Transcription details:

Date:	03-May-2023
Input sound file:	audio_only.m4a

Transcription results:

S1 01:14 Thank you for joining us. And welcome to the Riverwater Partners Q1 2023 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 cofounder and chief investment officer, will discuss current ESG perspectives and review the strategies performance for the quarter. Cindy Bolin, our chief mindfulness officer, recently published our 2022 sustainability report and will provide context on how Riverwater practices responsible investing through sustainable investing. After today's presentation, there will be an opportunity to ask questions. If you are 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 the replay will be made available. I am proud to share our firm has continued to grow throughout various market cycles and turned seven years old this past April. We are in a strong of a position as we have ever been and I am excited about the future of our firm. Riverwater Partners was founded in 2016 in Milwaukee with a team today dedicated to the mission statement, "To make the world a better place by growing wealth through sustainable investing." We are proud to be a signatory to the United Nations principles of responsible investment, a certified B corporation, and 100% employee owned.

S1 02:32 The firm's unique differentiator is our approach to ESG in the small cap universe, which we believe contributes to lower volatility and offers a complimentary perspective as a portfolio diversifier to small cap peers. With anti ESG rhetoric in the political environment, media, and among investors, I will turn it to Adam to discuss why implementing ESG analysis should be required to meet fiduciary obligation. He offers a unique perspective, having practiced traditional analysis on behalf of a multi-billion dollar fund for 10 years prior to starting Riverwater and committing to improve his investment philosophy. Adam.

S2 03:10 Thank you, Matt, and good afternoon to everyone. So I will cover our small cap overview and both of our small cap strategies. I will begin with some recent data on ESG performance. Companies have increasingly focused their attention on ESG issues over the last 10 years. This attention can be measured by both the assets going into ESG financial products and the number of companies adopting ESG practices. You can see here that over 96% of S&P 500 companies published sustainability reports in 2021. That number has risen for 10 straight years every single year. There's still not reliable data for small caps in the Russell 2000. But we think the trends are the same. You can see here the data for the Russell 1000 and where the bottom 500 stocks in that index fall is purple. And just the last year, the percent of companies reporting left from 49% to 68%, the largest jump in the short history of the data being tracked. The reason I want to share some recent findings is that there has been a growing political backlash against ESG. Utah's state treasure this past march referred to ESG governance and to the United Nations Act sustainable development goals as Satan's plan.

S2 04:34 This year, state legislators have found roughly 99 bills restricting the rise of ESG business practices up from 39 in 2022. But the backlash has not been supported with data. And I would argue if states were successful in banning ESG-driven investors from managing their money, you will find it increasingly difficult to own any public company as just about all are going to be adopting and improving their ESG policies and practices. How bad really is it to analyze the company's operations, strategy, capital allocation framework, the competitive dynamics, valuations, plus a myriad of other variables, and then also through in how they impact and are impacted by their environment and communities in which they operate. Well, we think not that bad. We've repeatedly pointed out that the KLD 400 has outperformed the S&P 500 over the last 30-plus years as being statistically significant and proof that a company's focus on ESG can enhance returns. This slide shows the KLD 400 outperforming the S&P 500 by an average of more than 30 basis points per year.

S2 05:52 We've also referenced meta-studies analyzing 2000 academic studies that have concluded there is not a cost that must be bored to invest with an ESG lens as 90% of strategies perform inline or better than traditional strategies alone. We wanted to point out a new study. Yes, it would be helpful to have a background in stats to fully appreciate the data here. So ISS-ESG governance insights recently published a study that explores the relationship between a company's ESG performance and its enterprise value. ISS is a leading provider of corporate governance data covering 48,000 shareholder meetings and delivering proxy research for clients with more than 12.8 million ballots. The study finds that firms with stronger ESG performance have higher evaluation ratios highlighting the importance of ESG efforts and contributing to alpha. It was a large global sample with over 3,000 companies observed over a five-year window from 2017 to 2022. It controlled for a company's size, industry, and country of domicile. So this study supports our belief at river water partners, and it emphasizes the potential for companies to add value and contribute to alpha through their ESG efforts.

