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THE WALL STREET TRANSCRIPT
Connecting Market Leaders with Investors

Capturing on the Upside and Protecting on the Downside with a Unique Process

DAVE HARDEN is Chief Executive Officer and Chief Investment Officer of Summit Global Investments. A graduate of Boston College, B.A., and Boston University, M.S.C.S., Mr. Harden has established himself as an expert in investment technology and quantitative research. Over the past 21 years in the investment management field, he has proven his ability as a portfolio manager and equity strategist. Mr. Harden worked with Fidelity Investments, Evergreen Investments and Ensign Peak Advisors, where he was responsible for developing and implementing numerous portfolio strategies. For the past eight years, he focused on managing institutional assets taking a managed risk approach to asset management and continues to do so at SGI. He is one of only a handful of active portfolio managers in the world who has researched, constructed, implemented and actively managed significant assets in the managed risk or low volatility equity space.

SECTOR — GENERAL INVESTING

(AHS502) TWST: Can you provide a brief overview of Summit Global Investments?

Mr. Harden: Summit Global Investments started in 2010, and we are a privately held institution founded in Salt Lake City, Utah. We have over $1 billion in assets under management. We manage primarily in three main strategies: U.S. large-cap equity strategy, benchmarked to the S&P 500, that is available in separately managed accounts, model delivery and through a mutual fund. We also manage a U.S. small-cap equity strategy, benchmarked to the Russell 2000, that is also available in separately managed accounts, model delivery and a mutual fund. Our global equity is benchmarked to the MSCI ACWI Index, available in separately managed accounts, model delivery and a mutual fund.

We are a firm that takes a managed risk approach to equities. We like to buy outstanding companies with the least amount of downside surprises in the delivery of high risk-adjusted returns. We are a boutique asset investment firm in the sense that we have very specialized, highly experienced individuals here, so a lot of CFAs — over 80% of the firm is CFA — as well as an in-house General Counsel and Chief Compliance Officer. We just won two awards from the Institutional Asset Management Awards for 2019. We were awarded the Active U.S. Large Cap Strategy of the Year for the SGI U.S. Large Cap Equity Strategy and the ESG Strategy of the Year for our SGI Global Equity Strategy.

TWST: We talked in 2017 about the process you use to manage the funds. Have your approaches changed since then? Also, can you give us a brief recap of the process and tell us how you might be different from other active managers?

Mr. Harden: Has the process changed? I would say that the markets have changed drastically. You always have to reevaluate and evolve and grow and make sure processes work. But from a big-level perspective or maybe a 25,000-foot-level perspective, no, a lot of the processes or steps in the process are the same.

From a methodology perspective, we are looking to capture equity-like returns through managing risk. Most of the time, you are going to see the volatility of our products be anywhere from 20% to 30% less volatile than their respective benchmark. We are looking to either get benchmark-like returns or actually outperform the benchmark over market cycles through significantly protecting in down markets with a low correlation to help with diversification.

If you look at our methodology, there are four main parts or processes on how we manage money and why we do it so differently. The first one is about risk and risk management. The first process is answering the question: How much risk should I take in the equity market today?

The second thing is that we are looking at a quantitative multifactor alpha model. We are not a value model or a growth model shop, or momentum or low volatility shop. There's a lot of different factors out there. We are using a multifactor model approach. After constructing the portfolio, in our third step, we go beyond the quantitative processes and turn on the qualitative, fundamental process whereby we fundamentally look at the stocks to buy, specifically looking for downside idiosyncratic and ESG risks. If we find such risks, we will not buy the stock.

TWST: Walk us through more of the steps if you would.

Mr. Harden: When you think about identifying the type of risk you want to take in the equity markets today, that's a really important question, because if you just simply say, "Hey, I can buy whatever I want to," then you're not paying attention to the risk side of the coin. Instead, you are just focusing on the return.

There are a couple of different ways you can do this. One way that the Street does it is to look at benchmark risk. I'll just use the S&P 500 as an example. Managers will look at the S&P with a standard deviation or volatility of a 10 or 12 or whatever it is and then de-risk off of that number. Maybe they take a look at some backtests, maybe 10, 20 or 30 years or whatever they do, and they say the best thing to do is de-risk it by 20% and then reduce the risk, from the S&P, by 20%.

