Market Update
Winter 2022

THE GROWING APPEAL OF LONG-TERM FUNDAMENTALS

Executive Summary

In this paper, we discuss factors that contributed to the equities of companies with strong long-term fundamentals, such as earnings per share (EPS) and revenue growth, dramatically underperforming the broad market in 2021. We also explain why a handful of factors, such as macroeconomic changes, valuations and strengthening earnings, may potentially reverse this trend. In our view, conditions are particularly favorable for equities of high-quality, innovative smaller growth companies.

Highlights include the following:

- In the first half of 2021, optimism about the economy caused a strong shift in preference from secular growth stocks to economically sensitive cyclical stocks.
- In the second half of 2021, anxiety about tightening monetary policy drove a violent rotation into larger, more defensive stocks.
- Underlying both halves of last year was a duration trade in which long-duration assets, or equities with potential for generating strong future EPS growth or revenue growth, underperformed more established short-duration companies, having higher current cash flows and slower growth expectations.
- The epicenter of the rotation occurred in the longest duration assets, or small cap growth stocks, which by some measures are now the least expensive on a relative basis in decades, potentially setting up strong relative returns in the future.

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Challenging Times Create Potential Opportunities

After falling out of favor among investors, equities of companies with attractive long-term fundamentals have strong potential for outperformance in 2022, in our view. To understand events of 2021 and why market conditions may change, it's helpful to look at specific market rotations that occurred in each half of the year.

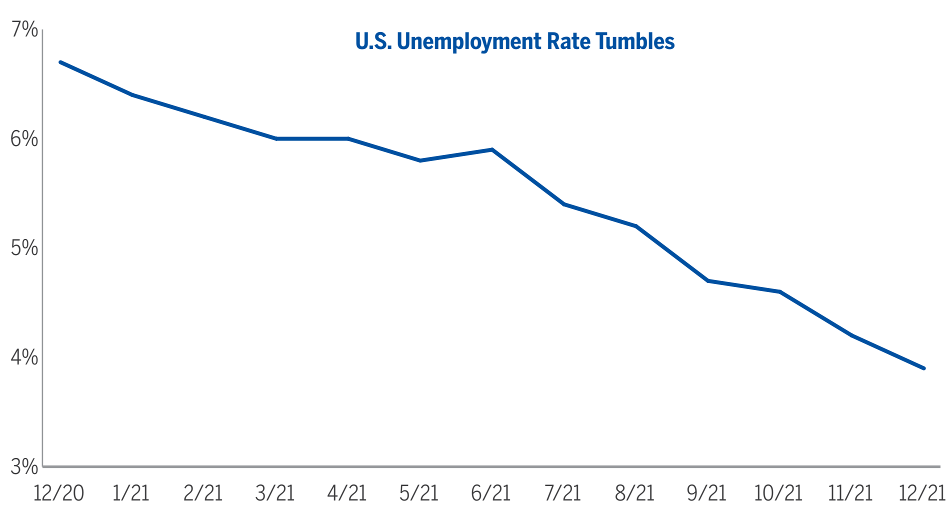
Economic Outlook Leads to Cyclicals

Economically sensitive stocks such as Energy and Financials performed best in the first half of 2021 as investors clamored for exposure to an accelerating economy. The stage for this change in investor preference was set in late 2020, when favorable COVID-19 vaccine trials sparked optimism about the pandemic faltering and hopes that efforts to curtail the public health emergency would be scaled back or eliminated. This optimism combined with record levels of fiscal stimulus caused the economy to start rebounding after lockdowns had previously sparked a deep recession. The optimism strengthened when the Food and Drug Administration eventually granted emergency use authorization of COVID-19 vaccines and by the end of the 2020, some 2.8 million Americans had received their first dose —a slow start but a start nevertheless. The aggressive ramping up of the vaccination campaign in the subsequent months and continued economic growth sustained investor optimism and a selloff in safe-haven Treasury bonds with the 10-year yield rising 53bps in the first half of 2021.

A few points illustrate the dramatic strength of the economy.

- At the start of 2021, consensus GDP growth forecast was 4.0%, an estimate that increased 250bps during the first half of 2021 to 6.5%, according to FactSet.
- Unemployment dropped substantially from 6.7% to 3.9% by year end (see Figure 1).

Figure 1
Seasonally Adjusted Unemployment Rate



Source: Bureau of Labor Statistics.