S2 07:17 Okay, let's move on to the portfolios starting with the sustainable value. We've got our top five holdings. Our top names are all up in the first quarter by an unweighted average of 13.5%. Our 30-stock portfolio tends to have most position sizes start around 3%, the most common way. To get into the top 5 is by growing, not by starting out as a larger position. The five

stocks represent four different sectors and five different industries. We are all bullish on believing they are positioned well for economic volatility ahead and are all on average still undervalued. Our top three holdings trade at an average PE ratio of 8.9 times forward. A large discount to the market. On the next page, we've got our sector weightings. And I'll remind everyone that we try to stay within 5% of our benchmark's sector rates and have a hard and fast limit at 10. Today, the largest underweight is in real estate at roughly 7, and the largest overweight is in consumer staples at 6. Outside of those two, we have no major deviations from the benchmark.

S2 08:23 So what can we say? Who doesn't like to eat? Guess we jumped ahead a little bit early, but our consumer staples holdings are Smuckers, a leader in PB&J, and Limoneira, a less well-known company, but a leader in lemons. Limoneira means lemon tree in Portuguese, and the company has been around since 1893, the same year that the diesel engine was invented, so they've got some staying power. Now on to the next slide. You can see we align pretty closely to our benchmark on just about all metrics, with the only major deviation in ROE, where we have higher quality companies with return on capital about double the market's average. We do have higher P/E ratios, but they are driven by a couple of triple digit P/E companies that are either cheap on a cash flow basis or are net asset value [placed?]. Limoneira is one of them. Limoneira currently trades at 562 times earnings. The reason we like it though is because the value of their land and extensive water rights in the west are worth more than two times the value of where the stock trades today. Every company we own is forecast to be profitable in the coming year.

S2 09:32 On to attribution, we outperformed in the quarter and the largest contributor was [Atkore's?] second quarter in Rome. [Atkore?] is the number one or two player in the electrical conduit market for commercial buildings. It's super cheap at less than eight times earnings, with a great management team and a positive growth outlook. First Solar came in a close second. They are the number one domestic producer of solar panels and are a beneficiary of the IRA legislation passed last year. The company has grown to be one of the largest companies in our benchmark and we used this strength to trim the position in the [quarter?]. Our two worst performers were Cullen/Frost and Talos Energy. Cullen/Frost is the only bank we own. It was dragged down with the rest of the sector on the collapse of SVB Bank, Signature, and [inaudible]. We are [underweight the banking industry?] and this contributed to why financials were our best performing sector on a relative basis. Banks are becoming attractive on a price-to-book basis. All else equal, a bank should trade at one times its book value or the value an investor would receive if the bank was liquidated. Dozens of banks now trade below one times book.

S2 10:42 Today's banking turmoil is quite different from what we went through in the great financial crisis. We explained why in more detail in our latest quarterly letter. Bottom line is we don't expect another great financial crisis. But we also think it will be tough sledding for a while. We will certainly look to add to the industry where we can see both an attractive valuation and positive future fundamentals. Over the last 12 months, we've beaten the benchmark by over 11%. The aforementioned First Solar led the way. The top detractor was Hannon Armstrong. We made the decision to sell Hannon after owning it for three and a half years. We were uncomfortable with the accounting and decided to reinvest into a more stable [reap?] that has a 32 year track record of dividend increases. And with that, I will pass it back to Matt.

S1 11:32 Thanks, Adam. The performance factor that often stands out relative to the small value peer group and [inaudible] is the portfolio beta of the sustainable value strategy. In the category, we have consistently been a leading manager in limiting portfolio beta as illustrated by this graph, which places us among the lowest beta strategy. Since inception, we have delivered outperformance over year to date, one, three, five, and since inception period. With a since-inception beta of 0.77. We believe the low volatility is attributed to two factors. One being investors with a long-term horizon that allow small caps to mature into midcaps. And two, investing in high-quality small-cap companies that are focused on mitigating idiosyncratic risks through ESG practices or are able to realize opportunity as a result of their position in the market. Integrating ESG data is not as prevalent as further up the market cap spectrum, which presents opportunity for our team to exploit inefficiencies and identify truly quality businesses. We proudly conduct our own ESG research and are regularly updating our proprietary small-cap ESG database. As we come into our seven-year track record on this strategy, we have outperformed by about 370 basis points gross since inception and offer competitive fees as we are early in our firm's development. I will note with the new marketing rule, the net of fee returns are based on the highest fee schedule that can be applied at 1% for retail clients. Adam will walk through our micro strategy. Adam?

