# Day Hagan Smart Value Strategy Update

March 2023

## Summary

The DH Smart Value Portfolio continues to invest in companies producing excess returns through positive economic profitability, supported by solid balance sheets (quality), significant cash generation (profitability), and trading with considerable margins of safety (valuation). We believe these factors will continue to provide rational opportunities for the foreseeable future. Using our consistent and differentiated investment approach, the DH Smart Value Portfolio is focused on outperformance, seeking higher total returns with lower volatility.

## Strategy Update

Year-to-date through the end of February, the portfolio was up +1.61%* net of fees vs. the benchmark Russell 1000 Value Index Total Return ETF up +1.45%.

Over the past three years (2-29-2020 thru 2-28-2023) there have been two major bear markets, a global pandemic, and Russia starting a war, among many other things. Over those three years, the portfolio gained at an +12.76%* net of fees annualized rate, vs. 10.76% for our benchmark.

During that time, the portfolio's Beta was 0.76, illustrating that the portfolio's outperformance was achieved while experiencing 24% less volatility risk than the index. The portfolio's Jensen's Alpha was +4.2, indicating that excess return was achieved relative to the risks being taken in the portfolio. Upside capture comes in at 84.7% vs. downside capture of just 71.3%. Our view is that this reinforces our focus on companies supported by quality, profitability, and margins of safety. We believe that companies exhibiting the aforementioned characteristics provide positive risk vs. return opportunities regardless of where we are in the economic, business, and inflation cycles.

Macro (economic) data releases in February seemed to surprise investors with their strength. This caused equity and fixed-income investors to reassess their views regarding 1) the probability of recession and 2) the magnitude of said recession. The economic reports' collective "better-than-expected" results led many investors to increase their odds of a deeper recession, in the belief that the Fed would likely stay hawkish for longer to combat the surprisingly persistent inflation pressures—ultimately driving the economy into a downturn. Investors' reactions were underscored by the 10-year Treasury yield spiking from 3.49% in early February to almost 4% by the end of the month, leading to stocks being generally weaker in February.

Nevertheless, throughout February, our Major Market Model's Internal Composite (made up of price-related indicators) remained bullish. This was due to the continued strength in indicators with more intermediate-term time horizons. However, we do note that a small portion of our shorter-term indicators have recently reversed to sell signals. This indicates that the current pullback, as of the date of this writing, is considered to be within a normal range from an intermediate-term perspective, with the overriding intermediate-term trend still positive. The shorter-term sell signals are "Get Ready to Take Action" types of indicators that we evaluate daily for signs of distress. Should our intermediate- and longer-term indicators roll over and confirm the short-term signals' message, we will be quick to take on more defensive positioning.

Interestingly, even though February was a down month for the market, risk-on sectors outperformed risk-off sectors. Information Technology was the only sector with a positive monthly return (+0.29%), followed by Industrials, Consumer Discretionary, and Financials. The worst-performing sectors were Energy (down -7.61% in February), Utilities (-6.37%), Real Estate (-6.07%), and Health Care (-4.72%). The strength in the Information Technology sector was somewhat surprising in that the sector typically moves inversely to interest rates (as interest rates go up, long-duration tech stocks go down). However, tech stocks have been a rare bright spot during the Q4 earnings season. Many of the largest-cap names have recently announced layoffs, buybacks, and cost-efficiency initiatives that investors have cheered.

The Energy sector (we are market-weight) has lost momentum and was the worst-performing sector in February. We are watching the sector closely for signs we should upgrade or downgrade given the model's neutral stance. There are several potential positive factors according to NDR: 1) If the U.S. begins refilling the SPR (strategic petroleum reserve), that would create demand, 2) a weaker U.S. dollar is positive, and 3) continued sanctions by the West would keep supplies tight. On the bearish side, we see Energy prices as susceptible to a recession and the associated drop in demand (which got priced in last month), and we also have noted that despite the sanctions and price caps on Russian crude, the physical markets look to be loosening more than tightening.

We note that many of 2022's headwinds are now "Past Their Peak" (PTP). For example, Fed and Global Central Bank hawkishness is waning, with the Fed closer to the end of the tightening cycle than the beginning. Inflation, interest rates, and oil prices peaked last year and are PTP. Supply chains are improving, and commodity prices have stabilized—both are certainly past their peak levels of obstructing economic progress. Meanwhile, employment, corporate balance sheets, and consumer balance sheets remain generally healthy.