The other common practice you find out there in a managed risk approach is to use what is called a risk covariance matrix, helping managers put together a minimum volatility portfolio or a low volatility portfolio, where the manager will then increase the risk off of that portfolio. They say, "Hey, where's the sweet spot in the marketplace? Where's the highest Sharpe ratio, etc.? Let's look back in history and increase the risk above the minimum volatility portfolio."

So all they do is find the risk of the minimum variance portfolio or low volatility portfolio and increase their risk off of that. The problem is, there's an actual spread that exists between the benchmark and the minimum variance portfolio, and it varies. When risk is really high and the variance is very extended, you're going to see a very large spread as the risk of markets can be much more than the risk of the minimum variance portfolio.

Those two approaches work great in very large spread environments. But in the last three or four years, you have very tight spreads. The difference between the very risky stocks and the very conservative stocks in the market are extremely tight, and their volatility patterns are very, very similar.

If you try to de-risk off the benchmark, you find yourself sometimes even less risky than the minimum variance portfolio. You're buying too many utilities. You're buying too many consumer staples. The other strategy is also problematic. If you're going off of the floor, or the minimum variance portfolio, you actually can find yourself more risky than your benchmark.

What we do in this process is, quantitatively, we've built technology that looks at the difference and plots all of the spreads between the benchmark risk and that minimum variance risk. We are able to look between these two boundaries, if you will, and look at the higher Sharpe ratio and where they exist in the current market and where along that risk curve it is. That is how we are able to dynamically target risk that actually has the most payoff for that level of risk. That is really important, so we are getting the most bang for our buck. Maybe in beta terms, it is 0.85 beta, 0.72 beta.

TWST: What is your average number of holdings and average turnover rate percentagewise?

Mr. Harden: It varies by product. The small-cap fund is going to have a little bit more turnover relative to the large-cap or the global portfolio. In our global and large-cap portfolios, we are looking at a turnover of about 40% to 60% on average over the last number of years, which is relatively low for those type of products. In our small-cap portfolio, it actually has averaged

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Highlights

Dave Harden discusses Summit Global Investments. The firm has three strategies: a U.S. large-cap equity, a U.S. small-cap equity and a global equity. Mr. Harden uses a managed risk approach. He likes to buy outstanding companies with the least amount of downside surprises. The portfolios generally have 20% to 30% less volatility than their benchmarks. Mr. Harden's process starts with determining how much risk to take. From there, he combines a quantitative multifactor model and a fundamental process that looks for downside risks, or red flags.

Companies discussed: Target Corporation (NYSE:TGT); Costco Wholesale Corporation (NASDAQ:COST); Walmart (NYSE:WMT); Bayer AG (OTCMKTS:BAYRY); Johnson & Johnson (NYSE:JNJ); Boeing Co. (NYSE:BA); PG&E Corporation (NYSE:PCG); Nike (NYSE:NKE); Amazon.com (NASDAQ:AMZN); Eli Lilly and Co. (NYSE:LLY) and Microsoft Corporation (NASDAQ:MSFT).

about 60% to 80% on average over the last number of years. They are fairly tax-efficient. With SMAs, you can be much more tax-efficient.

For number of holdings, we typically target around 100 holdings for both large cap and small cap. Whereas in global, the number of holdings has averaged around 60. We are anywhere between about 50 at a low and about 75 at a high.

TWST: The last time we spoke, we concentrated on the large-cap fund. Can you today address more about the small-cap and the global funds as far as their compositions and even talk about some of the top five holdings right now?

Mr. Harden: Several aspects distinguish our funds from other funds. A lot of people do quantitative mathematics. That is not necessarily what is unique about us. What is unique is how we take factors and combine them together. We know from academics that factors have certain payoffs over long periods of time. Exposure to those factors benefit portfolios over longer cycles, whether that means small-cap value, growth or momentum factors.

us unique is we are not looking for upside return. We are looking for downside risk.

We have developed a very good ability to look at red flags — in terms of downside risk or idiosyncratic risk — with individual companies whereby we can look at these flags, such as unexpected management changes, aggressive accounting, litigation risks, regulatory risks, investigations, deteriorating business models, disruptive innovations, poor earnings quality, high/short interest, etc., and have a greater understanding of potential downside risks. When we find acute negative risks and/or poor environmental, social or governance, that's when we will not purchase the company. If we own the company, we sell out 100%.

