Active Insights Podcast – North Square Tactical Defensive Fund: Seeking to Generate Positive Returns Over Time with Lower Volatility

Diane Merritt:

Welcome to North Square Investments Active Insights podcast. North Square Investments is dedicated to bringing differentiated, active investment strategies to financial advisors and investors through our multi-boutique asset management platform.

Today, Mark Goodwin, Chief Executive Officer of North Square Investments will discuss C.S. McKee's strategies for tactical asset allocation, and in particular the North Square Tactical Defensive Fund, ticker symbol ETFRX, with Brad Thompson, Portfolio Manager with C.S. McKee. Brad will also provide us with his insights and outlook for the market. C.S. McKee is a partner firm in the North Square platform.

Mark and Brad, 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 C.S. McKee have strong, and we believe, timely capabilities in providing risk-managed alternative strategies.

Brad, you, and your team manage three distinct strategies for us with a common thread of managing risk and volatility, the North Square Tactical Growth Fund, North Square Trilogy Alternative Return Fund and North Square Tactical Defensive Fund. Can you tell us what the general portfolio strategy and investment objective is for each of these funds?

Brad Thompson:

Thank you for having me on again, Mark. I look forward to our discussion.

The twin hallmarks of the two tactical equity funds you mentioned are their varying degrees of risk management and their ability to diversify across markets. The Tactical Growth Fund offers a growth orientation while maintaining a diversified allocation with a defensive bias. For additional risk mitigation, the Tactical Defensive Fund provides equity market exposure, but seeks to manage risk with significant and timely reductions in equity exposure during periods of market uncertainty.

The Trilogy Alternative Return Fund is very different. It is an absolute return strategy designed to be market direction agnostic over the course of a year with the goal of providing stable returns, no matter which direction the equity markets may have taken.

Mark Goodwin:

Brad, today I'd like to focus on the Tactical Defensive strategy, mutual fund, ticker ETFWX, which focuses on trend analysis in evaluating risk in the broader equity markets.

What are the key trends and factors you are looking at, and how do you measure risk in different areas of the market?

Brad Thompson:

Mark, we use a combination of technical models that are designed to assess market risk levels and trend strength over several time periods. And we do this for diversification of process purposes.

Our longer-term trend following model is designed to assess trends that are more cyclical in nature. So this model is less sensitive to smaller dislocations in the market and tends to have fewer signal changes. Half of the portfolio is governed by this longer-term model that is designed to be fully invested during periods of prolonged market declines.

Since the weakness of a longer-term trend model is it is slower to react, we combine this with our dynamic trend technical model, which is a faster-moving model designed to assist short-term to intermediate-term market trends and risk levels. This model governs the other half of the portfolio, and it is constructed to react quicker to market dislocations so that we can begin reducing or adding equity exposure sooner. And as you know, in this market, things can change quickly based on global news events, Fed policy changes, and now we're dealing with multiple variants of COVID that continue to impact the economy.

But both models use price trend measures. These trend indicators are constructed to identify what the market trends are over various time periods. And that ranges from two to three weeks to six to eight weeks and on up to three to six months for our cyclical trend measure. Both models also use a combination of market breadth and relative strength indicators to assess the strength or weakness of the price trends. And what we're looking for here are potential dislocations in price action versus the underlying sentiment in the markets. Generally, we see breadth divergence occur ahead of negative price action. So, this allows our model to react quicker if price trends do in fact reverse. But as we all know, not all price declines are preceded by negative breadth or market sentiment. And there can be news-driven events that impact stock prices. And that is why we use a combination of price, breadth, and relative strength to assess market trends.

Mark Goodwin:

Brad, how often are you going through this process?

Brad Thompson:

Well, Mark, for the longer-term cyclical model, we assess it on a weekly basis. However, that model has historically only generated trading signals an average of a couple of times per year and at times has remained on for years at a time during prolonged market growth cycles. As a trend follower, “the trend is our friend.” So even though we monitor this model weekly, if the trend is positive and persistent, we want to continue to follow it as long as it will allow.

We monitor the faster-moving dynamic trend model daily. And really, the same thing, while this model does generate more frequent trades, “the trend is our friend” mantra still applies.

Mark Goodwin:

Brad, can you talk about the overall objective of a trend-following strategy like tactical defensive?

Brad Thompson:

Well, Mark, the biggest difference in this type of strategy compared to others is that instead of the potential value-add coming from security selection, it comes from the allocation decision to be offensively invested in risk assets or defensively positioned in more defensive securities like short-term fixed income or cash. So, what we are looking to do is really basic. We want to participate during equity growth cycles and step aside and let others take the risk during high-risk market environments when market price action is decidedly bearish.