This isn't to say we are sanguine about the current trajectory of the economic and corporate profit cycles. We recognize earnings expectations are likely still too high, the labor market is tight, the housing market is under pressure, credit conditions (lending) are tightening, and although interest rates have peaked, they remain at restrictive levels. U.S. Large Capitalization equity valuations remain high, a potential debt-ceiling showdown is in our near future, and geopolitical upheavals loom large.

At this point in the cycle, we continue to focus on value-oriented stocks as we navigate the tug of war between many of the major headwinds in 2022 being "Past Their Peak" vs. some continuing concerns around a Fed-induced recession and greater-than-expected earnings decline. We continue to focus on companies evidencing the characteristics that have led to long-term outperformance: quality, profitability, and reasonable valuation.

Turning to our portfolio holdings, we made two portfolio changes in February. On February 3, we sold Gilead Sciences (GILD). We first purchased the position in February 2021 and added to it in May 2021. The holding significantly outperformed both the S&P 500 Total Return and the Russell 1000 Value index, and ultimately achieved our measure of Fair Value. It reported earnings and fortuitously jumped higher on the news. We used it as an opportunity to realize our profit.

On February 28, we purchased Public Storage (PSA).

- PSA is the leading self-storage owner, operator, & developer with over 2,600 facilities with 182M net rentable square feet. Spanning 39 states, PSA has the largest national footprint in the industry. In addition, PSA is a 35% stakeholder in Shurgard Self Storage, which is a European self-storage operator.
- Since PSA is in the real estate sector and traditional financial statements for real estate companies are often misleading, we started by focusing on PSA's ability to generate economic profits. Here, PSA scores well as the company is currently returning over 30% in adjusted economic (EVA) margins for shareholders, and this is expected to increase. This is also supported

by standard metrics, with PSA's ROIC (return on invested capital) of 12.7% vs. their WACC (weighted average cost of capital, i.e., the company's hurdle rate) of just 3.2%. The wide spread can be interpreted as PSA's management doing a good job of allocating capital effectively.

- PSA also scores highly for Profitability and Risk. The 3-year Free Cash Flow growth rate is 11.8%, and Gross and Net margins are at the high end of the 10-year range. When we think about risk, we consider stock price volatility and margin volatility. Both are relatively low and are therefore positive. Further, Free Cash Flow/Capital, Operating Cash generation, and Total Debt/EBITDAR indicate lower risk and a higher quality balance sheet.
- From a valuation perspective, PSA's EVA-adjusted book value indicates that investors are somewhat pessimistic and potentially underpricing PSA's opportunities, as it is currently at the low end of its historical range. In addition, the stock currently trades at a price-to-funds from operations (similar to P/E but for REITs) of 10.52, which is well below its 10- and 15-year medians of 23.93 and 23.02 respectively.
- The forward dividend yield is currently about 4%, which is at the top end of its 10-year range and well above its 10-year median of 3.11%.
- Regarding the potential takeover of Life Storage by PSA, our view is that PSA may increase its bid slightly, but the overall takeover and potential efficiencies are positive. Conversely, should PSA not prevail in the takeover, our view is that the stock will likely appreciate as PSA management gets credit for not chasing the acquisition.

From a sector perspective, our current weightings are Information Technology (16.6% portfolio weighting vs. 8.6% benchmark), Health Care (11.5% vs. 17.0%), Financials (17.9% vs. 20.3%), Communication Services (9.2% vs. 7.3%), Industrials (11.2% vs. 10.3%), Consumer Staples (2.2% vs. 7.2%), Consumer Discretionary (6.2% vs. 6.1%), Real Estate (4.1% vs. 4.5%), Energy (3.7% vs. 8.8%), Materials (2.0% vs. 4.1%), and Utilities (5.4% vs. 5.5%).

From a portfolio perspective, the median Forward Price/Earnings multiple is 13.5x, with a dividend yield of 2.46%. The median cash flow yield is 10.7%.

Please let us know if you would like to discuss the portfolio in more detail or would like to know more about our approach.

**Sincerely,**

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**Disclosure: The aforementioned positions may change at any time.**

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**Beta** is a measure of the volatility, or systematic risk, of a security or a portfolio in comparison to the market as a whole. **Jensen's Alpha** is a risk-adjusted performance measure that represents the average return on a portfolio or investment, above or below that predicted by the capital asset pricing model (CAPM), given the portfolio's or investment's beta and the average market return. This metric is also commonly referred to as simply alpha.

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