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S1 00:07

Hello, this is Matthew Drvaric. Thank you for joining us this afternoon and welcome to the Riverwater Partners Q2 2022 webinar. All participants will be in listen only mode. To review the agenda for the call today, I will provide a brief firm update. Adam Peck, our co-founder and chief investment officer, will walk through the economic environment, address drivers of performance, and walk through the portfolio to discuss portfolio decisions during the quarter. Cindy Bohlen, our chief mindfulness officer, will discuss our current ESG efforts. After today's presentation, there will be an opportunity to ask questions. If you're at your computer, please submit your questions in the questions chat box located at the bottom of your webinar control panel. Please note this event is being recorded and replay will be made available. Riverwater Partners was founded in 2016 in Milwaukee with the mission statement to make the world a better place by growing wealth through sustainable investment. We are proud to be a signatory to the United Nations Principles of Responsible Investment, a certified B corporation, and 100% employee owed. The firm's unique differentiator is our approach to ESG in the small value space through focused portfolios of 20 to 35 homes. Our SMID Strategy is the only offering in the small value category with a five-year track record integrating ESG.

S1 01:34

Our team is proud to be recognized as Best for the World 2022 in the customers category among all 5,400 certified B corporations globally. This award recognizes businesses that set the standard for serving their customers. To achieve this recognition, Riverwater scored in the top 5% for the customers portion of the B impact assessment. We credit this award to our passionate team focused on delivering our firm's mission to clients. Additionally, the Future 50 program, established in 1988, recognizes fast growing, privately owned companies in southeastern Wisconsin that have been in business for at least three years and have shown significant revenue and employment growth. Brand awareness among institutional market is an important factor in the development of our firm and a factor that characterizes long-term success in a competitive market. eVestment publishes a quarterly report based on a metric connected to viewership in the database among asset owners and consultants. We are humbled to be ranked among the top 20 firms for the brand awareness in Q2 22 for emerging firms with less than two and a half billion in assets under management among both categories, consultants and asset owners. Riverwater was one of only eight firms represented on both lists for the quarter. We are committed to being recognized as an ESG leader in the small-cap community as our firm continues to develop. Thank you for joining us today. At this time, I will turn it over to Adam to share his thoughts on the market. Adam?

S2 03:12

Thank you, Matt, and good afternoon, everyone, and again, welcome. I'll quickly cover how we see things on the macro landscape, and then we'll provide an update on both the SMID and Micro portfolios. We say we're 80 to 90 percent bottom-up and 10 to 20 percent top-down thinkers. We've been thinking a lot about where we are in the economic cycles and how inflation and supply chain issues have and will impact our holdings. We focus on two main data points on the macro: the yield curve seen here and the initial unemployment point. We think these are the two data points with the best forward-looking track record. Here I'm showing the 10 year to 2 years treasury spread as opposed to the 10 to 3 month, which has not yet inverted, but by all accounts should invert after the next Fed meeting. Historically, after an inversion, a recession occurred 6 to 24 months later. It seems the market is betting on more of a six-month time period in this instance.

S2 04:07

The other metric we watch like a hawk is initial unemployment claims. When this metric increases by 20%, it has heretofore been accurate in calling recessions 100% of the time. We're coming off astronomically low levels, and so absolute increases make that 20% easier. So it's not a good sign that claims are now trending higher. As you can see, claims bonded in March at 171 and have risen today to over 250,000. The most discussed macro topic today is inflation. We're at levels last seen 40 years ago. And, as you can see on the chart, inflation has rarely been higher than it is today. Since World War II, there have only been two periods lasting no more than about six years in total with higher levels. And so, even with two negative GDP quarters and leading economic indicators rolling over, the Fed is forced to raise rates aggressively to combat rising prices.

S2 05:02

As you can see here, the three green arrows represent the three times the Fed engineered a soft landing. It's possible they could do it again this time, but the odds are not on their side. We think that inflation was caused by too much money chasing too few goods. Washington DC approved 6 trillion in stimulus in 2020 and 2021, and a good chunk of that money was spent while supply chains were snarled. M2 money supply peaked out at about 27% growth earlier this year. If you regress M2 to inflation but shift it back 13 months, which is the amount of time it takes to work its way through the system, there is a very high correlation with inflation of the CPI. So if this correlation holds, we should begin to see inflation growth slow over the next year. If inflation slows, the Fed should relax, and stocks and especially microcaps, should like that.

S2 05:56

So how does the macro impact the micro? Small caps are historically more volatile than large, and year to date has been no exception. This chart shows small cap performance after two negative GDP quarters, which is what we just had. You can see we're actually about at the average decline, and the only declines that are much worse was the great financial crisis and the bear market of 1973, 1974. The good news is that following two quarters of negative GDP, small caps have an average rate-forward returns, with plus 20% annualized returns going out three years. Additionally, we're at a very good time in the election cycle. Here you can see on the left, on the next slide, during midterm elections, the market does poorly leading up to the election, like this year. But post-election, in midterm years, actually is the best environment for small caps.