S2 13:10 Thanks, Matt. So we'll start off again with the top five holdings in the micro. All five have grown to be here and are still cheap in our eyes. The average PE ratio excluding Lumenera is 10.4 times, and as we said before, we believe that Lumenera is undervalued based on their significant real estate and water holdings. You'll notice that we do own Lumenera in both portfolios. We typically have a [inaudible] names in both. We have both a higher conviction and the sizing works. Today, we have four companies that overlap between the two. Moving on to sector rates, we don't have any hard sector constraints in the micro for each sector only that no one sector can represent more than 30%. The closest we come here is industrial at a current 19.6% rate. On the next slide, you can see our metrics are fairly in line with the benchmark, the Russell 2000. I would note that we do consider the Russell microcap as our main benchmark, but due to licensing issues, we can't show that to you. Our weighted average market cap would be in line with the Russell micro benchmark. Moving on to attribution, we outperformed in the first quarter driven by positive stock selection. [Perion?] and [inaudible] were our top performers. They're both still very attractive in our eyes. We think both have positive fundamental outlooks and both should trade at higher valuations. Our worst performers were First Western, First Internet, and First Business. The main problem with these companies was they all have first in their name. No, they were all down because they are banks.

S2 14:45 As of yesterday, they all traded way below their stated book values of 0.59 times for First Western, 0.86 times for First Business, and 0.31 times for First Internet. We do not think any of these banks are at risk of insolvency, but again, the outlook is poor for the industry and micro-campaigns can be volatile when there are more sellers than buyers. As you look

over returns for the last year, you can see at the top we've just slightly outperformed. All three best performers were bought out last year and none remain in the portfolio today. On the downside, the largest negative contributor is in the healthcare space, Harvard Bioscience. Harvard manufactures products that enable research testing and the development of drugs. They had major supply chain issues which hampered the results last year. Those issues are now behind them, and the stock has reacted quite well subsequent to this past quarter's end, rising 100% from its lows this past March. It's been a volatile market for all asset classes, but I'm happy with how most of our holdings have performed. I feel confident in our company's outlooks for the future and with that, I will hand it back to Matt

S1 16:02 The microstrategy analysis shown is relative to the Morningstar small co-peer group. The portfolio is designed to carry a little more volatility as we will purchase companies as small as $50 million in market cap and hold as they mature up to $2 billion. Our approach in this portfolio allows us to find businesses that are at cash flow breakeven or hitting that inflection point with business optionality, sound 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 as shown by the rolling three-year Sharpe ratio in the top quartile since inception. Next slide, please. Like the sustainable value strategy, the micro-opportunity strategy has delivered outperformance against the Russell 2000 over all presented time periods. As Adam said, ideally we would bench this against the Russell micro-cap index. I will turn it over to Cindy to review the highlights from our 2022 sustainability report.

S3 17:20 Thank you, Matt. Today I'm going to talk about how Riverwater practices responsible investing using its sustainable investing framework. I'll also discuss our impact by sharing highlights of our 2022 sustainability report. As Adam discussed earlier, as a fiduciary, Riverwater is bound by two primary responsibilities. Loyalty, a fiduciary must act in good faith in the interest of its beneficiaries, and prudence, a fiduciary must act with care, skill, and diligence, investing as any ordinary prudent person would do. Prudence requires taking a long-term view of all factors that may impact returns. Sustainable investing recognizes that these include company-specific factors such as revenue growth and profitability, as well as macro factors such as an equitable society, environmental resilience, and sound governance, all of which have the potential to affect the overall economy and individual company profitability and therefore portfolio returns. In short, sustainable investing is responsible investing. This slide shows that according to the 12th United Nations Global Compact Accenture CEO Study, CEOs recognize that social and environmental factors have the potential to materially impact their businesses.

