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THE WALL STREET TRANSCRIPT
Connecting Market Leaders with Investors

Value Manager Sees Opportunities in Underearning Auto Sector

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SECTOR — GENERAL INVESTING

TWST: Before we dive into specific strategies and funds, would you mind giving us a brief introduction to SKBA, the business and its overarching investing philosophy?

Mr. Segura: SKBA Capital Management is an independent boutique asset management firm based in San Francisco and was founded in 1989. We are 100% employee and founder owned, with a singular focus on discovering undervalued investment opportunities not yet realized by the market.

We currently offer two mutual funds based off of our Value*Plus* (BVPIX) and Socially*Responsible* (BVSIX) strategies. Value*Plus* is a dividend-oriented, large-cap value strategy, and Socially*Responsible* looks for undervalued opportunities within an ESG framework.

The overall investment philosophy and approach has several differentiators. We use a team-based portfolio management approach to ensure a consistent and disciplined investment process. We believe the market routinely overshoots on both the upside and downside and is therefore irrational. We use valuation metrics that are focused on what we believe a company can earn in a normal environment — that's through cycle — which helps us determine if a company is over- or underearning.

By buying securities when the downside is already priced in, we believe this maximizes upside potential while also minimizing downside risk. We are long-term investors with an investment horizon of about three to five years.

TWST: Is there anything you would add about the investment process specifically for the Value*Plus* strategy and its corresponding Baywood Value*Plus* mutual fund?

Mr. Segura: We utilize our relative dividend yield discipline to identify opportunities and risks for the portfolio. The main point of differentiation is our focus on relative, not absolute, yield. We look at a company's dividend yield relative to a proprietary universe of other dividend paying stocks and to itself over time.

This could lead us to buy stocks with low absolute yields but high relative to its past, because even with a lower absolute yield the high relative dividend yield compared to its own history may capture pessimism priced in the stock. Similarly, we might avoid a high absolute yielding stock if its yield is low relative to its past, like a lot of bond substitutes have been over the past five years or so.

In short, we believe that dividends are important for four reasons. One, as a signal of a company's long-term earning power. Management tends not to set dividends whimsically, therefore a company with a solid long-term dividend policy will have a dividend that is a good proxy for what the company believes its long-term earning power is. Two, as already mentioned, they signal relative valuation attraction. By looking at a company's relative dividend yield, we can identify valuation extremes. Three is to provide income. And four, it lowers the overall portfolio volatility.

We are also fundamental bottom-up investors. As I mentioned, the relative dividend yield discipline is a signal. Most of the work performed is through our bottom-up fundamental analysis, where each analyst at SKBA is responsible for a cross-section of industries. I, for example, am responsible for covering autos and auto parts, IT hardware, independent power producers,

insurance, and household products such as **Procter and Gamble** (NYSE:PG). This doesn't necessarily confine us to these industries; for example, if I see an attractive opportunity in another part of the financial sector, like banks, I may analyze it.

Once we identify an opportunity, we look at a company's fundamentals in three main steps. One, is in isolation. What are the company's profitability characteristics through cycle, balance sheet, cash flow, management team tenure and experience, weakness, strength, governance, etc.?

Then we look at the company compared to peers. There we compare the profitability and growth characteristics against the peers. We look at market share gains and losses, competitive positioning, long-term strategy, any unique circumstances, and why they might change over our investment horizon.

Lastly, we look at it compared to other investments within the portfolio.

In summary, we look for stocks with a combination of strong fundamental characteristics, low valuations, and generally above-market dividend yields. Most companies we put in this portfolio provide a set of characteristics that, over a full market cycle, are very competitive and consistent. We've been able to outperform our benchmarks over every full market cycle since inception, as well as overall since inception, while taking less risk than the benchmark as measured by standard deviation of returns.

We have shown that it is possible to get higher-than-benchmark returns with less risk. We believe that if you don't dig yourself into big holes on the downside, then you don't have to take as much risk on the upside to have an attractive risk/return profile.

TWST: You mentioned a few sectors that you cover. Are you finding that there are certain sectors or industries, or other kinds of general themes, where you're finding the best opportunities right now?