Because of this overlay and because of our high hands-on look at these companies, it is one reason we won the ESG Strategy of the Year. We are laser-focused on governance, for example. If management is not honest or if we feel like anything is hidden, we are out. These red flags have really set us apart in the sense of being able to manage individual companies.

"But what about the factors that have been outperforming lately? We have within our quantitative second step of multifactor alphas the ability to look at the momentum of factors and actually overweight factors that have some near-term outperformance. We can also tilt our factors toward those that have the most stable payoffs."

But what about the factors that have been outperforming lately? We have within our quantitative second step of multifactor alphas the ability to look at the momentum of factors and actually overweight factors that have some near-term outperformance. We can also tilt our factors toward those that have the most stable payoffs.

And lastly is a macroeconomic overlay within our factors. We know that certain factors do well when the market is expanding or when the market is contracting. You want to be able to tilt your factors toward the stronger payoffs in the current macroeconomic environment. We are able to do that. Our factor weightings are dynamic. That helps set us apart in a lot of the things that we do from an alpha perspective. Not only are we targeting our risk dynamically, but we are targeting our alpha dynamically.

Risk is managed throughout all our processes. For example, we also use multiple risk covariance matrices. Most shops out there today, if they even use a risk covariance matrix, only use one, and we use multiple, and that's very important because risk covariances have weaknesses. Understanding those weaknesses and utilizing multiple matrices allows us to have a better, more robust suggested universe of what to buy and what to sell and ultimately manage risk better. We are the only one that I know of that does that.

A lot of managers will stop there and proceed to turn over the portfolio. We add another layer of fundamental analysis, focused on downside risk. The key here that makes

1-Year Daily Chart of Walmart

Chart provided by www.BigCharts.com

The secret here is protecting downside without giving up the upside.

Let's say we go back a number of years and look at **Target's** (NYSE:TGT) data breach. We held **Target** at the time. At the time, we thought the situation was really bad. There were a lot of people affected. It was upward of 40 million. Later, **Target** announced it was more like 80 million people affected. They also seemed to indicate they didn't know how it happened. At this point, we sold 100% of our **Target**. We got out.

From a statistical standpoint, when we sold **Target**, we could buy **Costco** (NASDAQ:COST) or **Walmart** (NYSE:WMT) or some other type of company that had the same factor exposure, same risk exposure, and our portfolio is virtually the same as it was before, but we don't have that idiosyncratic risk. Peers that manage money didn't sell **Target**. I believe the soonest I saw didn't sell until May. At that point, the CEO already resigned, and the stock already had immense volatility to the downside. We were able to avoid all of that.

More recently, think of **Bayer** (OTCMKTS:BAYRY) over a year ago, when they lost Roundup. We sold **Bayer**. Think of **Johnson & Johnson** (NYSE:JNJ) and their baby powder issues. We sold **Johnson & Johnson**. Think of **Boeing** (NYSE:BA) with its 737 MAX problems. All of these companies do not have to stay in your portfolio.

TWST: What's an example of a red flag that might not be so obvious that you acted upon?

Mr. Harden: Why does the rest of the Street continue to own **Target** or **JNJ** or **Boeing**? Why wasn't it more obvious day one that there were problems and issues? One area that comes to mind is short interest. What makes short interest go from, say, 3% to 15%? Why are people shorting this company? What do shorts know that the rest of the public doesn't know? Why did this company increase its debt three times the amount it had two years ago? Why is it increasing debt so much? Can it pay off that debt? Red flags like these increase downside risk. We know this.

We also look at things like earnings announcements for the last eight years. What happens to the stock? Do they typically go up? Do they go down? We know there can be certain risks around management teams. Maybe they don't have the ability or don't have the data to be able to manage expectations properly or to set expectations properly. Whatever is happening that is causing that stock to really be volatile around earnings announcements can be an indicator of other problems. What other people might not see very clearly, we clearly get in the weeds about. We are just very hyperfocused on downside risks.

Another example is **PG&E** (NYSE:PCG). We were holders of **PG&E** back in 2017, when they were somehow attached possibly to the fires in California. I remember the bankruptcy in the 1990s that **PG&E** came out of, and that was attached to fires. So we actually sold out of that company 100% when it was in the high $60 to avoid all of the last two years of junk that they've had to go through and they're still going through.

