Active Insights Podcast – Advisory Research Investment Management: "We like to think of multiple ways to win with our businesses"

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 the approach to 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 Small Cap Value Fund, ticker ADVGX. Matt and Mark, 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.

Matt Swaim:

Thanks for having me.

Mark Goodwin:

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

Matt Swaim:

Sure. Be happy to. Advisory Research was founded in Chicago over 30 years ago, and the primary focus of our business has been to serve institutional clients through highly researched, more concentrated portfolios. And we've been doing that through over several market cycles and have done that in a way that provides unique portfolios to institutional clients. We are a partner-owned firm, meaning that the employees own the firm. We have our capital invested right alongside our clients. All the partners invest in portfolios right next to their clients. And we think that that one, creates sustainability of the firm, obviously being around for over 30 years, that has held true. And two, aligned incentives with our clients and our institutional investors certainly like that. And we think that the community that could access this mutual fund should take solace in that as well. So happy to be partnered with North Square on this opportunity.

Mark Goodwin:

Matt, as a fundamental manager your investment approach is very research intensive with a strong focus on stock selection. What would you say is the core investment philosophy of your team in managing equity portfolios?

Matt Swaim:

Sure. So as we mentioned, we do a lot of research upfront to make sure that we understand the investment that we're making. So we are not traders. We are looking at the markets to buy businesses for our portfolios and we buy those in the form of public securities, but we're looking at them as though we're buying the entire business. So, it's important for us to buy it right, meaning that we're buying in a valuation that's not demanding and that allows us to accrete the higher returns if the investment pays out. We're looking for durable businesses, probably because we believe in the first rule of investing in our team. And first rule of investing is to not lose money. We want to make sure that if we do make an investment and the thesis does not play out, that we're likely walking away with our capital or something slightly more.

And then we want to make sure that we have time on our side. So, these businesses that we are investing in have the ability to put capital to work, self-funded from the cash flows in their operations and continue to invest in the business to accrue earnings power on the behalf of shareholders. If you get those things right, you have good nice capital protection and you have a nice return on the reinvestment opportunity, if we've invested in a well-structured business. Beyond that, we look for ways to create operational and strategic catalysts. So each business, not every business as we well know, is run perfectly, especially in the small cap space, there's often room for operational improvement. So beyond just the reinvestment opportunity, can the entire organization be more efficient? Can it get capital back to shareholders more efficiently? Have we properly thought about capital allocation?

Those are things that we think we can add value alongside just a nice business opportunity. And then finally, after operational, is strategic. We like to think of multiple ways to win with our businesses. Compounding is great, but if we have a well-situated crown jewel that may be a larger business or a financial buyer would be interested in, often we can create a premium through a strategic outcome as well. So that continuum of great research, durable business, buying it at the right price, the ability to reinvest and compound, and then also have the upside of operational and strategic catalysts are kind of the continuum that we think through as a research team.

Mark Goodwin:

Matt today, we're talking about small cap value and as such, you have to filter through the universe of small cap equities, either Russell 2000, Russell 2000 value, et cetera, to develop a workable set of potential investments. How do you get to that workable set? And in doing so is your primary focus here on quality or value metrics?

Matt Swaim:

Sure. So to get to that workable set yes, we have a few thousand businesses that we can choose from daily. And so I talked about in our process, we want to make sure that we do have some sort of durability to the business. So we are looking for profits. We're looking for cashflow, we're looking for responsible balance sheets. Those are things that are going to begin to screen our criteria. But then we want to make sure that we're buying them right. And to do that, you often have to go to inefficient parts of the market. So we'll look for things coming out of bankruptcy. We'll look for things that have great balance sheets and a redefined business plan. Maybe they're a smaller part of a larger organization that took them into bankruptcy, but something that made it uncommon or maybe other investors aren't looking at it. We'll look for spin out opportunities.

There's large cap companies that are constantly spinning out smaller businesses that likely were mismanaged inside those larger companies. So we want to look there. We look for management change, somebody who's taking an asset that may have been managed a certain way or maybe undermanaged, but somebody that wants to take it to the next level and sees an opportunity for that business to expand. So we're looking in these different inefficient parts of the market where the typical sell side analyst or somebody in the investment community, likely isn't paying attention to these things that are changing the potential outcome. And we want to target those, screen those, and make sure we're talking about those every week in our research meetings.

Mark Goodwin:

So to recap, what would you say the key characteristics are for a stock to ultimately become a holding in your small cap value portfolio?

Matt Swaim:

Right. So in that beginning parts, making sure that the return profile and the financial profile are durable. So we want to make sure that we have those two things in place. And then to keep time on our side, we're looking for that reinvestment opportunity to compound with the business. So do they have the opportunity to continue to grow with their capital? Can they continue to grow their business? Can they accrete shareholders just doing that at a nice rate of return and then management quality is part of that. Can they execute? Do we believe they can execute? Have our conversations showed that they have a nice handle on the business? So you line all those things up. It's likely a candidate if we can buy it at the right price. And then finally, as I mentioned at the beginning of our conversation, making sure that we stick to the operational and strategic catalysts, often can give us more alpha relative to other portfolios if we get those two equations right as well.