Many equity investors reacted to economic optimism and higher long-term interest rates by rotating into cyclical stocks or companies with earnings growth that is closely or directly tied to economic expansion. We consider these companies, which usually have weak long-term growth potential and are typically found within the value category, to be lower quality, unlike secular growth leaders that use innovation to disrupt their respective industries and generate future earnings growth. The investor preference for these companies can be seen in the performance of various corporate characteristics in the first half of 2021 when factors such as high debt, low margins, high beta, slow long-term growth and low shorthand metrics of valuation, such as price-to-book value, outperformed (see Figure 2).

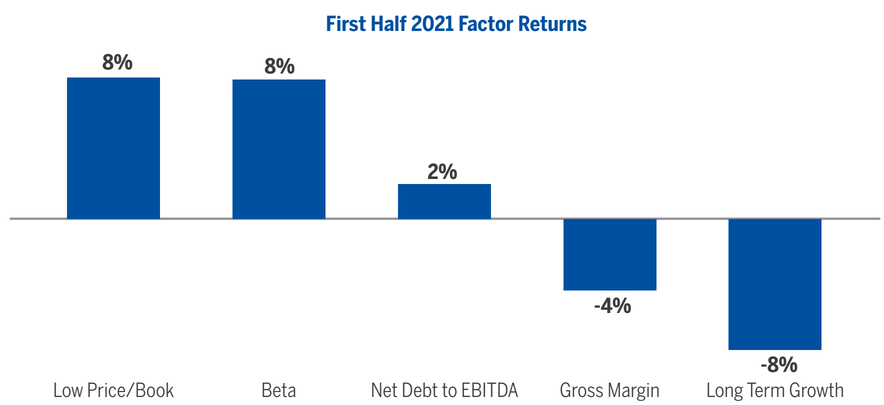
In the second half of 2021, inflation came in hotter than expected, topping 6%, and the Fed signaled a desire to raise rates sooner than anticipated. As a result, the yield curve flattened with yields on shorter term debt increasing rapidly.

Rate Hike Anxiety Leads to Defensiveness

In the second half of 2021, inflation came in hotter than expected, topping 6%, and the Fed signaled a desire to raise rates sooner than anticipated. As a result, the yield curve flattened with yields of shorter term debt increasing rapidly. During this period, the 2-year Treasury Bill increased nearly 50bps after only rising 13bps in the first half. Investors responded by selling stocks perceived as riskier. This was reflected in the market sensitivity factor or Beta underperforming the sector-neutral S&P 1500 by a large 7%, after having outperformed in the first half.

Investors also sought safety in large companies with the small cap Russell 2000 Index underperforming the S&P 500 by nearly 1,400bps in the second half of the year. This was particularly true in the large cap growth area of the market, which is more concentrated than ever – the top ten companies accounted for nearly half (48%) of the Russell 1000 Growth Index at the end of 2021. Indeed, for the year we estimate that the top ten constituents accounted for 62% of the index's performance, thereby outperforming the rest of the index by a stunning 2,000bps, approximately. Accordingly, the average growth stock did not fare nearly as well as the Russell 1000 Growth Index.

Figure 2
Lower Quality Economic Sensitive Equities Outperformed



Source: Cornerstone Macro. Factor performance relative to the S&P 1500, which is sector neutral and is calculated by taking the relative performance of the top quintile of stocks against the bottom quintile of stocks for each factor. The constituents in the quintiles are rebalanced monthly. Net Debt/EBITDA is defined as (Total Debt - Cash)/ LTM EBITDA and Gross Margin is defined as (LTM Revenue - LTM COGS)/LTM Revenue. Beta represents the slope of the line through a regression between the monthly stock return and the monthly market return over the past 5 years. Book yield is book value per share/current share price. long-term growth is mean estimated 5-year EPS growth.

Short duration cash flow stocks, businesses with limited opportunities to invest their earnings and instead distribute their cash to shareholders, did very well at the expense of long-duration cash flow equities that are more likely to reinvest for long-term growth.

