Active Insights Podcast – Advisory Research Investment Management: "A Research and Ownership Culture is in our DNA"

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 Advisory Research Investment Management with Matt Swaim, Managing Director and Executive Chairman. Advisory Research is a partner firm in the North Square platform and sub-advisor to North Square Advisory Research All Cap Value Fund. Mark and Matt, 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 Advisory Research have a long history of success with their approach to fundamental equity investing. Matt, thanks for being with us today.

Matthew Swaim:

Great to be here Mark.

Mark Goodwin:

Matt, Advisory Research has managed equity portfolios for over 30 years, primarily for the institutional marketplace. Many financial advisors and retail individual investors may not be familiar with the firm. Can you give us some background on Advisory Research and your investment team?

Matthew Swaim:

Certainly. Thanks for the questions. Advisory Research is based in Chicago, Illinois. It's been here since actually the mid-70s and the firm dates back to handling money for some prestigious families in Chicago. And then over time we morphed those into institutional product offerings and research product offerings, putting equity portfolios together on behalf of institutions and ultimately mutual fund families.

So we built this research culture over many decades and it really permeates the firm. And today we're proud that we are a 100% employee owned and we think that that is a differentiator. Everybody at the firm doing research on behalf of client portfolios is an owner of the business, that just creates a different mentality we think and the different work ethic, and that permeates our whole organization. And also, it really augments our investment process. We know you act differently when you're an owner. We know you act differently when you are making a capital allocation decision as an owner. We know you act differently when you're setting incentives for your employees and your own personal incentives and that ownership culture, we have learned together what it means inside our firm. And we also take that mentality externally as we're doing research for client portfolios. So a big part of the DNA of the firm.

Mark Goodwin:

Thank you, Matt. I know your team spans a variety of asset classes from growth equities, value equities, which we're going to speak about today and global equities. Can you just talk about the structure of the team for a minute?

Matthew Swaim:

Sure. So over time we have continued to invest in investment talent. Beginnings of the firm started with our value-based framework, which is currently all cap value product that we subadvise for North Square. Our value to them is the longest standing franchise and very deep, fundamental research, very deep team with a niche area of expertise. And we communicate with operating executives in order to enhance our portfolios. We also have a growth vertical run by a partner group, who is a little more technical in his thinking and also find these thematic forces that are affecting change in the growth market. And we have a global franchise able to invest across the globe with more of a dividend framework and fundamental framework. So we continue to grow our teams and our investment pool, and we would expect to continue to do that at Advisory Research.

Mark Goodwin:

Thank you, Matt. Your investment approach is very research intensive with a strong focus on stock selection. Can you talk about the core investment philosophy of your team in managing equity portfolios?

Matthew Swaim:

Sure. It really dates back to the beginning of Advisory Research, when we were investing on behalf of the families and high net worth individuals. And the mandate back then was really don't lose money. We have already created a lot of wealth and we want you to find individual businesses that are interesting and make sure we're coming in at good prices where we can compound over time. How we seek those investments out and exactly how we execute around that, continued to change and evolve. Now that same tenet fits in place for us that as we're going into an investment, we begin to think about where we do downside protection first. So at the multiple I'm coming in at, with the balance sheet and financial position I'm coming in at, with the managers that are at the helm and with their capital allocation and investment framework, they're starting with today, is there a pretty high degree of probability that if my upside thesis does not play out, I'm able to walk away with my initial investment or maybe something slightly greater.

Matthew Swaim:

And that is where we start. We're thinking about screening and sourcing, that's where we start. When we're looking in the markets for interesting opportunities where we have low expectation, but interesting assets, interesting business plan and capital flexibility to execute those business plans. So we start there. We then begin to think about upside potential. So if there is a really rigid business plan, a strategy, a market opportunity that the company is trying to take advantage of and a management team that we think has the right talent, both inside the organization and at the board of directors level, what type of conviction do we have around what that outside opportunity should look like, and are there multiple ways to win? Just investing capital high rates of return, obviously can drive earnings power. It can drive markets being more attractive to security.

It can drive market appreciation as that plan builds. But we also want to think about, are there larger acquisition opportunities for that business? Is it a platform that they can build from, or is this a business that they're building in one particular segment where there may be a larger company or a financial buyer that ultimately will pay a premium for what this management team is trying to build? So we start with that downside thesis and we're probably not going to create permanent loss of capital here. And then we think about that upside thesis, over a month, a year period, can we double our money or more with the execution plan the company has in front of them? And that's really risker/reward to us. Risk is losing money, any amount of money and reward is the compounding and driving return through management execution plan.

