Transcription details:

Date: 09-Nov-2023

Input sound file: GMT20231109-184611_Recording.m4a

Transcription results:

00:00 Good afternoon. This is Matthew Drvaric. Thank you for joining us. And welcome to the Riverwater Partners Q3 2023 webinar.

00:31 All participants will be in listen-only mode. To review the agenda for the call today, I will discuss I will provide a brief firm update. Adam Peck, our co-founder and Chief Investment Officer, will discuss performance for the strategies and walk through our second pillar in the investment process, exceptional management. Cindy Bohlen, our Director of Responsible Investing, will review engagement activity for the quarter. 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 the webinar control panel.

01:04 Please note this event is being recorded and a replay will be made available. River Water 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. River Water continued in the quarter to mature as a leading emerging manager.

01:35 The firm is proud to welcome Tito Pombra as Chief Compliance Officer. Tito joined the firm during the quarter. His background includes over 30 years of Global Investment Advisor Compliance Experience. He is the former Chief Compliance Officer for Matthews Asia Fund, where he spent 14 years and prior to that worked in various compliance roles for Franklin Templeton. Further, we are proud to share the pending launch of our CIT in the coming weeks through SEI. A founder share class will be established and offers a compelling opportunity to partner with our firm.

02:06 We welcome your consideration and are happy to share details upon request. I will turn it over to Adam to review the positioning of the strategy further. Thank you, Matt, and good afternoon to everyone. So I'll cover both our small cap strategies. Then I'll end our discussion by explaining what we look for in exceptional management teams, the second pillar of our research process. You can reference our last quarterly letter call for a review of our first pillar, superior businesses.

02:33 So starting with the top five for a sustainable value strategy. Four of the five were here last quarter. The only change is that Grand Canyon lept ahead of Technoglass. Technoglass's stock has been weak recently with the rise in interest rates. I'll discuss its contribution in a few slides. Grand Canyon has been in our strategy since day one, and in its most recent quarter, posted nice results. Our 33 stock portfolio tends to have most position sizes start around 3%.

03:00 The most common way to get into the top five is by growing, not by starting out as a larger position. The top three all had strong absolute and relative returns over the last year. Our top five holdings traded an average P/E ratio of 12.98 times, and three of the five are under 11 times earnings. Here we've got our sector weights. And I'll remind everyone we try to stay within 5% of our benchmark sector weight and have a hard and fast limit at 10.

03:30 Today, the largest underweight continues to be in real estate at 6, as well as materials now at 6.4. We sold our only material holding in the past quarter. It was FMC Corp. We had owned FMC for the last seven years and since strategy inception. It had been a standout performer, and we actually did sell it at a game. We sold because we became concerned with the patent clips they are facing on lead products and felt it was best to allocate capital elsewhere. Though at the right price, as it is declining now, we could own it again.

04:00 Materials can be a tough sector for us as it's predominantly comprised of companies that are commodity in nature. We have a handful of names on our watch list and would expect a purchase in this sector sometime over the next few quarters. Areas we're interested in in materials are aggregates, specialty chemicals, and specialty metals. Our real estate underweight is likely to continue for the future as we don't expect the sector headwinds to ease. Largest overweights are in consumer staples and technology.

04:29 We were not happy with Smucker's purchase of hostess brands, which is one of our staples names. We haven't sold it yet, but thinks Staples is likely to be a source of capital. Technology was hit hard in 2022, and we are adding to industries in technology where we think the cycle has bottomed and is inflecting upwards. Think semiconductors. Here 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 returns on capital about 77% higher than the market's average.

05:05 We focus on quality companies that earn their cost of capital and have conservative balance sheets. Every company we own is forecasted to be profitable in 2024. We slightly outperformed in the quarter and the largest contributor to that with CNX resources. CNX is a natural gas producer based in Pittsburgh with operations in the Marcella Shale. They hedge almost all production to take volatility out of natural gas pricing out of their P&L.

05:35 This allows them to consistently generate free cash. They've generated free cash for the last 14 quarters and have used it to buy back 30% of their outstanding shares. Even though the stock trades at a double-digit free cash yield, Wall Street could care less. Only two of the 15 analysts that cover the stock rated a buy. We think there's plenty of opportunities for ratings upgrades once the street figures it out. They are environmental leaders.