S2 06:54

To wrap it up, small caps are on sale. This chart shows the Russell 2000 price-to-earnings going back to 1987. Right now, it is close to one standard deviation below the average. So small caps have rarely been this cheap. And I can attest personally that I do not recall a time seeing so many high-quality companies with single-digit P/Es. Speaking of single-digit P/Es, here's our top five holdings in our spin portfolio. Three of our top five have single-digit price-to-earnings ratios. CNX, ATKORE, and StoneX. CNX Resources, our largest holding, trades around five and a half times earnings with a plus of 20% free cash flow yield, a solid balance sheet, and a very strong environmental profile. While they drill for natural gas, they're actually carbon negative, as they sequester the equivalent of 7.5 million tons of carbon per year by capturing methane and sending it through their system. Displayed here is our quarter and sector weights. We are pretty much in line with the bench, with a slight underweight in real estate and a slight energy.

S2 08:01 I will say that our energy weight was right in line with the Russell before the Russell reconstitution, but with the strong performance, half the companies moved over to growth, and the weight then dropped in half. We still like our two energy names, CNX and Talos, and intend to maintain where we are. Here we have our metrics, which again, are pretty tight to the benchmark. I'll point out that we do have a better return on equity with slightly better balance sheets, and so our companies look to be of better quality overall. Here's performance for the quarter, and we slightly beat. You can see that there was absolutely nowhere to hide in any sector other than cash. Every sector was negative in the quarter, with the best relative performance deemed the defensive areas, consumer staples, and utilities. Year to date numbers are basically no different. Here we are slightly underperforming. And with that I will pass it back to Matt.

S1 09:00 Thanks, Adam. Our mission and investment philosophy aligns well with high network families, foundations, and endowments that seek to use their investments to go beyond financial return. These clients all generally also share a mutual interest of limiting portfolio volatility. In the small cap value category, we have consistently been a leading manager in limiting portfolio beta. Since inception, we have delivered gross performance of 181 basis points through 6/30/22 with a 0.76 beta. We believe this is a function of our long-term investment horizon that allows holdings to mature from small to midcaps, coupled with our focus on businesses that meet our three pillar approach, which seeks to invest in superior businesses with exceptional management teams trading at attractive valuations. Returns are presented here, and we believe our process coupled with the ESG overlay creates opportunity for us to generate alpha over time. Adam, I'm going to turn it back to you to walk through the micro strategy.

S2 10:06 Thanks, Matt. So in the next slide, we show our top five holdings in the micro strategy. Two of our current top five received and accepted buyout offers in the last quarter. USA Truck more than doubled in June after announcing a deal with the German [inaudible] company, and Meridian Biosciences also agreed to an offer from a Korean competitor at a 30% premium. It's always good to see other companies attracted to portfolio companies as it indicates we hold both undervalued companies but also ones that hold strategic value to larger firms. We don't have strict sector constraints in the micro like we do in the SMID, but as you can see, we have exposure across all sectors and are within our maximum sector limit of 30%. Our metrics are for the most part tied to the benchmark, other than our weighted average market cap. If you compared us to the Russell Microcap benchmark though, we would be right in line on market cap. It was a rough quarter across the board for the micro strategy, but we did eke out gains on the next slide. In both utilities and industrials.

S2 11:14 The only reason industrials was positive was again due to the USA Truck buyout, which created over 200 basis points of outperformance. On the next slide we have the year to date figures, which are just more of the same. I will say that after deep downturns in micro, it does usually set the stage for strong future performance. And with that, I'll hand it back over to Matt.

S1 11:39 Great. The Micro strategy analysis shown is relative to the Morningstar small core tier group. Now, the strategy recently turned four years old at the end of July and has generated an exceptional capture ratio. Capture ratio is defined as up capture divided by down capture. Since inception on a rolling three-year basis, the strategy has been in the top of the peer group on this metric. As a reminder, our approach in this portfolio allows us to find businesses that are at cash flow, break even, or hitting that inflection point with business optionality. Some balance sheets and are starting their ESG journey in many cases. Studies have shown that companies with ESG momentum outperform their best-in-class peers. We want to be active owners, not activists, and believe our influence in these companies creates opportunity to provide competitive risk-adjusted returns. A review of the returns for the various time periods, I will turn it over to Cindy to review our engagement efforts for the quarter. Cindy?