Mr. Segura: Broadly speaking, 2022 was one of the most interesting years in my investing career. Our Value*Plus* strategy had positive returns while the broad market was down significantly. I'm sure you've read how value held up well in the downturn, but it really played into our hands being active value managers, and the fact that we stuck to our knitting and didn't drift outside of our philosophy to keep up with the broad market over the long period of value underperforming growth.

2022 was unique because it was possible to be fully invested and diversified and be a long-only equity manager and be up for the year without making any heroic assumptions about stocks. And, specifically paying attention to what to avoid as much as what to own helped enable Value*Plus* to post positive returns for the year.

We weren't short the market, we didn't invest in any esoteric securities or any hedge that one might assume when you need to be positive for the year. It was just prudent capital allocation among a variety of ignored, neglected, yet fundamentally sound stocks.

As we look forward, we start with what worked well for us last year and ask ourselves if there are any reasons why that might reverse. On the opposite side of the coin, we also look at some sectors and industries that performed the worst, and if we own them, we question whether or not they are still worth owning. Or even, perhaps we should own more?

With the broad market being down so much, we're also looking at opportunities to own good companies which, right now, might trade at much more reasonable prices than they have in a very long time.

"We weren't short the market, we didn't invest in any esoteric securities or any hedge that one might assume when you need to be positive for the year. It was just prudent capital allocation among a variety of ignored, neglected, yet fundamentally sound stocks."

1-Year Daily Chart of AT&T Inc.

Chart provided by www.BigCharts.com

Communication services is one of those sectors. It was one of the worst performing last year, mostly driven by **GOOGL** (NASDAQ:GOOG), **META** (NASDAQ:FB) and **Netflix** (NASDAQ:NFLX), some of which are actually really good companies. If or when they pay a dividend they might actually become attractive for our strategy, albeit not right now. For example, **Microsoft** (NASDAQ:MSFT) is another one of those big companies that has done well lately. After the 2007/2008 crash near the bottom of the market, we bought **Microsoft** at a very high relative dividend yield and paid less than $20 per share. We held on to that for almost 10 years before it reached a stratospheric valuation.

Those companies just mentioned might fall into this realm; they haven't yet, and they don't currently pay a dividend, but someday they might.

However, there are a number of other companies in the sector whose underlying fundamentals are not nearly as volatile. Some of these companies underperformed, in our opinion, because they simply resided in an underperforming sector. In other words, they're guilty by association.

Companies like **AT&T** (NYSE:T), for example. It's taking market share from its cable peers and recently unwound years of bad capital allocation decisions by selling DirecTV and spinning off its media assets into **Warner Brothers** (NASDAQ:WBD). It's repaired its balance sheet, and it's focusing on the fundamental blocking and tackling in its core telecom business.

Those are the companies that we like. **Comcast** (NASDAQ:CMCSA) was another one that last year declined 30%, yet its fundamentals are a lot more stable than that price decline would suggest.

Information technology was another sector that led the market lower last year, after years of outperforming with elevated valuations and, in our opinion, higher than normal earnings. This is an important aspect of how we look at stocks and what we do and don't find attractive.

last year, they're going to decline this year, and over the next four or five years they might overall increase around 5%.

So we found a much more attractive opportunity in **NXP** where its price declined nearly the same as a lot of the other semiconductor companies but with much better fundamentals.

1-Year Daily Chart of NXP Semiconductors NV

Chart provided by www.BigCharts.com

"Semiconductors in autos, for example, are expected to grow approximately 13% per year over the next four years. By contrast, semiconductors in PCs and servers started their decline last year, they're going to decline this year, and over the next four or five years they might overall increase around 5%."

These two ingredients often create a disaster like what we witnessed last year. The market actually begins to believe that the elevated levels of earnings growth are normal and then rewards companies with higher valuations. These were similar factors that led to the dot-com bubble, as earnings were pulled forward to fix the Y2K problem in the late 1990s.

Now, we estimate that earnings had been pulled forward to increase bandwidth for all the remote working and living during the pandemic. Coupled with easy monetary policy and low inflation, you have all the ingredients for a market bubble. When the bubble bursts, the opportunities these create for investors like us can be broad based.

More recently, we initiated a position in **NXP Semiconductors** (NASDAQ:NXPI). We believe its competitive position and end markets are very different from a number of other semiconductor peers that tend to operate in more focused end markets, like **Intel** (NASDAQ:INTC), for example. **NXP's** end markets are industrial and auto, which we expect to grow at an elevated rate over our investment horizon as semiconductors continue to become an increasingly larger part of the industrial complex.