The technology we have is really highly specialized technology, in the sense that it is looking across all of the wire and new services and everything out there to alert us if a company had any involvement at all with misconduct, with hurricanes, fires or earthquakes, or anything that can disrupt this company. We were notified immediately. Then, we can do a deeper dive. We can see how they handled it in the past. We can see how they are handling it now. We can make some better-educated decisions whether or not we like it and it's OK or not.

But if we find increased downside risk, we are out. And here's the key: If we're wrong, we're OK because we're going to put the money to work in something statistically very similar, like selling **Target** and buying **Walmart** and **Costco**. If retail does well, we'll probably do great. If we're right about a company's downside risk, we just saved a lot of money for our clients.

TWST: Can we talk about a few current holdings?

Mr. Harden: If we look at the global top 10, one of the bigger holdings that we have right now is **Nike** (NYSE:NKE). **Nike** has about 75,000 employees across the globe. This is a very well-managed company. It has a really good management team in place. It scores great on all of the earnings quality and all of the different growth and value factors. It does a very, very good job.

It missed its margins by 0.1%, and the Street has it down a little bit today. It admits that this is primarily due to about 20 or 40 basis points that is attributed to the China trade war. So if you look, the trade war is out of the way. It hasn't missed earnings since 2012. It has a long track record of knowing how to do what it does. It has all the systems in place to do what it does.

People still buy shoes. They are a necessity. It is a really, really good company quantitatively and generally is an outstanding

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1-Year Daily Chart of Nike

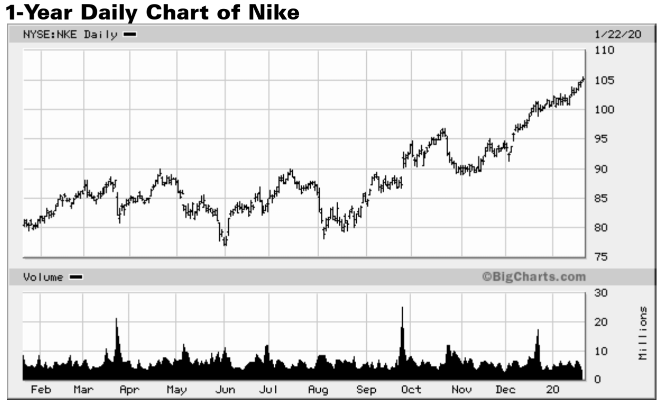

Chart provided by www.BigCharts.com

company. It fits right into our investment basket of how we manage money. It is down 1% or 2% today. But it actually outperformed on both the bottom-line and topline numbers.

Another one of our top holdings is **Walmart**. Now this is a large company with a lot of U.S. consumer exposure. But it is a global player in the sense that it receives probably on average about 30% to 40% of its sales from international markets. The reality here is that **Walmart** has done a very good job. They were late to the online game after **Amazon** (NASDAQ:AMZN). But its online sales have been growing. Actually, they've been growing at about 30% a year.

An interesting thing about **Walmart** and its online growth is that it does well if the market actually goes down. If the economy went down, **Walmart** has found that more shoppers come to its stores. It actually attracts more when the economy is worse. So it is an interesting play in the sense of not only good upside and a good management team and well-diversified across the globe and has its online growth, but it also has some protection if the market declines. It may increase rather than decrease.

1-Year Daily Chart of Eli Lilly and Co.

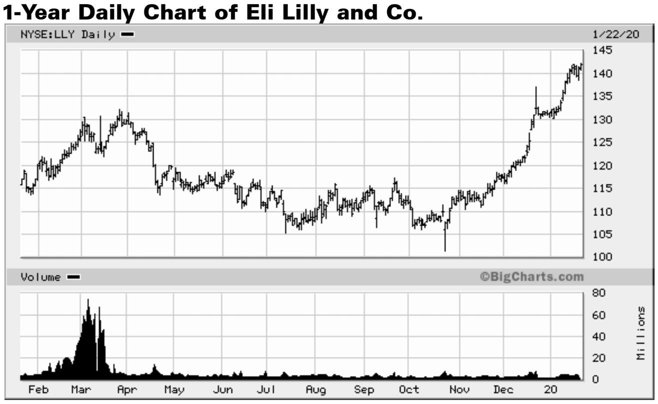

Chart provided by www.BigCharts.com

TWST: It is interesting to me that of your top 10 holdings in this particular fund, three of them are major pharmaceutical companies. What made you decide to go in that direction, and why these particular ones?