S3 12:46 Thank you, Matt. And thanks to everyone for joining us today. During the first quarter webinar, we discussed our three pillar approach to incorporating ESG into our investment process, due diligence, engagement, and collaboration. Today, I'd like to describe our engagement practice in a bit more detail, and then I'll highlight some of our second-quarter engagement efforts. Let me start with the purpose of engagement. As active investors, Riverwater engages company executives and board members regarding environmental, social, and governance, or ESG policy and practice, with our ultimate goals being superior performance and increased impact over time. We seek collaborative engagement on the most salient ESG factors, allowing executives to prioritize and employ their expertise to effect meaningful change. Engagement can take several forms. First of all, we hold direct conversations with portfolio companies regarding ESG issues, trends, and efforts. We do this every time we meet with company executives.

S3 14:02 We write to portfolio companies regarding ESG issues, and we offer tools and advice for them to begin and stay on the ESG journey, because it is a journey. We have the ability to write or join shareholder resolutions. This is a policy-- or this is a practice we have not undertaken with any small companies as we view it as a little bit more combative. We much prefer to work in partnership with companies and really would only use this as a last resort. We vote proxies according to our proxy voting policy, which favors management and shareholder resolutions that align with our ESG views, and we write to boards of directors when we vote against them. We advocate for public policy that favors a focus on and adherence to ESG factors, and we provide educational outreach to the marketplace via talks at universities, serving on panels with NGOs, and being at conferences where we share our expertise as well. And all of this engagement is done in a collaborative and educational approach which really brings executives to the table. It makes them understand that embracing a focus on ESG can help their employees, customers, the environment, which ultimately all help their business. And again, we're looking for opportunities to generate meaningful impact.

S3 15:42 Next slide, please. So let me talk a little bit about some of our engagement highlights during the second quarter. So the first example here was an example of collaboration with issue experts. We signed onto a letter written by the Heartland Initiative and in partnership with other socially responsible investors, calling on companies to respect human rights in relation to the crisis in Ukraine. And while this letter was sent largely to large-cap companies who have a significant business presence in the Ukraine, those companies often rely on smaller companies, the types of companies we own, in their supply chain. And so the practice we outlined in a letter like this trickles down to companies we might actually own. And that's why we collaborate with other investors and thought leaders in educational practice like this. Another engagement we undertook during the quarter related to public policy, we submitted a comments letter to the SEC regarding their proposal to enhance disclosure requirements for corporations on climate-change risk. And we were in support of this enhanced disclosure, including measurement and recording of greenhouse gas emissions.

S3 17:11 We suggested a phased-in approach because this is a big lift for companies, particularly as it relates to Scope 3 emissions because Scope 3 emissions are someone else's Scope 1 and 2 emissions, much harder to measure and track. But we were in favor of this because we believe in a system-stewardship approach to ESG. And what that means is we understand that a lot of these ESG topics and factors, whatever you want to call them, have the ability to pre-risk for companies and the economy overall. And so it's important that all companies pay attention to it so that no company is creating a lot of externalities that negatively impact the economy and all companies' performance over time. And climate change is a very significant risk and poses a lot of externalities that has the ability to bring down returns for companies, in general.

S3 18:19 The next four engagements were with companies, specifically. So the first one I'm highlighting is Accor which is a SMID-cap holding. And we had a meeting with the CEO, CFO, and investor relations people in our office recently, and they were interested to learn about our thoughts on their current ESG focus. They had published an initial sustainability report and wanted to know what we thought about it, given the fact that we're responsible investors. And we bought this company knowing what they had already done and seeing how robust their practice and reporting was. And so we shared with them our accolades for some of the areas they had begun to put in practice, the important topics for their business. And we then turned to an area of improvement, which for this company was really a focus on measuring and reducing their greenhouse gas emissions. And so we shared with them the Task Force on Climate-Related Financial Disclosure, TCFD, Guidelines for Reporting and Measuring and Reducing Greenhouse Gas Emissions. And this is the type of educational outreach we do to companies to help them get on board and make improvements. Even a company like Accor, who is already doing quite a bit, has room for improvement.

S3 19:52 And so they gladly accepted this framework to use as they embark on this journey BlueLinx is a company that is in the building materials space. And we had a dialogue with the CEO, CFO, and investor relations about their business. And we suggested a focus on their supplier, environmental, and social practices given the nature of their business. And we shared with them information again on why a focus on ESG is important and tools for looking at this. And BlueLinx is a company we don't own yet, but whenever we meet with company management at conferences or in our offices, we always have this dialogue with them, and we are happy to share with them information so that they can begin or move along the ESG journey.

