NORTH SQUARE INVESTMENTS

Active Insights Podcast – “Biases are very strong here in the small-cap area, and narratives shift faster, and that creates more opportunity for active managers like us and more chances to turn behavioral inefficiencies into alpha.”

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 small-cap equity investing with CS McKee Portfolio Managers, Mark Roach and Mario Tufano.

CS McKee is a partner firm in the North Square platform and is sub-advisor for the North Square Small Cap Value Fund, ticker DRISX.

Mark, Mark, and Mario, 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 CS McKee provide value-oriented strategies from micro-cap to large-cap equities.

Mark, can you start off by discussing the key elements to your approach to managing equity portfolios?

Mark Roach:

Absolutely. Thanks for having us on the podcast again. So, our approach really to managing equity portfolios comes down to blending behavioral insights with fundamental research. Markets are not just about numbers. They're really about people, their biases, their stories, and how they react under stress. So, our process is designed to capture both sides of that equation. So, we build on four pillars, valuation, which is making sure we're paying the right price based on earnings and real economic profit. The second piece is momentum because price and earning trends often reveal what the market is only slowly recognizing, and it helps us to avoid getting anchored in cheap names that never really move higher.

The next thing, I guess, is quality. We look for high ROIC (Return On Invested Capital) companies with strong balance sheets. We don't mind debt, but we don't want it over-levered or dependent on perfect conditions. That's usually a recipe for disaster. And the last piece is our narratives, where we use tools like natural language processing, Google Trends to measure how companies talk about themselves, how the street frames them, and what stories are really gaining or losing traction. That helps us identify when the market is anchored to the wrong narrative, and that's often where opportunity sits.

The process has evolved since the early 2000s, but that constant has been that behavioral lens. And this is especially powerful in small-caps today. It's part of the market where information is less perfect. Biases are very strong here in the small-cap area, and narratives shift faster, and that creates more opportunity for active managers like us and more chances to turn behavioral inefficiencies into alpha.

Mark Goodwin:

Thanks, Mark. That's a great overview. Mario, I want to focus on the North Square Small Cap Value Fund, ticker DRISX. There are about 2,500 plus small-cap stocks available in the US market. What characteristics are you looking for specifically in order for a stock to become a position in the small-cap portfolio?

Mario Tufano:

First, thanks for having us again, Mark, to be on this podcast. It's always a blast. As Mark mentioned previously, we are behaviorists at heart. A lot of what we do and much of what we talk about is rooted in understanding the biases of market participants. Our edge lies in recognizing this kind of fear and greed cycle that is not only pervasive in individual stocks, but in entire industries. And this may sound counterintuitive coming from active stock pickers like us, but we often tell people that markets are efficient. They're efficient at pricing in investors' biases. And these human biases haven't changed in what I like to call human 1.0 for thousands of years and is a big reason why our strategy is not only repeatable, but successful.

So, underlying this behavioral aspect that we just talked about and this philosophy of ours as our quantitative process, which does a fantastic job in scouring the entire small-cap universe for these mispriced opportunities, these mispriced companies. And over the years, we've refined a host of factors that go into the quantitative aspect of our front end. And as Mark mentioned too, it's value, quality, and momentum-based. And all of these factors that we've refined over the years help us capture those behavioral inefficiencies. So, this quant front end narrows the universe down from about 2,500 names to more manageable lists, roughly around 200 to 300 stocks.

And it's this part of the process, the second stage, where we really roll up our sleeves and move into what I call the art process. And Mark had coined that a while ago. It's the art of this process that brings it all home. And if you play poker like we do, it's like reading the players that are holding the cards, right? This is where our fundamental research, our narrative work, takes over. We build models, we analyze filings, read reports, and we use technology to help us efficiently read reports. We use tools to simulate game theory and the broader story around stocks or industries in general. And it's this stage where it's very, very crucial for small-cap where within small-cap, the inefficiencies are so pronounced. And understanding the narrative and getting that call right makes all the difference.