Semiconductors in autos, for example, are expected to grow approximately 13% per year over the next four years. By contrast, semiconductors in PCs and servers started their decline

You asked me what am I looking at in some of the sectors that I cover. I'll first start with what we do not find interesting, which is an important part of our process. Currently, I'm not a fan of consumer staples.

If you think about what's gone on in the market over the last 10 years, central banks around the world fought to keep interest rates at zero or below. A lot of sectors and industries became bond proxies as investors had to reach outside of traditional fixed income markets to get yield in the equity markets. The beneficiaries of that were mostly consumer staples and utilities. A lot of these companies are overpriced as a result, and a majority of them have very unattractive relative dividend yields with poor-to-fair fundamentals.

Last year's correction largely bypassed a lot of these sectors because investors held on to this belief that because they have in the past acted defensively during an economic slowdown, that they will so into the future. But we think this environment is a little different.

Because of high levels of inflation, a lot of these high-priced staples are struggling to pass through price increases without affecting volumes. Volumes are declining and we believe more is to come.

During the pandemic and the high level of retail concentration that occurred — you had a lot of bankruptcies, a lot

of family businesses going out of business. Meanwhile, **Target** (NYSE:TGT), **Walmart** (NYSE:WMT), **Safeway** (NYSE:ACI) grocery stores all increased their market share and now have more ability to push their own private label products at the expense of branded products.

High valuations and poor-to-fair fundamentals do not create an attractive investment opportunity from our perspective. The relative dividend yields are not very attractive either, so we’re staying away from a lot of the staples sector.

full force and are already beginning to restore margins back to pre-pandemic levels. While the OEM manufacturers like **Ford** (NYSE:F) and **GM** (NYSE:GM), on the other hand, have enjoyed higher prices due to lower inventories, and up until recently, they enjoyed the benefit of higher prices without associated costs because the contracts between suppliers and OEMs generally have about a one-year lag on them. So they’re going to face lower prices for their vehicles as more supply comes into the market and higher costs.

“Governance tends to be a leading indicator, not a lagging indicator, of a company’s interactions with the environment, their supply chains, and with social issues. Governance tends to drive these interactions, and so we focus on governance and simply try to avoid bad actors.”

As mentioned, we try to stay away from companies that are overearning and overvalued. I much prefer companies that are underearning and undervalued, where you can find really good opportunities for above-average dividend yields at depressed prices. In autos, even before the supply chain was disrupted from the pandemic, the global auto market was already in decline due to the trade wars and the tariffs of the Trump-era economic policies. When the pandemic hit, auto manufacturers shut down manufacturing for several months and were not able to restart at levels that would match demand.

1-Year Daily Chart of Aptiv PLC

Chart provided by www.BigCharts.com

We believe there’s a good amount of pent-up demand for autos, which may be partially offset by higher interest rates and possibly higher prices. Having said that, the auto sector can firmly be placed in the underearning, not overearning bucket. Combine that with the near extreme low valuations and increasing dividends off the pandemic lows, we believe there are some attractive opportunities in this industry over our investment horizon.

Currently, we prefer the auto parts suppliers as the contracted price increases for inflation are beginning to kick in

For this reason, we own the semiconductor manufacturers like **NXP** and **Texas Instruments** (NASDAQ:TXN), other sensor and connector manufacturers/distributors like **TE Connectivity** (NYSE:TEL), and electric wiring and battery harness and seating manufacturer **Lear** (NYSE:LEA).

TWST: I want to switch gears, since the firm also runs an ESG portfolio and mutual fund. Tell us a bit about the strategy driving that portfolio and fund. And how you define “socially responsible”? Do you use positive or negative screens, or something else?

Mr. Segura: SKBA’s Socially*Responsible* strategy was incepted in the year 2000. Unlike a lot of peers in this space, we have a long history, not just since strategy inception but nearly since the inception of the firm. I believe it was in 1990, we had a Catholic Diocese client that had specific requests as to what we could or couldn’t invest in. And if you think about it, that’s how the ESG industry started, with clients having unique needs and desires to include or exclude certain types of securities in their portfolios. So we had about 10 years of experience in managing portfolios for clients with these unique desires and needs.