S3 18:58 Again, these factors are deemed material by CEOs. They do not represent Riverwater's own social agenda. Therefore, we uphold our fiduciary duty of loyalty by giving them attention. It's not hard to understand how factors like talent scarcity, climate change, or trade regulation might meaningfully impact company profitability and stock performance. This is the graph Adam showed earlier, and it demonstrates how sustainable investing with its attention to salient ESG factors helps avoid risks and realize opportunities presented by the constantly changing environmental and social landscape. This makes it unsurprising that investment managers that focus on sustainability tend to outperform their peers financially. As fiduciary we believe one must consider ESG factors as part of a responsible investment process. Now, I'd like to share with you the sustainability impact of our responsible investment process during 2022. As a reminder, our process has three pillars: due diligence to understand a company's current ESG efforts, engagement, allowing us to help with companies improving on their sustainability efforts, and collaboration to inform our practice and partner and engagement.

S3 20:38 These donut graphs depict the percentage of our portfolio holdings that had efforts in each of the ESG categories we look at during 2022. We use due diligence to uncover these efforts. This can include dialog with management, looking at sustainability reports, and working with ESG thought leaders. I'll share with you here that we have recently made our ESG scoring system more gradient. When we created our scoring system seven years ago, many companies had not yet begun reporting on their ESG efforts as indicated in the slides Adam shared with you earlier. Seven years later, the majority are now doing so. In order to capture the more varying layers of effort, we needed to change our method. By example, in our old system, stated intentions about greenhouse gas emissions merited a whole point. Today, that would merit a quarter of a point, with additional quarter points being awarded for measuring and reporting, goals for reduction and progress toward these goals.

S3 21:53 We expect scores for most of our companies will initially decline under the new system because it's more difficult. And that they will improve over time as companies further adapt policy and practice relative to these factors. One thing that hasn't changed in our scoring method is the awarding of points for a company's business by its very nature offering a social or environmental good. This graphic shows the portion of our investee companies whose businesses seek to achieve one or more of the SDGs. An example would be first solar, a solar panel maker whose business is 100% dedicated to clean energy, which is goal number seven. Our second pillar is engagement, through which we promote improvement on attention to ESG factors. Note that during 2022, 44% of our portfolio companies had an improved Riverwater ESG score. As Matt mentioned earlier, this ESG momentum is more highly correlated with alpha generation than a higher absolute score. The graphic on the right shows the various stakeholders CEOs look to for help navigating the environmental and social factors relating to their businesses.

S3 23:19 Today, shareholders are valued by a third of CEOs and note it has grown over time. Our specialization in small cap investing means we meet a lot of companies that are early in the ESG journey. We work in partnership with them, providing information about how sustainability can positively impact their business, and offering tools for the journey. During 2022, 11 companies began reporting on their sustainability, many because of the guidance we gave. On this page, we show the results of our proxy voting during 2022, and proxy voting is one of our engagement efforts. We vote all proxies in favor of management or shareholder resolutions that align with our ESG views. During 2022, we voted against management 19% of

the time. The majority of these against votes were for governance issues, primarily board chair, CEO roles, not being separate, and also say on pay, where incentive comp was not aligned with long-term value creation. We also voted against 1% of environmental proposals and 4% of social proposals. We did write to directors when we voted against them. The graphic at the bottom of this page shows how our engagement efforts during the year aligned with the SDGs. So for every engagement effort, we seek to have improvement on one of the UNSDGs.