S3 20:52 Harvard Bioscience is a healthcare name in our microcap strategy. And this is a company that we have owned for a couple of years. And we wrote to the company--wrote to the chairman of the board who is also the CEO because we voted against him for reelection on the proxy. And we voted against him because, in our view, best practice for governance is separation of the chair and CEO roles. The CEO's job is to run the company. The chair's job is to oversee the board. And we believe that the best governance comes when those two roles are separate. And so we wrote to him about this, and he wrote back and said he'd like to talk with us about our rationale and why he thought it's okay to keep them the same. And so we had a good dialogue with him and we understand that given where Harvard Bioscience is in its life stage, having those roles be combined is not atypical. But we suggested to him that they strengthen the role of the lead independent director, that they eliminate their staggered board. And as the company grows and matures, they look to separate those roles. And then, we took the opportunity to discuss with him Harvard

Bioscience's general ESG practice and shared again with him information about why it's important and tools to help them really get started on this journey.

S3 22:27

Anika Therapeutics, another name in our microcap portfolio, had just published their first sustainability report, and we were having a dialogue with the CEO, CFO, investor relations about the business. And we acknowledged their ESG efforts in their report, particularly, the fact that they had begun with a materiality assessment, which is an exercise a company goes through to understand what are the factors, the ESG factors that are most salient to their stakeholders, their customers, their employees, the environment, shareholders, and what factors are most important to the company, its profitability, and you lay it out on a matrix and that should guide your efforts toward those most salient factors. And so they had done that, and that was a great place for them to start.

S3 23:23

We appreciated their water stewardship efforts, some of their cultural efforts, and then again, we introduced the idea of beginning to measure and report on their greenhouse gas emissions, given how important that topic is. And we shared with them the TCFD framework and suggested that they get started on that. So as you can see from this, we have this collaboration type engagement policies and practices. We engage on public policy, and then we have company-specific engagements, sometimes that are specific just to a company and sometimes that are more topical like greenhouse gas emissions which is a topic we are engaging with almost every company we're talking with these days, just because it's such a critical issue, and it has the potential to affect every company out there. So we also send these educational materials and offer our consultation to companies we don't own or maybe don't even intend to own, again, with the idea that it just helps all companies in the world if more companies are getting on board with this. So after doing this, we have learned that companies appreciate this collaborative approach, and our goal is always to educate management, share tools, and offer this consultation. We track and report progress in our annual sustainability report on all of our efforts. And then we're just looking to move companies along the journey of ESG, which was the theme of our most recently published sustainability report. So thank you very much for your attention, and I'll turn it back to Matt.

S1 25:06

That was a great update on the market environment, our strategies, and engagement efforts. At this time, we welcome any questions. We received a question earlier. "Are there any themes that the firm is focused on across both strategies?"

S2 25:22

Sure, I can take that, Matt. So when you look back to our sector weights versus our benchmarks, you can recall there weren't any major divergences, and so I would say, overall, we haven't taken any large bets from a sector-theme perspective. It's not like we are putting our heads in the sand thinking the economy is going to fall apart, and so we're only buying utilities and staple stocks. We're pretty much broadly diversified across all economic sectors. The only major theme, I think, that initially comes to mind is that, as I said earlier, in my entire career, I can't remember so many high-quality companies that aren't in commodity businesses with key-price earnings ratios this low. I'll use an example of a company of about earlier this year, which is Crocs. I think most people are probably familiar with the shoe. You either love it or you hate it. I happen to love them, but it has historically grown very fast and has traded at a multiple of earnings of roughly 20 times, going back 10 years. They did make an acquisition, and so they took a little bit of debt on the balance sheet, but we think it's very manageable. And today, the stock trades at roughly 7 times earnings.

S2 26:44 So do I think it's possible for a company like Crocs to get back to 20? Yeah, I think it's possible. Is it probable? I don't know. But if they can just get back to a market multiple, say, of 14 times earnings, the stock should double, and that doesn't even include if they can increase their earnings. So I think, as I said before, as an example, in our Smith portfolio, of the three companies that have single-digit PEs, one, Cindy discussed, ATCOR, trades at around 5 times earnings. CNN's resources trades around 5 times earnings, and Crocs is at 7. So I think there's a lot of value in the market. The market, like I said earlier, again, needs to get through the election, I think, to have that uncertainty gone. But I think by that point, hopefully, we will start to see inflation rolling over, which, maybe, the Fed won't be done raising. But the market anticipates the future, and the market has already anticipated a normal recession. I think by the end of the year, the market will anticipate the Fed to end increasing interest rates, which will, again, be good for stocks and in particular, small-cap stocks.

S1 27:48 That is all the questions at this time. Thank you, Adam and Cindy. To conclude the call, we are passionate about small-cap ESG investing and are proud of the brand recognition for serving our clients. We are excited about the future of the firm and welcome your consideration as a manager. Additional data on the strategies can be found in eVestment, Morningstar, and Investment Metrics databases. If you have additional questions or would like to speak directly with a member of our team, please contact me. We look forward to talking with you again next quarter. Enjoy the rest of the summer.