So that's where we start. We looked at a lot of companies, we set price targets, just how we work. We will have risk rewards or these upside/downside theses built for a variety of businesses in the marketplace. And then as the market gives us the opportunity as it did just recently in this last year, we will act on the best opportunities we see and form portfolios that are relatively concentrated with the best ideas we see out there. So that's how we act and work on a daily basis. We have some risk management tolerances that we think about, certainly with all caps. And I think Mark, we'll probably get into this later in the conversation. We are able to work across capitalization. So we know that smaller businesses likely have more growth opportunities, likely have opportunities to get capital to work. We know the larger businesses, many times end up with excess free cash flow. So we do like to see a more of a dividend strategy as the company grows, but those are nuances that play out as we build portfolios. So that's what we started. And that's the philosophy of the team.

Mark Goodwin:

Thank you, Matt. As you think about the typical funnel of looking at the entire universe, coming down to the investible subset of stocks that you can finally select for addition to the portfolio. Are there certain key criteria that are important with those stocks that ultimately make it in, in terms of balance sheet strength as a value manager? How much does yield mean for you in your portfolio and other certain industry aspects as an outgrowth of the process that you tend to focus on certain industries more than other industries?

Matthew Swaim:

Sure. Yeah, let's start with the balance sheet. We are certainly looking for financial stability for a couple of reasons, one with that downside tendency, we want to make sure that we don't end up with a credit event or in a situation where there is capital needed at the wrong point in time. So we do certainly look for balance sheet strength and we look for free cash generation, start with primarily because we know long-term wealth will be created from compounding.

And so the second tenet would be, do they have re-investment opportunities? Do they have a large market they're going after? Do they have a legitimate growth plan with those capital re-investments? Are there good returns on capital? Because when you set up that framework, time is on your side. You compound, the market will do what it does in the short periods of time.

But if you're making rational investments with free cash flow, time is on your side. And then, the Omaha parlance, the weighing machine takes over. So, we just look for that set up at any business we have, whether it be large or small. As I said, businesses do get larger, it's likely that they're going to end up with excess free cash flow. And if they are responsible, it is probably good to be returning that to shareholders. Now that's not the answer in every situation, but we do think it adds some discipline. So as you see us go up market cap, you'll see our dividend begin to increase, but as you're down in the smaller end, we would hope they would have reinvestment opportunities, that's what's exciting about investing in a corporation if they have opportunity, filtering through this set.

We will start with balance sheet screening, but we almost call it a sourcing meeting these days. There were the days of screening on very basic value-based metrics, from low P/E, low price-to-book. The accounting has become so hard on the balance sheet now. Low price-to-book in our view is probably lost a little bit of it's relevance. P/Es could very much be influenced by GAAP accounting and whether that's economic reality or not. So most of our sourcing is, okay, let's look for good businesses that have good return. So margin structure, return structure, and then let's look for change.

Let's look for something that we can fundamentally research harder and understand better than anybody else out there and get so much conviction around that. We're willing to add that to a 30-stock portfolio. So that change could be an industry change, a competitor that falls in hard times or a pricing structure that falls apart that may or may not change or growth dynamic that was not there prior that does this to take advantage of, it can be a capital change where maybe somebody has spun off an asset or sold an asset to, all of a sudden, the balance sheet and the focus of the business is changed dramatically, likely the public market won't catch up that fast.

It's very slow moving, and some of that, when you change the business structure. So we'll look for those change catalysts and then leadership. I mean, people matter, incentives matter and new leaders can have a slightly different view of the same asset and really drive outcomes. So yes we have some financial screening criteria and sourcing mechanisms, but the change catalyst and things changing out of business is something we're always looking for.

Mark Goodwin:

Thanks, Matt. I've always liked how you described the investment process as investing in a business, as opposed to buying a stock, you know very much like Warren Buffett. And ideally you invest in companies that have a long horizon of compounding but eventually if you're successful, you may need to sell a particular company. Can you talk about what the selling criteria might be in terms of when a name might leave the portfolio?

Matthew Swaim:

Sure. Yes. We're always putting up our ideas on our watch list against the portfolio we own. I would say that the basic way the things move in and out as you get a really steep discount to a business you're really attracted to, you know you're going to sell your least attractive position, you know that start waning in some ways. And we're thoughtful about taxes there. And generally with our long-term horizon, we'll be tax efficient but those Darwinian swaps are probably the way that we usually do that. And our team is 10 people large. So we maybe own in our value portfolios, 45 positions or so across all portfolios. But we probably have a watch list of another 150 companies that we're interested in. So we're constantly doing our research to keep fresh and keep that Darwinian process in motion. You know, give us opportunities like we had last year, so that's the first.