And the overall goal of that approach is to generate positive returns over time with lower volatility than in a passive equity strategy.

And we believe that managing volatility in an investor's portfolio can be very valuable, particularly for those approaching the distribution phase of retirement. If you can side-step the majority of the major market declines and participate to a fair degree during market growth cycles, it can be a successful goals-based investment strategy. And what I mean by goals-based is if you need an average of 6%, as an example, to achieve your personal investment goals, then you should not be swinging for the fences and taking undue risk to get 16% returns. We believe many goal-based investors that a lower volatility strategy can help achieve those goals without taking undue risk.

Mark Goodwin:

What would you say are the key factors or events that would lead you to significantly change the allocation within the portfolio?

Brad Thompson:

Well, Mark, the most recent example I could think of is the COVID crisis that we're all too familiar with. The economic shutdowns began, or when they began, there was a tremendous amount of uncertainty in the markets. This led to a rapid reversal in the market trend.

And as we know, the market was rocking along beautifully and the S&P had hit an all-time high on February 19th of 2020, and then the trend reversed. Shortly thereafter, our faster-moving model signaled for more defensive allocation, which allowed us to manage the volatility in the portfolio during the drawdown. Fortunately, the Fed stepped in and policymakers added stimulus and the markets rebounded very quickly. As the trend improved, our model signaled full equity exposure.

The other examples that immediately come to mind are the financial crisis in 2007, 2008, and the dot-com bubble crash that saw the NASDAQ decline by more than 70%. Those are clearly examples of when a tactical trend-following approach could be valuable.

Mark Goodwin:

Brad, is this strategy useful for investors in certain market environments versus others, or is it designed to perform over the complete market cycle, including both bull and bear markets?

Brad Thompson:

Great question. The strategy has been designed specifically for full-market cycles, and honestly it takes a full cycle that includes a prolonged growth cycle and a prolonged bear market for this strategy to maximize its benefits. But that being said, we feel now is an attractive time to look at a strategy like tactical defensive. The market has been on a great run since it bottomed out during the COVID crisis. Markets are very near their all-time highs. Entering September, the S&P has been on a seven-month winning streak, and valuations are also at historic levels. New variants of COVID keep coming out and showing up threatening the economic recovery and the Fed is going to consider tapering. So, there are many risks that could result in a significant trend reversal, but on the other hand, all the Fed stimulus has pumped in a great deal of liquidity into the markets and many feel stocks have room to go higher.

So, for investors who feel they need to be invested in this market if it continues to climb, but who are also worried about the risks that could result in a trend reversal, this may be a good solution. If the trend continues, our model is designed to help us participate to a fair degree. But if the trend turns south, the Tactical Defensive Fund is designed to react relatively quickly.

And owning a defensive equity strategy prior to a negative trend reversal is obviously preferable to buying it after the fact.

Mark Goodwin:

Brad, much of the economy seems to be recovering. Although, as you mentioned, new strains of COVID continue to be challenging. Equity markets are at or near record levels and inflation is causing some concerns, but the Fed appears to be maintaining their reasonably accommodative stance.

Where do you see the economic environment currently? And what is your general expectation from markets over the remainder of 2021, and if you look into your crystal ball, 2022?

Brad Thompson:

Well, fortunately, Mark, the fund is process-driven and takes the guess work and human bias out of our process. So in this strategy, we do not make market predictions. And those who try to predict where the market is heading, usually have to update their estimates if the market moves away from their original forecasts. So that is where having a dynamic trend model that can adjust quickly to short-term moves and cyclical trend model that follows the long-term trends is beneficial. It isn't always perfect, but it helps the fund avoid intermediate moves to the downside while trying to participate in a market rally over the long term.

Mark Goodwin:

Brad, how do you see a tactical defensive strategy being best positioned in the diversified portfolio of an individual investor? And what benefits would you expect it to provide?

Brad Thompson:

We feel this fund makes a good addition as a piece of the equity sleeve to help diversify and reduce some volatility in the overall portfolio. Another way we have seen advisors successfully position it in the portfolio is right between the equity and fixed-income sleeves. And that allows the tactical moves to simply shift the overweight or underweight to equities and fixed income based on the trends in the market. So it kind of simplifies the overall portfolio strategy for the advisor.

Mark Goodwin:

Brad, thank you so much for joining me today. This has been a great discussion.

Brad Thompson:

Thank you very much, Mark. It is always a pleasure.

Diane Merritt:

Thank you for tuning in to 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.

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