06:03 They have the lowest methane intensity basin in the country and have goals to lower their intensity by 50% from 2021 levels by next year. They end up capturing waste methane from nearby mining operations, which helps them to be greenhouse gas negative in their operations. Technoglass was the largest attractor to performance. I think it's just having a breather after being a top contributor for much of the last year. Tecnoglass currently trades at only eight times earnings with sales growth of 18% over the last five years and capacity to continue growing.

06:35 They have a rock solid balance sheet at only 0.2 times net debt to EBITDA. We think they can maintain growth even in a slowing housing market as they take share from higher-cost competitors. We recently met with the CFO and came away confident in their ability to execute their expansion into the residential market. Specifically, they're now launching a new vinyl window, which we think will expand their total addressable market by over 50%. Over the last 12 months, we've beaten the benchmark by over 9%. Our largest holding Atkore led the way.

07:06 Atkore is a value stock. I repeat Atkore is a value stock. It trades for less than eight times earnings for both this year and next. It has an under-levered balance sheet, generates significant free cash flow, and has high returns on capital. According to both investment and Morningstar, it is not a value stock. I believe the reason it gets classified that way is because, one, they don't pay a dividend, and two, they have high returns on capital. Those two factors have a 25% weight on the value side.

07:35 And additionally, three, they've increased their sales at an average annual rate of 21% over the last five years. To me, the price you pay for earnings and cash flows determines if a stock is a value or a gross stock. If there's a hill I'll die on, it's that Atkore is a value stock at 7.7 times earnings. Technoglass, by the way, is also a growth stock according to Morningstar. Cullen Frost was the largest attractor. It declined along with the entire banking sector.

08:07 You can see above to the left that on a sector basis, our strongest active sector return was financials. This was due to our bank underweight, as well as strong returns from non-bank financials like Farmer MAC. Now, here we have our strategy compared to the benchmark, the Russell 2500 value, segmented by numerous factors on the bottom, which might be too small to see. But moving from the left to the right, the volatility factors in green and the white bar across the top would be the average.

08:37 We're less volatile than our benchmark. Since inception, the portfolio has a beta of 0.77. Momentum is an orange. And by momentum, they specifically mean the three-year price change and the one-year price change. Yes, we try to buy stocks that go up. Valuation is in pink, and you can see we are a good bit below the benchmark other than price to book. Price-to-book, we pretty much don't look at for most companies. We don't think it's a relevant metric other than for banks. Growth is in blue.

09:07 Again, we want our companies to grow their sales and earnings, but we will not overpay for that growth. And finally, purple on the right is quality like ROE and ROA. And here we are superior to the benchmark. What I want to convey is that often data providers will classify us as core. But as you can see on a valuation basis, we definitely screen value. Again, we want to own quality companies with good balance sheets and high returns on capital that can grow their business. But we have to pay a fair price for these qualities.

09:38 And with that, I will pass it back to Matt. Thank you, Adam. I think it's an important factor to share this chart because what it shows is the monthly rolling three-year returns of the Russell 2,500 value minus the Russell 2000 value. An important characteristic of the portfolio is that it is able to hold onto its winners over the long-term period.

10:04 The dashed line is the average performance on a rolling monthly three-year period that the 2,500 value outperforms the Russell 2000 value. In fact, the 2,500 value outperforms on average by 64 basis points when compared to the Russell 2000 value. And it does so 70% of money. Next slide.

10:35 The Riverwater Research Team of four has a combined experience of over 65 years in institutional money management and has delivered consistent outperformance relative to the strategy benchmark, the Russell 2500 value. Illustrated here are monthly rolling three-year returns for the River Water Sustainable Value Strategy. The strategy has outperformed the benchmark 89.8% of the time back to inception in September 2016.

11:02 We are often asked what is unique about our approach. We seek to find quality companies that have value to be unlocked through evaluating material ESG factors, holding on to our winners, and maintaining the concentrated portfolio that owns unique assets in each sector, all through consistent application of the three-pillar approach. In fact, using the small cap Morningstar separate account universe, only 37 products out of over 700 total small cap strategies have assets greater than 30 million with turnover less than 40% and less than 40 holdings.

11:38 We have averaged 25% turnover and 30 holdings since inception. With the strategy turning seven years old, it maintains the longest track record in small value integrating ESG factors. We are proud of these results, which have generated outperformance to the benchmark by 309 basis points, gross of fee. And as Adam said, with a beta of 0.77 since inception through the end of the third quarter. Performance for the strategy presented here and offers competitive performance across each period.

12:11 I will note, as I always do, that 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, we'll walk through our micro strategy. Thanks, Matt. So on the next slide, we have our top five holdings for the micro. All five have grown to be here, and all are still cheap in our eyes. And all have very unique stories and niches where they excel.