In the late 1990s and early 2000s, we were looking at the overall ESG space, and in our opinion it did not seem like there were very many, if any, value strategies. They all, or mostly all, were growth, which is still true today. There are few diversification opportunities in ESG. Companies owned in these other strategies, and the kind of companies often considered to have positive ESG perceptions, tend not to be extractive industries like mining or energy. They tend to be more in the technology sector which tends to make the economy more productive. So, on the one hand it makes sense, but on the other hand, you end up seeing a huge crowding effect.

We did a short analysis in late 2021 looking at some of the different funds through Morningstar. Across the 10 largest ESG funds there was over 70% overlap in the top five holdings. In other words, they all owned the same companies, whereas

we're very different. We're value. And that's why in 2000 we thought that we would formalize our process in terms of creating a value ESG strategy to help diversify away from this crowding effect that we witnessed. In addition, we already had developed perspectives given the 10 years of managing portfolios for clients with unique desires and needs.

We start off with the most commonly desirable screens, which is not really a part of the process. This just lowers the amount of investable companies in our universe. These include alcohol, tobacco, firearms, nuclear weapons, and a few others — your basic ESG screens. But what makes us unique in this strategy, we believe, is our focus on governance.

Governance tends to be a leading indicator, not a lagging indicator, of a company's interactions with the environment, their supply chains, and with social issues. Governance tends to drive these interactions, and so we focus on governance and simply try to avoid bad actors.

We don't necessarily exclude whole sectors. Industries like defense, yes, but not generally sectors. We do not have a large weight in technology at the moment, because as I previously mentioned, most technology stocks are in this overcrowded, overvalued, overearning bucket. Throughout time and depending on our investment opportunities and what we believe a company's overall ESG profile to be, that will affect how we're positioned.

TWST: Is there much overlap between the two portfolios?

Mr. Segura: There is some, but given the constrained universe in our Socially*Responsible* strategy, we don't just look at companies through the relative dividend yield framework. We also look at relative market cap for revenue, which is a fancy way of looking at price to sales. We also use other valuation metrics. In this strategy we relax the dividend constraint so that we don't limit the universe even more.

There are companies that we'd like to own in our Value*Plus* strategy, but they don't have a good or sustainable dividend policy, that we might own in the Socially*Responsible* strategy if we deemed it to fit our ESG mandate. On average, you might have 20% or so overlap at times, more or less.

TWST: Circling back to that topic of emphasizing dividends, investment strategies with a focus on dividends have been getting more attention lately. Do you think that will continue for the foreseeable future? What could change that? What are the broader investment market and economic factors that influence investor interest?

Mr. Segura: We believe that we're at the very beginning of a long unwinding of an asset bubble created by 10-plus years of zero interest rate policy here in the U.S., and even worse, the negative interest rate policy in the Eurozone. This was a global race towards free money supported by low inflation.

"Because of inflation and higher interest rates, money actually costs something. Investors are forced to make these decisions now. We think investors prefer companies with upfront cash flows that can pay dividends today, and have the ability to grow those dividends. This is important right now because bonds aren't going to grow."

I've been discussing the things that we don't want in our portfolio. But we also look at companies that can help. The climate is number one on most people's radar right now in terms of how we want to change the world, and some people think that through an investing framework they can help accomplish those goals. So we look for companies that can help get us there.

I mentioned previously we are attracted to autos, and **Aptiv** (NYSE:APTV) is the company in the auto supply chain that helps make cars more efficient. It helps enable this transition from the internal combustion engine to electric vehicles. They are the only company that can supply almost the entire end-to-end solution, including sensors, wire harnesses, and electric vehicle charging components to help move us beyond the internal combustion engine and hybrid vehicles as well.

So, yes, there are companies that we won't invest in due to our screens and what we believe would be higher risk profiles, with risk factors in their governance that would lead us to say, this is not really what we want to invest in. And there are some companies that we look to include in the portfolio that we think can help move the economy in a better direction.

Few will remember Alan Greenspan's comment in 1996 about "irrational exuberance," but the preceding comments were that the ingredients for these market bubbles were low inflation and easy monetary policy. That's exactly what we've had again. The market preferred risk assets when you had low inflation and easy monetary policy, i.e., free money. That is now reversing and we think that's one of the big drivers of this prevalent shift.