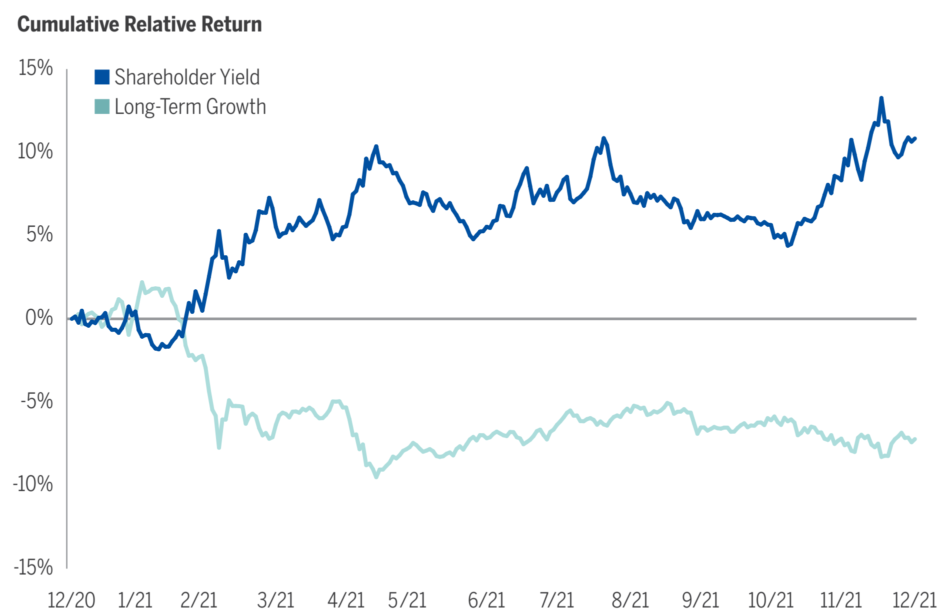
Summing up 2021

In a word, much of the equity performance last year can be attributed to duration. With investors seeking instant gratification from a one-time re-opening of the economy in the first half to hiding in defensive businesses in the second half, the one constant driver of stock prices was duration. Short-duration cash flow stocks, businesses with limited opportunities to invest their earnings that instead distribute their cash to shareholders, did very well at the expense of long-duration cash flow equities that are more likely to reinvest for long-term growth.

Whether it was rising risk-free rates or simply higher risk premiums, many investors adjusted their cash flow modeling by increasing the rate at which they discounted future cash flows back to the present, thereby lowering the value of long duration assets most, just as long-term bonds are impacted more by rising rates than short-term bonds.

We saw this dynamic in the largest spread in performance between the small capitalization Russell 2000 Growth Index and the S&P 500 in more than 20 years (over 2,700bps). On a more granular basis, there was a very wide performance spread between short-duration characteristics such as shareholder yield, which measures the performance of companies with the highest dividend and share repurchase yields, and long-duration characteristics, such as the long-term growth factor, which measures the performance of those companies with the highest forecasted long-term growth (see Figure 3).

Figure 3
Factor Performance in the Broad Market



Source: Cornerstone Macro. Factor performance relative to the S&P 1500, which is sector neutral and is calculated by taking the relative performance of the top quintile of stocks against the bottom quintile of stocks for each factor. The constituents in the quintiles are rebalanced monthly. Shareholder Yield is [LTM Common and Preferred Stock Purchased - LTM Common and Preferred Stock Sold + LTM Total Common Dividends] / Market Capitalization. Long-term Growth is mean estimated 5-year EPS growth.

As shown in Figure 4, this rotation to companies with high current shareholder yields was apparent not only in the broad market but within growth stocks, which helps explain why large cap growth, which tends to include more companies with significant current earnings, was relatively strong in 2021, with the Russell 1000 Growth Index generating a 28.7% return compared to the 25.2% return of the Russell 1000 Value Index. On the contrary, small cap growth tends to include younger companies that are aggressively investing in innovation rather than generating earnings or paying dividends.

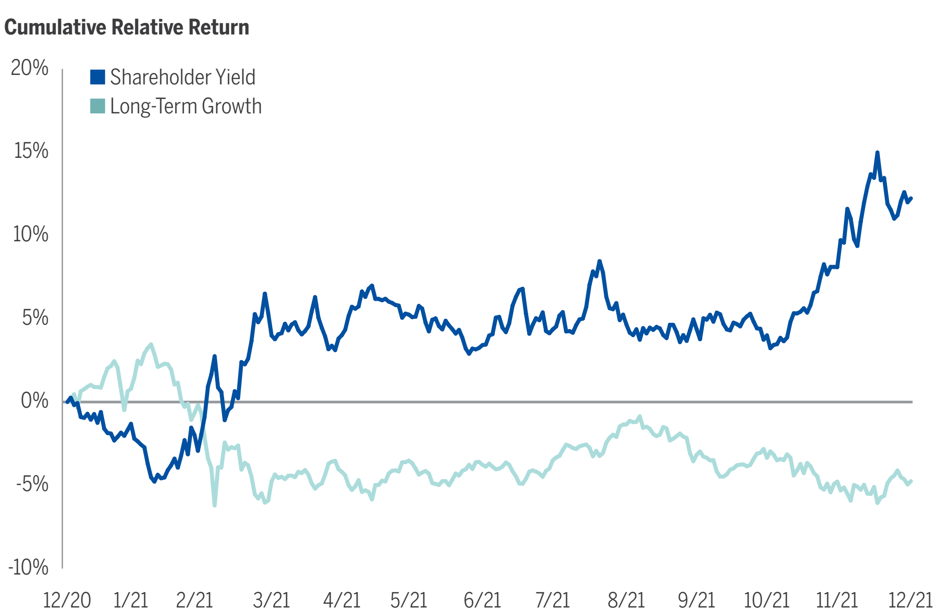
The rotation away from smaller growth equities juxtaposed with their strong fundamental growth has resulted in historically attractive valuations in these types of companies.