So just to sum up this section, this part of our process, we have a rigorous quantitative front end and a very disciplined qualitative back end. Both of them are designed to capture alpha from the behavioral dynamics of the market.

Mark Goodwin:

That's a great summary. Your portfolio is relatively concentrated. How do you consider risk management as you build a portfolio in terms of position sizing, etc.?

Mario Tufano:

That's a great question, Mark, especially because we're all trapped to our own biases, right? So, it's imperative to have risk management within the portfolio set up. So first, we size positions based on liquidity, specifically the trading volume of the stock. This helps us in two ways. It reduces the risk of the liquidity crunch, and it ensures that companies that make it through our rigorous process all have a fair chance to contribute to performance. The second piece of it are the factors that will lead upon the value, quality, momentum that we just discussed. They naturally provide downside protection, especially during market extremes. And the third layer is the narrative and sentiment analysis that Mark Roach has done a significant amount of work on along with monitoring key macro indicators to determine inflection points within the market. And such indicators are like the VIX spiking above 50 or high yield spreading above historical averages.

This step, this part of the process, helps us in navigating markets that are either going through a fear-driven period of heightened uncertainty, providing a massive buying opportunity, or being cautious during greedy ones when valuations look stretched. And it's during those periods when valuations look stretched that they will tilt a little bit towards higher quality names because we know they'll withstand a market downturn better.

So all of these tools that I mentioned, mindfulness on liquidity with appropriate position sizes, the factors that underpin our process, and an eye on the narrative, and a pulse on the sentiment driving market extremes, they help us adjust the portfolio dynamically and manage risk without diluting the opportunity for alpha.

Mark Goodwin:

That's great, Mario. Can you talk about sell discipline for a moment? What would compel you to sell a portfolio position, either from a negative standpoint or a positive standpoint, it's reached full valuation or it's not meeting up to expectations?

Mario Tufano:

A little bit of everything you just alluded to. Knowing when to sell is just as important as knowing when to buy. For us, it really comes down to three things. First, market cap creep. So, when the stock is starting to get above 10 billion in market valuation, it's most likely going to be on our blotter for a trim. Now, it's not a hard fast sell. We're going to allow some of our winners to run a bit, but we are mindful that we want to remain small-cap and not bleed into or blend into a SMID type of product. So, we want to remain true to small-caps.

Second, it's valuation discipline. We are patient investors. We will allow multiples to run a bit, especially if earnings are getting revised higher from the sell side, and we want to squeeze out as much alpha during this stage. But if a stock becomes significantly overvalued, and that's whether first in the market, peers, or even its own history, we're going to take that capital and redeploy in another area of the market that is trading at a lower valuation.

And the third aspect is quality deterioration. If a company makes an expensive acquisition or shifts into a strategy in a way that hurts its earnings power or balance sheet, that's a red flag for us, and we're going to be reducing our position or getting out of it and looking for a company that has a better quality setup.

On top of all this, on top of the three things I mentioned, market cap creep, valuation, and quality deterioration, we overlay it with the narrative work and momentum work, which helps us spot when sentiment or fundamentals are turning against the name.

Mark Goodwin:

Thanks for that summary. Turning back to you, Mark, thinking about the broader economic environment, the Fed who just eased rates a little bit today, as expected to continue to ease perhaps modestly for the end of the year. The annual CPI rate as of August is about 2.9%. Tax cuts and related business incentives have been made permanent, but the shift in trade and tariff policy has introduced some uncertainty for business and markets. With all those cross currents, where do you see the equity markets currently and what's your outlook for the rest of 2025 and into 2026?

Mark Roach:

Yeah, it's been a whirlwind of data coming in the last couple of weeks. So, equity markets have been resilient on the surface, but the leadership has narrowed. If you look at large-cap growth remains the market's focal point. Yet we are starting to see, at least from our version of things here, dispersion across styles and sectors. So, what that means to us is valuation is reasserting itself as a driver of returns, which historically signals more of a late cycle environment. And so, looking ahead to 2025 and 2026, markets are likely to reward selectivity over broad data. So not a lot. You want to have conviction in your names.