Then, the second would be just poor execution. So negative reasons to sell. They'd gone off the plan that we initially underwrote, the investments that we're making we're not seeing returns on, we're not seeing the incremental margins open up, we're just not seeing them win business. We want to walk away with our money before the investment falls apart. So we do something called thesis trackers, Mark. Every quarter, we get a new piece of financial data. The analyst is required to go through the three to five basic investment tenets around that business and re-underwrite that every quarter. And if we see slippage begins to go on a list of securities, we're going to watch closely. And if you see it changing or them doing an acquisition that wasn't on script, we're going to move on. So that would be negative reasons.

Then the third one I'd say is just corporate activity. We have a lot of forced turnover in this portfolio over time, in that, especially at the smaller end of the capitalizations you'll see buyout activities where either a financial buyer becomes attracted to the same characteristics that we see or a larger company wants to take a smaller company into their fold and continue to grow it in there. So those would be the three main ways we create turnover in our portfolio over time.

Mark Goodwin:

Thanks, Matt. To pivot for a second, as an all-cap manager, you have flexibility to go across the market cap range from mega-cap to micro-cap and everywhere in between to look for ideas. In practice, how does this work out in terms of how you seek to blend large, small, mid, and smid companies into the portfolio? And how do you think this flexibility allows you to create a beneficial investment experience for investors?

Matthew Swaim:

Sure. Yes, we certainly have a broad mandate and we really liked that. We think it's a great way to invest, because as you said, there's 3,500 some odd businesses that an investor can buy or sell on any given day. And we really think about each of those businesses independently and buying the business. As you look across the market cap spectrum, we understand a smaller business can be inherently riskier. They don't have the scale, they don't have the financial wherewithal. They may be scrappy in the market that they're trying to compete in. But when you start to see 50% discounts to intrinsic value, and we believe that this is a small business that is going to be a market share winner over a five-year period of time. You want to buy those. And we'll go very overweight to smaller businesses when we see those big discounts as we did last year.

Matthew Swaim:

So, where we sit today, we're pretty overweight some of the small caps in our portfolio because of the discounts we were able to buy at. And the larger end of the spectrum, as the small cap discount close, there's always opportunities and changing dynamics in the large caps, a stumble by a management team. It's a change in an industry structure that creates an event. And so we're looking for those market dislocations because we certainly know in the larger cap area, the price perfection is a little better. We need to be more intelligent about the capital reinvestment opportunities and capital coming back to shareholders there. So we recognize we won't be as at large a discount, we just have to jump on those opportunities. So it's coming to the office every day, Mark and making sure those 150 companies we follow are up to date and ready to move when the market gives us the opportunity.

Mark Goodwin:

Given that if you're successful when choosing small-cap names, they may grow up to be mid-cap names or large-cap names in the portfolio. How prevalent is this as an event as you invest down the lower end of the cap range?

Matthew Swaim:

Yes, those are the greatest investments. Those are the investments to we all look for, investments you can hold over a 10-year period that just have incredible wealth creation to them. I guess I'd say an example of that is CDW Corp, that's just outside of Chicago here a technology distribution company. And you know you think about all the things that creates the right incentives there. So CDW was private equity owned by Madison Dearborn, and they came back to the public marketplace as a pretty levered entity for our standards. But we knew people at the business, we knew the quality of those people and really watched it for about a year and a half, why it began to de-lever in the public marketplace and get it into a balance sheet position that we were more comfortable with. And we spend a lot of time out at their facilities,

We talk about culture and ownership culture, and they all own stock, but even the person that's just hired, that's just beginning to get new accounts that they're selling technology to, they are incented on gross margin dollars and the sales culture out there and ownership of your book is just so compelling in the way that they set up that business. So you knew they were going to win. They have the right incentives, the right mentality, the right passion, and just incredible opportunity.

We probably bought CDW and it was a couple of billion-dollar market cap today it’s doing up to well into the mid cap range, simply through them doing intelligent, consistent sales growth. Yes, they have done one act, a couple of acquisitions in Europe and an opportunity maybe to make it a worldwide business. But most of it has just been blocking and tackling. De-levering the balance sheet. Re-investing, hiring the right type of talent, setting incentives. And we've owned CDW for probably seven, eight years at this point. And those are the types of things that we want to build into our portfolio. So you have small-caps growing up in the mid and large companies are things we're constantly looking for.