12:40 Centrus is the only manufacturer of high assay, low-enriched uranium for nuclear power plants in the United States. They have a contract with the Department of Energy and should be positioned well to be a leading supplier to power zero carbon electric generation. Then on the bottom, Iradamed is the only supplier of infusion pumps in the country that can be used while patients are in an MRI. We don't have hard sector constraints in the micro for each sector, only that no one sector can represent more than 30%.

13:11 The closest we come here is in healthcare at a 20.1% weight. And here 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, we are not showing that to you. Our weighted average market cap would be in line with the Russell Micro benchmark. We outperformed the micro benchmark in the quarter, but underperformed the Russell 2000 in the third quarter.

13:41 Centrus was our top performer. As I just explained, they're a leader in high assay low-energy uranium. Their stock can also trade in sympathy with the price of uranium, which happened to be very strong in the third quarter based on fears that production would not meet demand. Technoglass was our worst performer after coming in as a top contributor last quarter. Easy come years ago. As I already stated, we think the outlook is bright and remain confident in their ability to grow.

14:09 As we look over the last year returns, you can see at the top, we underperformed the Russell 2000. But compared to the Russell Microcap, we handily outperformed over the last year. It's been a very tough market for microcaps. Our top performer was Perion. Perion is a global advertising technology company that assists brands, agencies, and publishers with advertising solutions. And they also have a partnership with Microsoft's Bing, which recently integrated ChatGPT earlier this year, potentially driving more traffic to Bing and benefiting Perion.

14:42 Perion continues to have good quarterly earnings. They've got roughly $450 million in cash on the balance sheet and no long-term debt. We did trim the position earlier in the year after some very strong performance. First, Internet Bank was the worst performer. On top of not being positioned well for high interest rates, they ran into credit issues with a few loans. And so we sold the stock in the second quarter. It has been a volatile market for all asset classes, but I'm happy with how most of our holdings have performed to feel confident in our company's outlooks for the future.

15:15 For more detail on stocks bought and sold as well as deep dives on new names, please reference our latest quarterly letters, which are available on our website. With that, I'll hand it back to Matt. Thank you, Adam. The micro strategy analysis shown is the three-year rolling excess return of the strategy relative to the Russell 2000 and Russell Microcap index. The strategy is a core product with a value bias.

15:41 Like our SMID strategy, the team takes a differentiated approach in the asset class through seeking to pay a fair price for the responsible deployment of physical, human, and financial capital in pursuit of superior returns. The chart illustrates the results of the inefficiencies we seek to exploit in the microcap space, having delivered in excess of 500 basis points relative to the stated benchmark, the Russell 2000. Like the sustainable value strategy, the micro-opportunity strategy has delivered outperformance against the Russell 2000 over longer time periods.

16:16 We ideally, as Adam has mentioned, would benchmark this strategy to the Russell Microcap index. For comparison, year to date, the microindex has declined by 6.8%. I will turn it over to Cindy to review highlights for the engagement of the quarter. Cindy? Thank you, Matt. Today, I'm going to discuss River Water's corporate engagement regarding ESG factors during the third quarter.

16:44 As a reminder, our three-pillar approach to responsible investing includes due diligence, where we seek to understand potential companies' current attention to salient ESG factors, engagement, where we work in cooperation with corporate executives toward improvement, and collaboration with sustainability organizations and responsible investing peers to both inform our practice and magnify our impact.

17:12 Our investment team meets with approximately one to 200 companies a year. In addition to discussing more traditional investment topics such as growth, profitability, outlook, etc., we inquire about attention to ESG factors. Given that we invest in the small cap space, companies are often just beginning their ESG journeys.

17:37 We typically offer educational information regarding the benefit to all stakeholders for a focus on ESG as well as tools for the journey, even if we have not yet invested. As we go through the engagements for this quarter, please notice that several topics of engagement are common among them. We've already talked about the educational outreach.

18:04 Second, we always advise that companies start with a materiality assessment. This is the process of gathering multi-stakeholder input about which ESG factors are most material to a given business and its stakeholders, which include employees, customers, suppliers, shareholders, society at large, and the environment. Companies should focus their efforts on these factors first because materiality matters.