And so, with the Fed gently easing, we just talked about that, and inflation settling right around 3%, the balance of power is really shifting from liquidity-driven rallies to fundamentals-driven returns. And that shift favors active management, and it's usually setting up to where small-caps can close the gap against growth.

Mark Goodwin:

Continuing on to that point, how do you view small-caps' position today in this environment? And are there potential advantages for the asset class given the broader backdrop?

Mark Roach:

Yeah. I mean, Mario and I were just talking about this the other day. Small-caps are trading at one of the steepest discounts to large-caps in decades. That discount is not necessarily rooted in collapsing fundamentals. Margins and earnings in small-cap land remain, or especially small-cap value, broadly intact, but in compressed multiples. So, in contrast, many mega-caps are being carried by narrative and investor enthusiasm with valuations that are expanding faster than what the companies can deliver in earnings. So, this creates a widening asymmetry sort of where small-caps are priced for low expectations with room to surprise on the upside versus mega-caps priced for perfection with little margin for error. In an environment where the cost of capital eases, small-caps are more sensitive and stand to benefit disproportionately. So, I think that is their advantage.

Mark Goodwin:

Great. Thank you. Within the overall small-cap universe, how do you see small-cap value stocks' position compared to small-cap stocks that are defined as more growth-oriented?

Mark Roach:

It's the same with, maybe not to the same degree, but it's the same as in the large-cap growth side of things that we just talked about. And it is stark. Growth has been rewarded with multiple expansion, again, well ahead of the earnings curve. Value meanwhile has been overlooked despite pretty good cash flows and decent balance sheets and steadier profitability. So that imbalance leaves growth exposed if sentiment shifts here, while value offers resilience and rerating potential as fundamentals regain influence. In a market that is rotating toward those earnings credibility, small-cap value looks positioned not just to participate, but perhaps to lead.

Mark Goodwin:

That's great. Where are you finding the best opportunities to put new capital to work, either in terms of sectors or themes, at the moment?

Mark Roach:

I think right now we are concentrating new capital in areas where the market has really mis-priced risk and where the narrative is showing some bias. Industrials are a good spot to start with, particularly those tied to reshoring, supply chain, diversification, infrastructure spend. That's been a theme for quite some time over the last couple of years. So, tailwinds from policy and domestic reinvestment support, multi-year earnings growth. So, industrials are in a good spot.

Energy, this is maybe a bit of a turnaround to some extent. It's been beaten up pretty good, but they're still priced as if the cycle is fading. Yet a lot of these companies are generating record-free cash flow and returning capital aggressively. The gap between fundamentals and sentiments is pretty wide there between energy and inside energy.

Technology is another area. We are avoiding obviously the big mega-caps and narratives. And instead, focusing on niche under-the-radar companies. And a lot of these companies have recurring revenues and good business models, but these names can quietly compound at a really reasonable price.

Mark Goodwin:

That's great. How is your small-cap strategy currently positioned, either in terms of sector tilts or overweights, underweights, cash position, etc.?

Mark Roach:

So, our cash position is fairly low, right around 2%, and our whole portfolio really reflects the valuation gap. We are overweight industrials, technology, and energy sectors where earnings power and entry points sort of align. Utility exposure is selective and fundamentals-driven. We have a couple companies that we think can compound quietly and do well for us, while in healthcare, we are staying disciplined,

right? That's an area where the MAHA (Make America Healthy Again) movement is coming in, and the narrative has shifted from big pharma under pressure. That was sort of the beginning. Everybody thought the pharmaceuticals were going to get banged up on the paying for the pills and the meds. And it turns out it's going to be on the insurers, at least right now, and they're going to probably carry the cost of that burden.

And in that area, we're avoiding those areas most vulnerable to policy headwinds, which is all about taking control of your life and your health, right? So, they want you to move, measure, and eat better. And so, there's a lot of different things you can do. And sort of the wearables and the watches will soon probably be something that will come out as something that your insurance will pay for. So, there's a lot of things like that that we're going to be looking out for. But over the entire portfolio, the goal is the same across the portfolio. It's to focus on high conviction names with strong fundamentals that will position us to outperform.