Mr. Harden: Eli Lilly (NYSE:LLY) is one of our holdings. And there are others. From a standpoint of global investing, we feel that pharmaceuticals are a really good play, as society is more and more dependent upon drugs. Whether these drugs are beneficial to our health or not, it seems like we are just really relying on them.

They are growing along with biotech, and the amount of quantitative information that's going on in the biotech field is absolutely robust. The pipelines are robust. They know the process in the U.S. with the FDA. They have that down. They've been doing this now long enough. They understand this pipeline very, very well.

So from a standpoint of new drugs coming out and drugs coming off, people get worried about generic drugs and stuff. But the reality is, they have enough in their pipelines to win. We want to be a part of that globally. In India and China, these drugs need to get into all of those economies much more than they are today. These markets are going to become much more the global players tomorrow than they ever are today.

So this is a growing global phenomenon that we want to be a part of for the long term, and they are great on the risk side too. These are lower risk than the ACWI benchmark. All of these have great numbers and may even have higher yields. There is high cash flow, high quality earnings and overall some great companies in that sector.

TWST: I'm looking at your small-cap fund and the sector weights in it. Obviously, it's fairly diversified, yet it seems at present heavy on financials according to the fact sheet from September 30, 2019. Can you talk about any aspect of this, including any one of the holdings?

Mr. Harden: The small cap is a very U.S. play. If the U.S. economy is doing really well, and the Fed is very much in our back pockets, then that is a big play. But with the U.S. economy right now, finance is a great place to be. Small-cap financials are even more into the U.S. economy. It really, really makes sense, so we are overweight financials. Small-cap companies are less followed by Wall Street. They receive less news, and they require more research. But if you're only looking for upside, you may miss the bigger side of the coin — risk.

These companies are great at the marketing game, right? They want to tell people how they're going to be the next **Microsoft** (NASDAQ: MSFT). You have to understand what drives downside risk. And so in small caps, we feel like our process, especially our fundamental analysis process, really digs into SEC investigations and any letters they receive from the SEC and into the CEOs. This is even more important than large caps because these individuals, these men and women out there running these small-cap companies, have much more power.

So I feel like our fundamental process in small caps even adds more value to make sure we're in really, really good, outstanding names. We tend to have lower standard deviation here. Right now, I would say from a price to book and price to cash flow, our value is cheaper than the benchmark. Our yield is higher than the benchmark, but our return on equity is that of the benchmark. We have about 100 companies in small cap.

TWST: In closing, why should an investor put money in a fund with Summit Global Investments as opposed to somebody else's? Any final thoughts about the market and what investors should be aware of?

Mr. Harden: What sets us apart? If you looked at our monthly return streams over the last nine years, when the market does well, we do well. Sometimes we outperform, and sometimes we slightly underperform, but we tend to do well when the market is up. We have captured over 85% to 90% on average of the upside market. Even in this year, the market is up 27%-plus, and we're up 25%-plus.

But if you look at those returns on the downside, when the market is down, we have protected almost 100% of the time. And the more the market goes down, the more we have been protective. This return pattern of being able to capture a significant amount of the upside while protecting on the downside has been really our forte, and we're doing that through both quantitative and fundamental processes, and that's important. That's what sets us apart.

There are just not a lot of people out there who are willing to have the staff and resources to do both, and we do. It shows in these award-winning strategies, where we competed against other institutional asset managers and came out on top. Also, before anybody even knew what the term ESG was, it was has been in our DNA. We have never bought a gambling company. We have never bought a pornography company ever. We've always been very, very strict on ESG factors, especially when they contribute to downside risk. This continues to set us apart.

When investors want to put money with a manager and get good Sharpe ratios, they also want to have an impact with their money and to think about themselves as ESG investors. SGI is the right firm. This is a fantastic play and the only one out there that actually has the ESG returns. Winning the ESG strategy award is also something that we very much pride ourselves on. Those are probably the two top aspects of what makes us unique as a firm and why somebody would want to put money with Summit Global.

TWST: Thank you. (KJL)

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