18:36 The next topic we engage on always is reporting on sustainability efforts in alignment with one of the widely adopted reporting standards such as GRI or ISSB being the most common. You really can't manage what you can't measure, so you need to have reporting in place to inform your process. And lastly, we suggest a focus on greenhouse gas emissions using the TCFD framework to inform policy, practice, and reporting.

| | |
|---|---|
| 19:09 | The fact that climate change is the crisis of our time makes it important for all companies to work toward emissions reduction in their value chain. And regulators are keen on this as well. So in addition to these common topics of engagement, we typically suggest a few other ESG factors for companies to focus on, which we believe are material to them based on their industry. |
| 19:36 | And typically, managements are in agreement with us on the topics we suggest. So our third quarter engagement highlights highlight our approach and impact. UFP Technologies is a company we talked with. And I want you to notice on this slide and for all of my examples, we've got the materiality assessment, the greenhouse gas emissions, climate change, and governance beginning sustainability reporting. |
| 20:09 | That is common among all of these examples I'm going to share. For UFP Technologies, which is a supplier to the medical device community, making product safety is very material to their business. Additionally, equitable treatment of the company's large workforce will be very important to their long-term success. As a software company providing travel services, Mondee will also benefit from equitable treatment of its employees. |
| 20:44 | Additionally, attention to cybersecurity is paramount for Mondee because that is their product safety. Like Mondee, USIO is a software company that provides transaction services to businesses and government agencies. This makes cybersecurity a top material concern for them. |
| 21:10 | Additionally, the company prints and delivers paper statements to its customers' customers, making use of recycled paper an important new area of focus. One other comment I'll share about USIO is that we have provided information to the executive team several times over the last two years in our meetings with them. The new head of IR, who we know came to us, actually, and asked for our advice one more time. |
| 21:40 | And things are now really beginning to move forward. And I bring this up to point out that we're patient if a company demonstrates an interest in working on improving their ESG efforts over time. Biote offers hormone replacement therapy. Again, that makes product safety its number one priority you know as a medical services provider. The company has been very grateful for our educational information to help the company begin its ESG journey. |
| 22:14 | During a recent meeting with Uranium Energy Corp, the CEO asked if we could have a follow-up call with their sustainability lead to discuss their current efforts in reporting. A review of their sustainability report revealed that this is a company with very robust policy and practice as well as reporting on all of the ESG factors listed here, including some others. But these we thought were the most material. |
| 22:42 | We're really pleased to see that they're covering these material factors and looking toward doing more as their business matures and the world changes around them. During our first meeting with Plexus, which is a Wisconsin-based manufacturing company, almost two years ago, we discussed ESG. The company was clearly incorporating attention to many factors into running its business. |
| 23:15 | They asked if we might offer some advice as they were working toward publishing their first sustainability report, which we did. We became shareholders almost a year ago, and we're very pleased when Plexus published its inaugural sustainability report in the summer. A few weeks ago, the company invited us to offer our thoughts on the report and where we thought they should focus next. We told them they had done a great job of identifying and focusing on material factors. |

23:43 We were pleased to see their focus on water stewardship per our recommendation, given that the company has a global manufacturing footprint. And we introduced them to one of our collaboration partners, the Water Council, for potential consulting on this factor. And they are considering that partnership. And speaking of water stewardship, I was invited to present on a panel at the Water Council's Water Leaders Summit in September about the importance of water stewardship by corporations from an investor perspective.

24:20 ESG factors have the potential for material pecuniary impact to businesses. This slide shows some examples of how water may impact businesses. For example, the consumer staples sector is facing a $200 billion impact from water scarcity. And by 2030, it's projected that water demand will exceed supply by 56%.

24:46 Both highly dependent on water and a major driver of water-related impacts, business has a crucial role to play and also a vested interest in delivering a water secure future. That was my message to attendees and also to the companies we engage with. Thank you for your interest. Thank you, Cindy.

25:13 So our three-pillar approach is our research process to analyze all companies. Our second pillar is exceptional management teams. We believe the smaller the company, the more important it is to have the right people in place. I always like to say, if any of us were one day picked to run Coca-Cola, I'm very confident it would be difficult for us to bankrupt the iconic brand. Bad magic could mess things up but not kill Coca-Cola.

25:42 If, however, we were charged with running Zevia, things would be different. Zevia is a micro-cap beverage company that differentiates itself with its zero sugar lineup. They have no debt, but I'm sure many banks would be happy to loan Zevia money to go make a dumb acquisition. And when the economy inevitably turns down, bankruptcy would be a possibility if the company couldn't meet its next debt obligations. So we look at a lot of factors when sizing up management teams, like do they have relevant backgrounds?