A Brighter Path Forward

While smaller growth company stock prices underperformed, their fundamentals did not. The next 12-month (NTM) EPS estimates for the S&P SmallCap 600 Growth index catapulted forward 63%, according to FactSet data, easily trouncing the still quite strong 36% increase in S&P 500 NTM estimates.

But what happens when price underperformance meets fundamental outperformance? Compressed valuations ensue. The rotation away from smaller growth equities juxtaposed with their strong fundamental growth has resulted in historically attractive valuations in these types of companies. The S&P SmallCap 600 Growth index valuation is 20% lower than the S&P 500, its biggest discount in two decades. Typically, small cap growth equities trade at a

Figure 4
Factor Performance in Growth Stocks



Source: Cornerstone Macro. Factor performance relative to the S&P 1500 Growth, which is sector neutral and is calculated by taking the relative performance of the top quintile of stocks against the bottom quintile of stocks for each factor. The constituents in the quintiles are rebalanced monthly. Shareholder Yield is [LTM Common and Preferred Stock Purchased - LTM Common and Preferred Stock Sold + LTM Total Common Dividends] / Market Capitalization. Long-term Growth is mean estimated 5-year EPS growth.

We maintain that the potential normalization of the small cap growth price-to-equity ratio (P/E) relative to the S&P 500 could provide a strong tailwind to small cap performance. Additionally, long-term fundamentals for small cap growth are compelling. Small cap growth EPS is expected to increase 17.4% over the next two years compared to only 6.9% for the S&P 500.

premium to large cap stocks based on their superior forecasted fundamental trajectory (see Figure 5).

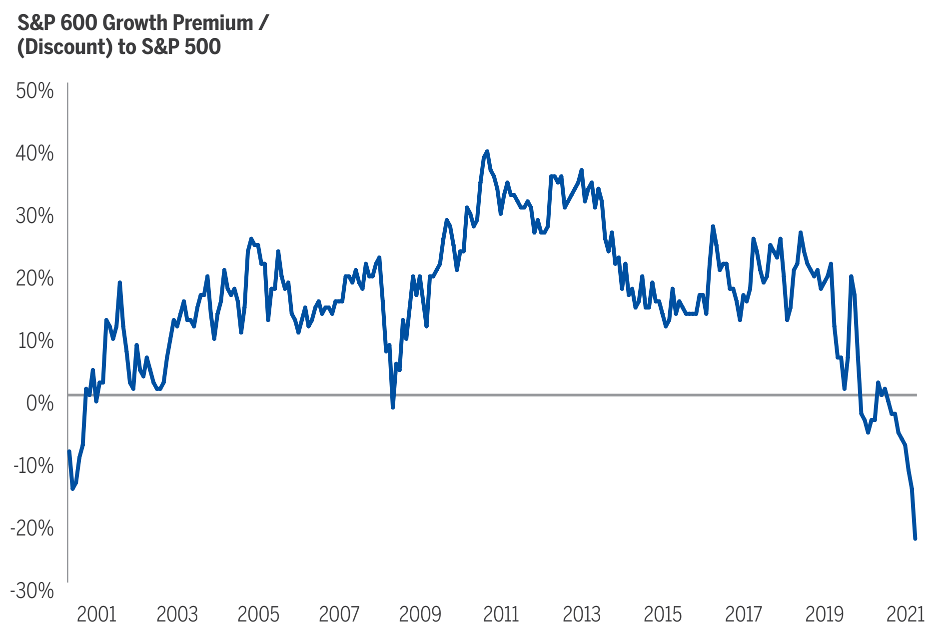
The last time this occurred in February 2001, small cap growth outperformed the broad market by over 50% in the ensuing five years. We maintain that the potential normalization of the small cap growth price-to-equity ratio (P/E) relative to the S&P 500 could provide a strong tailwind to small cap performance. Additionally, long-term fundamentals for small cap growth are compelling. Small cap growth EPS is expected to increase 17.4% over the next two years compared to only 6.9% for the S&P 500.