Mark Goodwin:

Matt, as I look at some of our competitors in the small cap space, some of their strategies have several hundred positions, almost looking like a quasi-index in and of themselves, but your portfolios are more concentrated with high conviction positions. Can you talk about portfolio construction and what are your key goals? And to what extent does risk management play into the overall process?

Matt Swaim:

So given the in depth and substantial research that we put into each investment, we want that research to pay off. We can only do that 30 or 40 times in a great way every year in the amount that we dig into the business and are out of the locations and meeting with the management teams. So we want our research to really be the catalyst, to get a name into the portfolio and make that payoff for alpha. That's why we work towards high conviction. That's also been good for our organization with our institutional clients over the last 30 years. We can be very additive to an index portfolio in that we can add a satellite type portion that can be alpha generating beyond just owning the broad market. And we think that is good for construction purposes.

From a risk perspective we certainly pay attention to diversification. Most studies would tell you that you get 95% of the diversification benefits once you go over 20 securities, if they're across the broad sector approach. So us up into the 35, 40 stock range, we see certainly get the benefits of diversification. We also have some single stock limits. We will not allow a position size to go above 5% of the portfolio. So we, at single stock wise, we make sure that we diversify there.

And then finally we have some sector limits. We will not go over 25% in any sector with the exception of financials, where that, we look at the sub sectors there, banks, insurance, real estate, et cetera. So some nice diversification benefits across securities and sectors. We also layer on some additional risk management tools, looking at factor analysis. That has evolved over our 30 year history. There are a lot of tools today to make sure that you don't have unintended bets in your portfolio. So we layer on a factor analysis at the end to make sure that we're not overweight one substantial factor. So bring that all together, we feel like we have a nice well-rounded risk management process.

Mark Goodwin:

Matt, I know that you folks generally look to hold positions for the long term, but at the same time, you're continuously evaluating portfolios for your current changes. Can you talk about what issues or catalyst would result in you selling a particular position?

Matt Swaim:

Sure. I begin with the Darwinian process. So as we find something that has a more attractive risk return profile than something we currently own, we'll look to make that change. Investments certainly have life cycles. So if we have compounded and we've played out the operational catalyst and the strategic catalyst seems relatively far off, it might make sense to rotate that capital into a new idea we've researched with a better risk return ratio. So that is the typical way that we'll rebalance into a new name. We also have forced turnover. So given how we think it's a lot how strategic and financial buyers would think. So we have quite a bit of merger and acquisition activity where our companies are acquired and we receive cash. So that would also be for selling activity that would provide a premium.

The negative reasons we sell would be that poor execution. We've underwritten a thesis where they can reinvest, where they can get returns out of those investments, where they can enhance the return profile through margin enhancement, et cetera. If we just don't see progress and we're not selling one quarter in because of a hiccup, but if we see multiple quarters of them not moving towards our thesis or executing around our thesis, it is time to move out. And I think that is something that small cap investors, especially in today's market need to pay attention to. It is tremendously easy for some investors to be lazy with their positions. And there are enough good businesses out there that we want to move on if we do see poor execution. And then finally, would this be something that surprises us, they do an acquisition with leverage that was off plan, changes the risk profile. That's going to be time for us to move on because we've lost some trust in the partners or the management team. So those are kind of the reasons that we'd look to make a change in the portfolio.

Mark Goodwin:

Matt, changing gears for a minute to look at the macro environment. Equity markets in general have had more volatility in 2022. The Fed is on track to be less accommodative and without question, geopolitical tensions have increased. As we move towards the end of the first quarter, where do you see the equity markets currently? And what's your general outlook for 2022?

Matt Swaim:

I'll tell you, Mark. I get nervous when we don't have walls of worry to climb. When the euphoria is out there and prices are too high and there's nothing that people are talking about is potential hurdles to overcome, you typically get a market that doesn't have a lot of return potential to it. I wouldn't say that's where we are today. We've probably begun a new business cycle through the pandemic and we didn't expect that to be the reason why the last business cycle ended, but that was the beginning of the next business cycle. And that starts with government support, accommodative policy, we get our legs under us, and we begin to move forward. And the beginnings of this year was the beginning to move forward with the Fed rate increases that need to happen. That typically happen in a business cycle.

That was the wall of worry we began to climb. And now we have geopolitical issues with the war in Ukraine. Again, commodity prices, inflation, things that this market has to digest. Those factors are still giving us opportunities to buy securities at pretty attractive valuations. And yes, we have to work through those issues, but the value of a business is defined in years, not quarters. And I do think that most of these issues in front of us will be resolved in the next few quarters here, which will allow value to continue to accrete. So in an environment where the typical bond yields are well under 3 or 4%, we're finding businesses that should have double-digit returns over any reasonable holding period. We would expect US small caps to be higher by the end of the year in that `earnings power is going higher and their reinvesting in the United States, and those are good conditions for returns.