Because of inflation and higher interest rates, money actually costs something. Investors are forced to make these decisions now. We think investors prefer companies with upfront cash flows that can pay dividends today, and have the ability to grow those dividends. This is important right now because bonds aren't going to grow. If you held a bond over the last year, your principal declined, and you are not getting compensated any more for that.

That's why investors in different asset classes are now preferring strategies that can grow dividends, because you don't get that with fixed income. Companies that pay dividends and have the ability to pass on that inflation in whatever service or product they are performing or making are very attractive right now.

Some of our biggest winners in the Value*Plus* strategy last year were from energy and basic materials, which was not by accident. We wrote a newsletter in early 2021 about how we thought inflation was going to appear and then persist, well before the Fed acknowledged that it was going to be a problem.

We began looking at companies who could pass along this inflation that would eventually become a major problem for the economy and for the market. A lot of those opportunities turned out to be in the energy and basic materials sectors. So we had pretty significant weights in both of those sectors along with companies that can pass through inflation, unlike consumer staples like I mentioned, without affecting volumes.

We think this environment is going to be here for a while, meaning we will continue to see elevated levels of inflation compared to the past 10 years. We may have passed peak inflation for the cycle but we don't think that it is going to go back down to where it was before. Similarly, we don't think the Fed's going to go back down to a zero interest rate policy.

For the next couple of years, the more likely economic scenario is stagflation — high levels of inflation combined with low levels of real GDP growth — with also a high risk of going into recession.

If the Fed continues to raise interest rates, that will eventually affect economic growth. So, either you stay in a stagflationary environment and the interest rates don't necessarily cause a recession right away, or the higher rates cause economic activity to slow down and we go into a recession. In either case, we don't think inflation needs to stay at 9% for this market preference to continue. But 4% inflation? Yes, we can see that lasting for a couple of years, to which we think the preference switch will last.

TWST: Any final thoughts to wrap up?

Mr. Segura: Every now and then we get these corrections where investors actually remember the value that active management can provide. Benchmarks can be risky; just take a look at the S&P 500 during the dot-com bubble burst, the great financial crisis, and again in 2022.

Moreover, we went back over these major market declines and tried to look for managers that had outperformed in every one of them; we couldn't really find many managers at all. We might be one of the few managers that outperformed in all three downturns, which the CEO of our company likes to call a "three-peat."

Benchmarks are not risk free, and active management can add value over a full market cycle. That's something that we think most investors ought to keep in mind.

TWST: Thank you. (MN)

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For standard Fund performance, please see the Baywood Fund Fact Sheet www.skba.com/baywood-funds.

Holdings are subject to change. For a list of current holdings, please visit www.skba.com/baywood-funds.

Before investing you should carefully consider the Fund's investment objectives, risks, charges and expenses. This and other information is available in the prospectus, a copy of which may be obtained from 855-409-2297. Please read the prospectus carefully before investing.

Baywood Funds are advised by SKBA Capital Management, LLC and distributed by Foreside Fund Services, LLC.

Glossary of Terms

ESG Framework: *SKBA believes that environmental, social and governance (ESG) factors often have long-term financial implications on a company's revenues, expenses and overall risk profile. By identifying undervalued opportunities where stock prices have overshot true changes in underlying fundamentals, SKBA seeks to generate alpha through disciplined, bottom-up research of responsible factors and company financials. SKBA's team-based process begins with the evaluation of both inclusive and exclusionary ESG criteria. Analysts then apply the firm's valuation framework to narrow the investment universe to opportunities reflecting low expectations discounted into current valuations. This subset is subjected to further in-depth fundamental analysis including both responsible investment considerations – that may include corporate governance, employee relations, environmental impact/sustainability, human rights record and product safety – and financial considerations that include earnings power, balance sheet and income statement strength, competitive position, and overall industry prospects. Aligned with SKBA's value philosophy, the team seeks to identify ESG improvers that it believes can offer the greater potential for a responsible investment, as well as a financial investment, for the firm's clients.*

Standard Deviation: *Standard deviation is the statistical measure of the volatility of investment returns, measuring how widely prices are dispersed from benchmark returns.*

OEM: *Original Equipment Manufacturer*

Fed: *The Federal Reserve Board*