We believe small cap growth stocks could also benefit from a rally in health care and biotech in particular, with the S&P Biotechnology Select Industry Index declining 24% in 2021, drastically underperforming the broad market and the small cap category. This underperformance has resulted in the equity market capitalization to net cash value ratio of the biotech group declining to 3x—its lowest level in 20 years.

Potential for Shifting Sentiment

In our view, valuations, while compelling, may not be enough to drive a shift in sentiment. To that end, we believe it's important to consider that the economy can only re-open once so the strong economic boost in the aftermath of the pandemic is likely to be a one-time event. Eventually, we believe GDP growth resulting from the re-opening is likely to weaken or a COVID-19 variant such as

Figure 5
Small Cap Growth P/E is Cheap Relative to Large Cap



Source: FactSet.

Omicron may weigh upon economic growth. If either occur, investors may be willing to pay a premium for companies that can grow earnings with innovative products rather than cyclical growth. Additionally, the Federal Reserve's shrinking of its balance sheet and increasing of the fed funds rate could potentially result in lower long-term interest rates, which would support the equity performance of long-duration companies. Ultimately, irrespective of changes in valuation, the potential for high-quality growth companies to generate compound earnings and revenue growth should support strong returns over the long-term, in our view.

We continue to believe that our investment philosophy is highly appropriate as historically high levels of innovation, including the digital revolution that is disrupting all industries, is providing leading companies with strong opportunities to generate secular growth.

The Road Ahead

In closing, since our founding more than 55 years ago, we have believed that companies with strong long-term fundamentals offer the best potential for generating attractive returns for patient investors. The significant rotation we witnessed in 2021 hasn't changed our strong conviction in using in-depth fundamental research for finding secular growth leaders with potential for generating long-term earnings growth. We continue to believe that our investment philosophy is highly appropriate as historically high levels of innovation, including the digital revolution that is disrupting all industries, are providing leading companies with strong opportunities to generate secular growth. We believe where there is growth in fundamentals, there will be solid returns. Now it is the stock market's turn to catch up.

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Earnings per share (EPS) is calculated as a company's profit divided by the outstanding shares of its common stock.

The price-to-book ratio is the ratio of a company's market price to its book value.

Price-to-earnings is the ratio for valuing a company that measures its current share price relative to its earnings per share (EPS).

Free cash flow is the cash a company generates after taking into consideration cash outflows that support its operations and maintain its capital assets.

EBITDA (earnings before interest, taxes, depreciation, and amortization) is a commonly used accounting measure of a company's overall financial performance. COGS (cost of goods sold) is generally defined as the direct costs attributable to the production of the goods sold by a company.

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Beta measures a portfolio's sensitivity to market movements relative to a particular index; a portfolio with a beta of 1.00 would be expected to have returns equal to such index.

The S&P 1500 is an unmanaged index that covers approximately 90% of the U.S. market capitalization.

The Russell 2000 Index is a small cap stock market index of the bottom 2,000 stocks in the Russell 3000 Index.

The S&P 500 tracks the performance of 500 large companies listed on stock exchanges in the U.S.

The Russell 1000® Growth Index is an unmanaged index designed to measure the performance of the largest 1000 companies in the Russell 3000 Index with higher price to book ratios and higher forecasted growth values.

The Russell 2000® Growth Index measures the performance of the small cap growth segment of the U.S. equity universe. It includes those Russell 2000 companies with higher growth earning potential as defined by Russell's leading style methodology.

The Russell 1000 Value Index measures the performance of those Russell 1000 companies with lower price to book ratios and lower forecasted growth values.

The S&P SmallCap 600 Growth Index measures growth stocks using three factors: sales growth, the ratio of earnings change to price, and momentum. Constituents are drawn from the S&P 600.

Investing in innovation is not without risk and there is no guarantee that investments in research and development will result in a company gaining market share or achieving enhanced revenue. Companies exploring new technologies may face regulatory, political or legal challenges that may adversely impact their competitive positioning and financial prospects. Also, developing technologies to displace older technologies or create new markets may not in fact do so, and there may be sector specific risks as well. As is the case with any industry, there will be winners and losers that emerge and investors therefore need to conduct a significant amount of due diligence on individual companies to assess these risks and opportunities.

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