S3 24:59 The third pillar of our sustainable investment framework is collaboration with thought leaders to inform our practice and partner of engagement. This slide shows the partners we currently work with. During 2022, we letters seeking to inform sound public policy. We wrote to the SEC on climate change disclosure in an effort to strengthen corporate disclosure on this factor which has the potential to materially impact businesses. We also wrote a comments letter to the SEC regarding ESG labeling by investment advisers, which seeks to enhance representation of the various approaches used by ESG advisers and funds to allow investors to make informed decisions about how their assets are managed. On the last page, we're highlighting our thematic focus on water stewardship. Here we discuss the importance of water stewardship to mitigate risk and realize opportunity by companies and to ensure access to clean water for all. We value our relationship with the water council, a Milwaukee based and globally recognized expert in all things water. Listed here are six of our portfolio companies for whom water is a key input in which we are engaging on the importance of water stewardship. [Riverwater's?] 2022 sustainability report is available on our website if you're interested in learning more about our responsible investment practice and our sustainable investment impact. Thank you.

S1 26:43 Thank you for the update on the strategy, Adam, and Cindy for all your work on pushing our portfolio companies to improve. At this time, we welcome any questions. We did receive a question earlier. Adam, could you just explain why you do not believe that this is the next financial crisis?

S2 27:04 Great question, especially when the bank index was done over 6% yesterday, is trading pretty much in line with the lows that we hit during COVID in the early ends of COVID. So not a 100% probability that I'm actually correct here. But I don't think it's the next great financial crisis because the major reason is I still feel like it's so fresh in bank management's minds that hopefully prepare-- the average bank is prepared for rough seas ahead. And one of the main factors that occurred in the last financial crisis were capital levels were too low. So capital levels are much higher this go around. And in the last cycle, you did have a bubble in housing, which was a major asset on banks balance sheets. So you could argue today there's a bubble in commercial real estate. Although, if there is one, I don't think it's to the same degree as we had in residential housing. And then the other bubble that you could potentially point out is in the fixed-income market. I'll call it a low-interest rate bubble. I mean, the banks that have gone out of business in the last month, they've all been very large. I think it's ended up being the second, third, and fourth largest banks to go under in the history of the republic.

S2 28:42 But I think those banks, for the most part, are all-- are very different from your average community and regional bank and even super-regional. Because those banks, Silicon Valley, Signature, and First Republic, just recently-- one, they were all very focused in attracting wealthy clients who would end up depositing large sums of money, which ended up being uninsured. So the uninsured-- and Matt, cut me off if I've drawn out too long on your answer here or whoever's ever questioned this was. FDIC insurance is at [$250,000?]. A lot of these wealthy clients [wouldn't?] put $10 million into a bank account that was essentially earning zero. Once they start to get nervous and they pull their deposits out, it could potentially create a deposit run. And that's what happened at Silicon Valley. That's what happened at First Republic. These customers really have no loyalty because they don't want to-- they don't want to lose all their money. Most banks don't have concentrations or 90% of the deposits are uninsured like the last three did.

S2 30:04 Also, those three banks did have a high concentration in the technology sector, so there weren't-- they weren't as properly diversified as they should have been. And what really put them under was horrific [Alco?] management or asset liability management. So banks obviously make their money-- it's a spread business. They make loans at a certain rate, and they want deposits to be at a lower rate and they earn the difference. Well, they made a lot of fixed-interest rate loans and bought a lot of fixed-interest rate securities at very low rates. And so when the Fed has raised short-term rates - there were roughly 500 basis points, the fastest rise in pretty much our lifetime - their fundamental business model got-- went upside down. So it's important when looking at banks to make sure that they've properly balanced their assets and their liabilities. And I think the ones that obviously have gone out of business did a-- did a very poor job, and I think are in the minority. And so I don't believe the average bank looks like them and therefore, that's why I don't think they're entering another great financial crisis.

S1 31:18 That's great to hear, Adam. Thank you for that. And that is all the questions we have at this time to conclude the call. We are passionate about Small-Cap ESG investing and believe these factors are crucial to help minimize portfolio volatility through maintaining positions in high-quality businesses that endure market cycles. We are excited about the future of our firm and welcome your consideration as a manager. Additional data on the strategies can be found in eVestment Morningstar investment metrics, PSN, Mercer and Callen databases. If you have additional questions or would like to speak directly with a member of our team, please contact me. We will look forward to talking with you again next quarter.

[silence]