Mark Goodwin:

I saw there are recent announcements from Apple with their new watches that measure high blood pressure among other things. So that's an area that probably won't stop evolving as the society moves forward.

Mark Roach:

Absolutely.

Mark Goodwin:

Do you have any key concerns or risks that could cause a significant shift in your market outlook and the way you position the portfolio?

Mark Roach:

Yes. I mean, the risks are not abstract. They are pretty visible, slapping us in the face. I guess let's just talk with the US consumer. They're carrying about $1.3 trillion in credit card debt, just below the October 2024 peak. Housing markets remain uneven. We talked about that up above. And questions about the Fed's independence and the ability to ease without rekindling inflation. That creates a lot of policy uncertainty, in my opinion. That ambiguity often breeds volatility. And we look at volatility as not just risk because it could be a catalyst. And so, in a market that no longer rewards growth at any price, companies with real earnings and strong balance sheets will have the advantage. Small-cap value trading at these historical discounts and tied closely to the domestic economy is positioned to turn that volatility into leadership. And so, I'm really excited about the small-cap space. And typically after, if there is a small pullback at some point later, 2026 to 2027, I really think that small-caps will take the lead there.

Mark Goodwin:

Thanks, Mark.

Mario, pivoting back to you. Your team applies a very disciplined approach to managing equity portfolios. How do you see a concentrated small-cap value strategy like the North Square Small Cap Value Fund, ticker DRISX, being best positioned in a diversified portfolio of an investor?

Mario Tufano:

Bluntly, I think small-cap value is as attractive as it has been in a generation. Now, that's going to sound biased because we're both small-cap value managers, Mark and myself. But if we take a step back and look at some numbers and historical periods for context, you'll see that we've been here before. And now, there's no denying it. This past decade has been brutal for small-cap's performance relative to large-cap. Since around 2011, small-caps have lagged roughly 500 base points a year. That's a large margin over that time period to lose that amount on an annual basis. And that's one of the toughest stretches in the last century.

But if you look, there were three other periods where that occurred. And it was the 1930s, coming out of the Great Depression. It was the mid-40s to mid 1950s, post World War II boom. And then again, the 90s with the dot-com bubble. And every time after that period, small-caps came roaring back, and they outperformed by not just a few, couple hundred base points a year. They outperformed anywhere from 500 basis points to 1,000 basis points for multiple years, a decade and more. So, we don't think the cycle's any different.

And one of the reasons why it has occurred this period, and Mark mentioned a few of those in his comments earlier, but one, we're still hooked on zero interest rates. Everybody wants low rates, and that's something that takes some time to unwind. On top of that, we've been through a period of massive fiscal spending. And that pushed those combinations, the monetary and the fiscal aspect pushed investors toward large-cap names, especially in a very anemic growth environment post the credit crisis.

On top of that, you've had massive passive inflows that reinforce the trend. And that's not going to go away. That's a reinforcing cycle when people are buying the indices. And the concentration of the indices are what they are. It reinforces that large-cap pool. And on top of that, you have this behavioral obsession, especially recently with big themes like AI and quantum computing, which has dominated the headlines for most of the past two years.

Now, as Mark alluded to, small-caps have not been fundamentally challenged over this period of massive underperformance. Now, large-caps have had real earnings power, no doubt. But when you look under the hood and you see that difference, that 500 basis points I just mentioned, every year, that small-caps underperform, a large part of that was due to multiple expansion for large-caps. And I'll put some numbers behind it. The S&P 500 today trades at 22 times enterprise value to cash flow. That's back to levels approaching the levels that it was during the dot-com bubble. And that's two standard deviations above its historical mean. Meanwhile, if you look at the small-cap index, the S&P 600, it trades closer to 15 times enterprise value to cash flow, just a fraction above its long-term average. That's a great setup if you're looking at the markets and saying, "Where do I want to park my money?" Small-cap, to me, is a no-brainer.