Mark Goodwin:

Thanks, Matt. Changing gears for a minute, equity markets have had a great run through the last nine months of 2020, and they're starting the current year strong, but maybe getting a bit stretched in particular and perhaps to the increase in treasury yields that we're seeing recently. Can you comment on where you see the equity market currently and what your broad outlook is for 2021?

Matthew Swaim:

There's a cascading effect. I mean, you saw off the bottom in March and April, the first businesses that were re-established were the growth businesses, the very large growth businesses that have brand names to them. You saw those recovered very quickly. You then saw some of the other technology and biotech businesses catch on with the pandemic thematic forces. It was just after the vaccine was announced on November 7th that the value part of the market began to recover. And we think there's long way to go in the value end the market. We are not stretched on multiples, in the value end of the universe. We're still well under 20 on a P/E basis. And our companies have reinvested, probably have earnings upside to them over the next couple of years. So there's been a very narrow part of the market that's driven a lot of return and it's certainly continued to rotate, but the value end of the market has not yet.

And we just are starting to see that as we start 2021. Typically when you see rates rise, that means that we're on the precipice of some decent economic growth. Obviously there's an inflation conversation today, but as rates rise, that tends to be a good thing for value stocks. One, from a quality value perspective, rising rates can bite into levered businesses. Then two, the discounting mechanism of a growth stock whose earnings power is five, six years out, looks a lot better when rates are zero than they are when they start to rise.

And from an economic growth perspective, our businesses may have a few harder assets to them than some of the technology businesses. And as you get economic growth and even inflation, you start to leverage that asset base, enhance ROICs. And ROICs is going higher usually means the stock price is going higher. So we still sit pretty compelled by what we own and the return potential from here. And really from a broad equity perspective, with Junk Bonds yielding 4.3% today, we still choose value stock yielding 2.5% trading at 17, 18 times earnings. So we still see some decent value out there as we look at the market.

Mark Goodwin:

To continue on that point, the value/growth performance, dichotomy, has been with us for a few years now. And last year, perhaps one of the largest, divergent years of Russell 3000 growth versus value, do you think the current environment with vaccines coming out, recovery, return to a more normal environment will promote a return to the mean, reversion to the mean for value stocks? What's your broad view there?

Matthew Swaim:

Sure. Well, I think the most pointed view I'd have there is that discounting mechanisms. Growth stocks tend to not have a lot of earnings to them. And then so, growth managers will speak on a price to sales basis, mostly because those sales turn into earnings somewhere in the out years, call it years five through seven. And if you're valuing something on years five through seven, as rates begin to rise, you see the growth valuation begin to change. I think that reversion will happen. We'll see if we ever get back to a 10 Year Treasury bond yield at 4% or 5%, but rates going higher certainly will help that gap close a little bit. I will say maybe something untraditional for a value manager though, in that the growth businesses and if you think about how I talked about compounding value, many of these businesses just are better mousetraps.

And so, we own Google in our portfolio that has maybe traditionally thought as a growth stock, we own some other technology businesses that have some growth characteristics to them because there's not a lot of incremental capital required in order to create sales growth and infinite ROIC. And so yes, there has been a dichotomy over the last 10 years, Mark, and I think evolution of a value investor, we've had to ask why. And in some cases, it's just the business model, they are superior. And so yes, there are stretched places where there's a lot of momentum out there and there's some retail buying that's probably unhealthy, driving to valuations that don't make sense.

But I think as an investor we've tried to be very cognizant that... our going in multiple, needs to be looked at relative to their opportunity to grow without a lot of capital required. And it has a lot of value to it. So, we're excited about some of the older economy businesses, having a trajectory here of nice earnings power and that's represented our industrial portfolio, but we're not blind to the fact that there's some pretty crisp business models out there that are the growth that have some value to them as well.

Mark Goodwin:

Thank you. Based on your research, do you think there are certain sectors of the market that you're finding the best opportunities for investors with a medium to long-term time horizon? And I'm thinking of a variety of possible effects that I've heard positive noise about, like airlines and cruise operators with a hopeful pandemic in sight soon. The savings rate has been roughly double its historical average recently. So there's clearly dry powder among people that want to get back and live their lives. I don't want to focus on consumer things specifically, but are there any general areas that you think offer particular attractive opportunities right now?

