframe?

Mark Gensheimer:

Mark, it all really stems from adhering to our process and of course, having the team together for so many years. But while consistent returns are certainly important, our risk adjusted performance characteristics are what we are definitely most proud of. And as Brian mentioned before, particularly the downside protection, that we've always provided our clients.

Mark Goodwin:

And Mark, with your focus on high quality issues, C.S. McKee has always looked for strong governance when evaluating investments. I noticed that more recently you signed on to the United Nations supported Principles for Responsible Investing, which is a significant commitment moving forward. Can you talk about why you decided to sign on to the UNPRI?

Mark Gensheimer:

Sure. We've always invested our client's assets responsibly, and we believe that we can always continue to be more cognizant of the many environmental and social and governance issues that are so important in the long-term management of any great company. And we just think that we have a lot to learn from other members of the UNPRI and hopefully be able to provide some value ourselves. So, we really look forward to being an active member.

Mark Goodwin:

How has this impacted your investment process? And the way you evaluate specific securities?

Mark Gensheimer:

Our clients and consultant partners have always viewed McKee as an extremely high quality manager. So, it really hasn't affected our core investment process at all. I guess I would say the additional ESG screens that we've built internally are more of an enhancement to an already solid time-tested investment grade fixed income process.

Mark Goodwin:

Would you say that this broader ESG commitment filter will work its way through to all of your fixed income strategies?

Mark Gensheimer:

I think it does. All of our portfolios are managed using the same process, with the same team. The only difference with the portfolios are duration and whether or not we hold credit securities in specific portfolios.

Mark Goodwin:

Thank you Mark. Brian, during most of 2020, we've experienced an unusual economic environment to say the least. And this has had a somewhat uneven impact across the U.S. economy. Where do you see the economic environment currently? And what's your outlook for the economy and fixed income markets in 2021?

Brian Allen:

Yes, we're definitely emerging from the depths of the sell off, certainly in financial markets, but the economy as a whole showed signs of recovery in the summer and fall. We're relapsing to a certain extent, both the U.S. and globally, with a spike in the (COVID-19) virus and concerns about mutation of the original diagnosed virus. That coupled with the conclusion of some elements of the CARES Act and support to the market, thankfully now to be replaced to some degree by the most recent budget approval over the weekend, gives us a fair amount of hope for next year. In economic terms, our outlook for growth, GDP, is about 4%. We see inflation ticking higher. And we'll certainly see a spike in inflation in the second quarter of the new year, largely due to just the year-over-year base effects. We do think that inflation will drift higher through the course of 2021.

And we're looking for inflation to be right around 2%, a little over that level and as we get to the fourth quarter of 2021. Our real concern, frankly, now is translating that economic outlook to the portfolio. We believe the markets are somewhat ahead of themselves in terms of discounting a complete recovery. That's certainly true in the degree to which corporate spreads have tightened, and the low level of volatility in the interest rate market. We are frankly relying on the fact that given the sort of show of force that the central government put in place with the treasury and Fed, back in March, that they will continue to support the markets. There's effectively a "Fed put" below most risk markets with valuations. We have cut back a portion of our risk allocation as a result. And again, not unusual for us. We tend to be nimble when it comes to changes in short-term valuations. We can do so on the margin to the benefit of performance and that's where we stand right now.

> "The additional ESG screens that we've built internally are more of an enhancement to an already solid time-tested investment grade fixed income process."

Mark Goodwin:

So, as you look out from here, where do you think the best opportunities for taxable fixed income portfolios lie in this market?

Brian Allen:

Usually, I'd say the long end of the market is really where most of the opportunity lies, again there's been significant recovery in the pricing of those assets that tends to just pale in comparison to short maturity, just due to the math, spread duration in the short end and the Fed's focus on buying securities or backstopping securities in the five-year and under maturity range. Valuations there are fairly tight. We're actually finding more attractive relative value in the securitized space in the 0-5 year range.

We're also very active in the asset backed market within the securitized space. Historically we're very focused on the large, more liquid deals but we do find, now again, taking advantage of our size, we can uncover relative value in subprime auto-lending. Some of the more seasoned, subordinate issues have now improved in terms of credit support. Really They are AAA securities that just hadn't been reviewed and upgraded to AAA. To the extent that our client's guidelines allow us, we will pursue AA-rated securities, taking on what appears to be slightly more quality risk. But again, we look deeper at the individual holdings themselves. It pays to take the risks that we really don't think are there. And again, with a firm our size, we can build a more meaningful position while maintaining liquidity than someone that's much larger.

> "With respect to our performance characteristics and minimizing downside capture, risk mitigation and risk management is really a key portion of our process."

Mark Goodwin:

Brian, 2020 has seen a remarkable number of new issuance of bonds in the marketplace in an attempt to build liquidity. Do you think that's going to moderate into 2021 as corporations bleed into the cash that they've raised in 2020?