Mark Goodwin:

Given the anticipated rising interest rates, there's obviously been a negative impact on discounting cash flows of growth companies. Would you say that with this backdrop, you see advantages to using a value approach for an investor's equity exposure?

Matt Swaim:

Yes. I mean, if you buy companies right, and you're not at nosebleed valuations, you certainly have more potential to not only protect capital, but find moderately rising returns. And so we didn't enter ‘22 with companies trading on price-to-sales ratios. We entered ‘22 with companies trading at 10 to 12 times earnings and our portfolios are down very modestly to start the year relative to the broad market indexes.

So just having that backstop has been very good, but as a value investor, we typically have harder assets, more durable assets. An inflationary environment, if not too high, is really good for returns on those assets. You get pricing power, you leverage your asset base. A little bit of inflation is really good for a value investor in that you get higher returns off your assets that might be depreciated.

So we're pretty excited with what we see going forward. It has not been a great value environment for the past few years here. And there's been a lot of excitement in the story type stocks. But if you look at really making an economy move, it's driven by more value-based investments. And we think the pieces are in place here for us to have a pretty good run.

Mark Goodwin:

When you look across the various sectors among small caps, where do you think you'll find the best relative value opportunities today?

Matt Swaim:

Certainly the industrial economy, we're spending a lot of time. It has been a broad industrial recession or stagnant growth for the past five to seven years really. It really never got going after the 2008, 2009 crash. And while there was some moderate growth in some of the industrial sectors, we have a lot of work to do. We have inventories to replenish. We have housing to build, we have supply chains to bring back to the US. We likely have some energy investments that we need to make. No matter how you're thinking about how we're going to produce energy, whether it's oil or nuclear or something greener, all of those things take good, hard assets and investment. And we just think there's a lot of activity to come there.

So we're seeing a lot of opportunity in industrials and those have really given us an opportunity here with the market taking an approach that selling off some of these investments here recently, there's a lot of great opportunities out there. We also think the consumer's pretty healthy. The job market's strong. Their balance sheets are strong because of the way the government supported us through the pandemic. They have spending power. Yes, gas prices are in front of us. Yes, inflation hits pocket books on a daily basis, but we see wage growth coming to them and we see some confidence and great balance sheets. And we think there's some good opportunities in the consumer area. So it's an exciting time to be a value investor.

Mark Goodwin:

Matt, many investors have increasingly looked at passive investment strategies for their equity exposure, particularly in the large cap side of things. How does Advisory Research's particular style of active management provide advantages for investors, particularly for small caps?

Matt Swaim:

I think we do a really nice job underwriting and buying in right, to generate returns. But I think we've really developed skills over 30 years to get close to boards and management teams and provide for catalysts that can enhance IRRs (internal rate of return) for our investors because we're speeding up the process for those assets to be recognized as valuable. We're investing more heavily, we're shifting the capital towards the returns for equity investors. We are actively making change and being thoughtful about how to maximize those returns and enhance those returns by having a communication dialogue with the management team.

So whether that ends up an asset being sold a year earlier than it was going to be, that's great for IRRs, right? Whether we get the assets better managed because we put talent around the asset, that's enhancing the returns and creating a catalyst driven event. So we won't be as correlated to the market because of that, because we don't know exactly which quarters these events will be announced and put out into the market. And so that not only provides diversification benefits, but it provides for some enhanced return potential relative to an index fund or a broad market portfolio.

Mark Goodwin:

Thanks, Matt. As we mentioned earlier, you are our partner in sub advising the North Square Advisory Research Small Cap Value Fund, ticker ADVGX. Can you summarize the current investment strategy and portfolio allocation for the Fund as we go into the end of the first quarter?

Matt Swaim:

Yes. The fund is positioned in the small cap value area of the market with about 40 positions, well diversified. We are in market caps that are typically underneath five billion, smaller businesses that would not be at the top of the S&P 500.

Mark Goodwin:

And the number of holdings that are potential for stocks to evolve into lower midcap range. What would you say?

Matt Swaim:

Yes, we will not sell just because the market caps are going higher. 40 positions today that top 25% may be pushing up around $5 billion in market cap. So those may go up towards $10 billion if we double our money over a reasonable period of time. So that part of the portfolio will continue to grow, but we will not own mega cap and large cap securities in this portfolio.

Mark Goodwin:

Thanks, Matt. To wrap up, how do you see an actively managed high-conviction, small cap value strategy being best positioned in a diversified portfolio of an individual investor?

Matt Swaim:

I think individuals can begin to—given the product that's out there today—position their portfolios much like institutions do, have a very low-cost market-based index portfolio in the middle that gives you allocation to the broad market. But having a focused small cap value strategy as a satellite to that can not only provide diversification benefits, but can provide a return potential, an alpha potential beyond the core market opportunity. So it should be an add on to the equity portfolios of individuals, much like the institutions use it.

Mark Goodwin:

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

Matt Swaim:

Thanks Mark. Always good to catch up.

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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