Matthew Swaim:

Sure. I think you always have to start and know as a U.S. investor, that two thirds of our economy is driven by consumer behavior. And what the consumer is up to always drive investment opportunity. And so, we've always had that framework over 25 years that we have to understand what the consumer is doing. And as you talked about, consumer balance sheets are in good shape and they're making different choices than maybe they did two years ago. And so we certainly follow those trends. One thing that we are focused on and that we're exposed to in our portfolio is what is going on in auto sales. We own Asbury Group, which is one of the five largest retailers of autos out there. The business was disrupted to some degree by the Carvana effect and how auto retailing is done, where you can deliver and shop online.

But the largest of players now are able to compete towards that. Every small auto dealer is looking to sell to another larger auto dealer because the technology is changing. And so between volumes of used and new cars and the [inaudible] nice downside protection, "Of repairs and maintenance effects that auto retailers can do." We just see a sea change in that business, partly driven by what's going on with the pandemic.

People have needed transportation to move out of cities and move around the country a little bit and seen a little bit of a mini boom in auto, but it changed the whole dynamic of the business. And you're seeing consolidation there, investment in technology and ultimately scale that is very interesting to us. So, consumer patterns, consumer behavior is driving part of that investment thesis, but also your ability to put capital down by buying other auto retailers and taking advantage of technology. So those are the types of things that would drive an investment conclusion on our portfolio and something that's been influenced by consumer behavior recently.

Mark Goodwin:

Thanks Matt. One thing we've been seeing progressively over the past dozen years or so is the growth of passive investment strategies, taking a larger share of investors while at effectively, both institutional one and retail. How does Advisory Research's particular style of active management provide advantages for investors who might also use passive strategies for a piece of their portfolio?

Matthew Swaim:

Sure. Two ways. One, as an investor has a passive allocation towards equities, understand that and understand the low-cost mechanism there and what that means. We would say that our more concentrated approach is an add on to that passive portfolio and a way to make a more concentrated bet on great businesses that you want in your portfolio. So you see kind of that core satellite mentality that is how we've tried to position our whole suite of products and alpha generating and an additive to a passive portfolio.

I will extend your question a little bit to passive markets. We see them continue to take share. As an investor, it is a good thing for active management and more concentrated portfolios. When the price setting mechanism is a blind buyer of a security in the form of passive on a day when people decide they want to sell equities for whatever reason, it's just a liquidity trap. And us, as liquidity providers, as we have excess capital, can get better prices. So, the passenger effect, I think is also often seen; the active managers complain about it and try to see it as a problem. But we accepted it as people want to have low-cost solution. We just want you to know that in this portfolio, we're going to take advantage of uninformed buyers and we can see passive flows giving us that opportunity on different days.

Mark Goodwin:

Thank you, Matt. As we mentioned earlier, you sub-advised the North Square Advisory Research All Cap Value Fund ticker, ADVGX. Can you give us a little bit of your history with the fund and also tell us about what the current investment strategy and portfolio allocation is for the fund? Vis-a-vis market cap structure particular weights today?

Matthew Swaim:

Sure. So the history dates back to the early part of the century, where we had a very large state plan come and ask us to just do a very broad value strategy across market capitalization. We had grown up as a smaller cap investor and with the disciplines that I described earlier, and we had somebody who saw our investment acumen and gave it a large allocation to go across market cap spectrum.

So it was an institutional mandate. At that same time, we did launch a mutual fund, a sub-advised mutual fund product that mirrored that institutional strategy. So, we would say our investors are getting this institutional type of structure inside this mutual fund. So that was the legacy of the fund.

So we're proud of the track record. As we sit today, we are overweight the smaller end of the market cap spectrum as I mentioned earlier, we just see discounts there and opportunities mostly from the selling pressure last year and the liquidity, and it was able to get us in at very nice prices. So that's what recovery ensuing, rates beginning to rise and value stocks beginning to have a little motion to them. And we think we have a pretty compelling opportunity right here right now. So I'm excited about the portfolio.

Mark Goodwin:

Thanks Matt. A final question. How do you see an actively managed, high conviction, all cap equity strategy, being best positioned in the diversified portfolio of a typical retail investor?

Matthew Swaim:

Sure. I think with long-term, time horizon value investing makes a lot of sense. They have long-term reason for existence.

So, be patient, we are with our companies. I have that long-term horizon and buying at a good price and compounding is a very rational way to invest. So we think it fits somebody with a longer term horizon that's looking to compound.

Mark Goodwin:

Great. Matt, thank you again for joining me today. This has been a great discussion.

Matthew Swaim:

Appreciate the time, Mark, and thank you very much.

Diane Merritt:

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