Brian Allen:

Most definitely. Total issuance in the high-grade market in 2020 was approaching $1.9 trillion, definitely an all time high. Firms, when given the opportunity, especially in the first and second quarter, issued a very safe level, to reflect the very conservative view of future liquidity needs. And as a result, cash on balance sheets has gone up at the last count somewhere between $350 billion and $400 billion. As a result, we've seen a number of firms already begin to bring new issues to market smaller than it had been expected before. And with the number of older issues being retired, there is almost a net reduction in new issues already for the balance of this year. Certainly going into 2021, we expect about a one-third reduction in total issuance over the course of the year. And for those exaggerated or unusually high cash balances to be drawn down.

Mark Goodwin:

Over time, we've seen increasing growth in passive investment strategies, both in the institutional and retail channels and equities, as well as fixed income. Can you talk about the advantages of C.S. McKee's active style of fixed income management for investors, who may be considering using passive for fixed income exposure?

Brian Allen:

Definitely. And our long history shows that with our fairly conservative approach, with respect to managing core-fixed income assets, we can consistently deliver better than benchmark returns net of fees, and certainly justify an active approach in that sense. But unlike others, we don't outperform simply by taking on more risks. That isn't a permanent feature of our portfolios to any degree that's evidenced by any number of our portfolio characteristics for almost any timeframe that you look at, Sharpe ratio, information ratio, downside capture, they're all more attractive than you'll find with a passive investment. And we do think now in particular, it makes sense to look at an active manager who has long demonstrated superior downside capture ratios.

> "We are definitely a pure high quality investment grade manager. We'll always provide strong downside protection when there's instability in the credit markets."

Interest rates are admittedly low globally by any standard, certainly in real terms, artificially suppressed by central banks worldwide. And while we think that core-fixed income still offers one of the better diversifying elements of a balanced portfolio, we certainly have to be aware of the risk that exists with not only lower rates, but longer durations in fixed income benchmarks. So, as a result, we are always balancing a trade-off between earning enough in active returns to exceed our benchmark net of fees, and protecting principal, and recognize our role within a broad portfolio. And our role is to provide diversification and liquidity and not to assume risk or try to demonstrate the ability to carry a portfolio over the long-term in the fixed income portion of broadly diversified benchmark portfolio.

Mark Goodwin:

Thank you Brian. Mark, can you share how you see an active taxable fixed income strategy being best positioned in the diversified portfolio of an individual investor?

Mark Gensheimer:

Sure. I personally believe that every portfolio should have some investment grade fixed income holdings really just to provide stability to their higher risk holdings. And we are definitely a pure high quality investment grade manager. We'll always provide strong downside protection when there's instability in the credit markets. And there's certainly been a lot of growth in the sectors that we manage that really reflect that. So, I think it definitely should be part of every portfolio.

Mark Goodwin:

Thank you Mark. Brian and Mark, thank you for joining me today. This has been a great discussion.

Brian Allen:

Thank you

Mark Gensheimer:

Thank you, Mark.

*C.S. McKee's most recent PSN "Top Guns Manager of the Decade Award" is for its Intermediate Aggregate Fixed Income strategy in the PSN Intermediate Core Fixed Universe for the 10-year period ending December 31, 2019. C.S. McKee has been named to the "Top Guns Manager of the Decade" list every year since 2009. C.S. McKee was recognized in the PSN Core Fixed Income Universe from 2009-2017, the PSN All Maturity/Variable Universe in 2018, and the PSN Intermediate Core Fixed Income Universe in 2019. The PSN Core Fixed Income Universe is comprised of the following: 2009: 206 firms and 371 products; 2010: 208 firms and 375 products; 2011: 208 firms and 392 products; 2012: 209 firms and 399 products; 2013: 207 firms and 410 products; 2014: 205 firms and 407 products; 2015: 197 firms and 399 products; 2016: 199 firms and 402 products; 2017: 196 firms and 392 products; 2018: 161 firms and 314 products in the PSN All Maturity/Variable Universe. The PSN Intermediate Core Fixed Income Universe is comprised of the following: 2019: 128 firms and 188 products. Rankings were sourced from eVestment and are effective as of 12/31/19. The rankings may not be representative of any one client's experience because the ratings reflect an average of all, or a sample of all, of the experiences of C.S. McKee's clients.

The rankings are not indicative of C.S. McKee's future performance.

About the PSN Top Guns Manager of the Decade Methodology

The complete list of PSN Top Guns and an overview of the methodology is available at https://financialintelligence.informa.com. Top Guns Manager of the Decade is a recognition from Informa Investment Solutions PSN, an independent, national money manager database and is not indicative of future performance. Please see the following additional disclosures for the periods when the designation was made. Though the strategies were in the top ten, they were not ranked first in the top ten categories for each period. The PSN universes were created using the information collected through the PSN investment manager questionnaire and use only gross of fee returns. Mutual fund and commingled fund products are not included in the universe. PSN Top Guns investment managers must claim that they are GIPS compliant. Products must have an r-squared of 0.80 or greater relative to the style benchmark for the ten-year period ending December 31, 2019. Moreover, products must have returns greater than the style benchmark for the ten-year period ending December 31, 2019 and also standard deviation less than the style benchmark for the ten-year period ending December 31, 2019.

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