26:12 Are they well-liked by their staff? Here we use glass door ratings to help us, amongst other things. Are they paid appropriately? Do they communicate with Candor? Do they follow through with what they previously communicated? But the two most important factors we hone in on are, one, are they aligned with shareholders? And two, do they know how to allocate capital? We think about shareholder alignment in two ways. One is, do managers own enough stock so that they can enjoy a company's success?

26:41 But really, we want them to be incented to not do dumb things and destroy value. A common analogy is how do people treat objects that are rented versus owned? Like cars. Typically, owners take better care of cars versus when they're just rented. A common level we like to see is five to seven times a CEO's salary to be owned outright in stock. We also love to see recent insider buying as this is a clear signal that the stock is undervalued.

27:12 Two, we want to make sure that management is not incented in the wrong way. For us, this could mean they get bonuses for just raising sales or earnings. Sales and earnings can be manipulated by using debt, which increases risk and doesn't necessarily create value. We want to see incentive comp tied to return on capital metrics that compare income and cash flow streams to the capital required to produce those streams.

27:37 We also like to see total shareholder return metrics that only compensate managers when their stock price goes up over longer periods of time. Now, the second main factor is prudent capital allocation. The easiest metric to grade allocation is comparing a company's return on capital versus their cost of capital. We can analyze these measures over time to see if value is created or destroyed. Management teams have a limited number of options when allocating capital. They can either grow their business or return the capital to equity and debt holders.

28:08 To grow, they can increase capital expenditures. They can increase expenses or complete mergers and acquisitions. They can return capital shareholders by buying back stock, debt, or committing to a dividend. We analyze all of this to determine if management teams are spending and allocating capital appropriately. This can be accomplished by researching what has been done in the past and then speaking with CEOs and CFOs to understand how they will spend and allocate capital in the future.

28:38 The fastest way for us to give up on a stock is on bad allocation decisions around mergers and acquisitions. Analyzing management teams is the most opaque of our three pillars. There is not a plethora of metrics that can be used to grade CEOs and CFOs. We believe, though, that we have created a process that can effectively differentiate between good and bad. Since we are not investing in the Coca-Colas of the world, we will continue to spend a lot of time meeting and analyzing management teams.

29:09 And with that, I will hand it back to Matt to wrap up. Awesome. Thank you for the update on the strategies, Adam. And Cindy, congrats to you for being recognized in the quarter as a sustainable business leader by Milwaukee BizTimes. At this time, we welcome any questions. I did receive a question earlier to kind of kick this off. We touched on a unique characteristic of the portfolio that stands out is the portfolio beta. What do you believe is the driver of this?

29:39 And is it a factor you anticipate controlling going forward? Sure. So when we are analyzing stocks, we don't ever look at the stock's individual beta. It's not a factor we put a lot of merit into that it's a forecaster of what will create value. The reason we have a low beta is because we buy quality companies that have good balance sheets and more consistent cash flows than our benchmark.

30:11 And that is what actually drives the lower beta. So when things are blowing up, there is much lower risk that any of our companies will go bankrupt than comparable companies in the benchmark and lower risk that they will actually lose money. So I think that is what prevents the stocks from going down less. So hence, it's our process that generates a lower total beta. It's not us looking to buy low beta companies. Good question, though. Thank you.

30:40 And we did receive one question. It's along the lines of how is the portfolio positioned for a higher for longer interest rate type environment? Sure. So I'm not totally convinced it's going to be higher for longer. But with that said, the reason interest rates are higher now than they have been historically is because inflation is higher now than it has been historically. Though inflation has declined, I think at the fastest clip in a long, long time, at least 40 or 50 years.

31:13 But the way we think about quality companies is do they have businesses that are so good that there is elasticity to their pricing? So if you are a customer and the business raises their price on you by 5%, are you likely to say, "No, I'm not going to pay the 5%," or are you likely to say, "Okay.

31:42 I love the product or I love the service. I'm going to continue to I'll pay the extra 5%." So we typically want to invest in companies that have pricing power because those are better businesses. And so I would say, on average, if we are in a higher interest rate environment, we inherently have positioned the portfolio for that because we want to invest in companies that have pricing power. Thank you, Adam.

32:12 That is all the questions 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 superior businesses that endure market cycles. We welcome your consideration as a manager. Additional data on the strategies can be found in investment, Morningstar, Investment Metrics, PSN, Wilshire and Calend databases. If you have additional questions or would like to speak directly with a member of our team, please contact me.

32:40 We wish you an enjoyable holiday season and look forward to talking with you again next year.