Now, why us versus some passive small-cap ETF vehicle? I'll give you a few reasons. And the main driver is because passive isn't really passive the way people view it to be. The indices overtime have drifted. They're making these implicit bets. No one's really looking under the hood. And it's something we wrote about in one of our white papers two years ago, but it's still true today, and even more so as we speak. If

we look at the largest small-cap ETF, now, I'm not going to name its name, but it's one of the largest out there, it has $150 billion in assets under management. Two thirds of those holdings are in stocks that have market caps above $6 billion. Think about that. It's not really a small-cap product. 10 years ago, that number was only 4%. Now it's at roughly 67%, two thirds of its holdings.

Then you have the Russell 2000 core ETF. 15% of its portfolio weighting is in stocks that are negative cash flow companies. That's nearly double what it was in 2009 at the bottom, at the nadir of the credit crisis. That's shocking to me. And then finally, if you look even at the Russell 3000, it's not really specifically a small-cap, but captures a little bit of small-cap there, it has invested in companies that are trading above 10 times price to sales, which is exorbitant multiple. About 25% of its portfolio weighting is in those companies. And that's not the kind of quality small-cap exposure, I think, investors want.

So, I mean, to sum up knowing all this, I think it is one of the most attractive moments we've seen in decades, to be honest with you, for not only small-cap value, but active value. And I think our fund, the North Square Small Cap Value Fund, can be a very powerful complement to a diversified portfolio. It's going to deliver you true small-cap exposure, given our sell discipline, as we mentioned above. It's going to provide downside protection through our quality bias. And you're going to get some meaningful alpha with our value tilt when this cycle turns, and it will turn. So, get on board now because this train's leaving the station.

Mark Goodwin:

That's a great capstone, Mario.

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

Mark Roach:

Thanks for having us. We appreciate it.

Mario Tufano:

Yes. Thanks, Mark. Always a pleasure.

Diane Merritt:

Thank you for tuning into 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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Definitions of terms used in this podcast:

The **price to cash flow ratio** (P/CF) is a common method used to assess the market valuation of publicly-traded companies to determine if a company is undervalued or overvalued. The P/CF ratio formula compares the equity value (i.e. market capitalization) of a company to its operating cash flows.

Momentum is the rate of acceleration of a security's price—in other words the speed at which the price is changing.

A **basis point** is a unit of measure to describe the percentage change in the value or rate of a financial instrument. One basis point is equivalent to 0.01% (1/100 of a percent) or 0.0001 in decimal form.

Momentum is the rate of acceleration of a security's price—in other words the speed at which the price is changing.

The **CBOE Volatility Index, or VIX**, is a real-time market index representing the market's expectations for volatility over the coming 30 days. Investors use the VIX to measure the level of risk, fear, or stress in the market when making investment decisions.

Alpha represents the excess return of an investment strategy compared to its benchmark index, after accounting for risk.

The **CPI**, or Consumer Price Index, measures the average change over time in the prices of a fixed market basket of goods and services paid by urban consumers, serving as a key measure of inflation and economic health.

Compressed multiples in equity investing occur when a stock's valuation multiple, such as its price-to-earnings (P/E) ratio, shrinks because the stock price doesn't keep pace with or declines against earnings, or because the earnings decline faster than the stock price. This compression can signal changing investor

sentiment, reduced confidence in future growth, or a shift in macroeconomic conditions that make investors less willing to pay a premium for growth.

The **S&P SmallCap 600 Index** (S&P 600) is a stock market index established by S&P Global Ratings. It covers roughly the small-cap range of American stocks.

The **Russell 2000® Index** is a market capitalization-weighted index that measures the performance of the smallest 2,000 companies in the Russell 3000 Index. It's widely considered the benchmark for the U.S. small-cap market segment.

The **Russell 3000® TR Index**, measures the performance of the 3,000 largest U.S. companies based on total market capitalization, which represents approximately 98% of the investable U.S. equities.

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