DAY HAGAN SMART VALUE

Day Hagan Smart Value Strategy Update

May 2024

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

Even though equity returns for April were negative for the first time in 2024 for most developed markets, it's important to note that U.S. equities are less than 3% from the all-time high. Moreover, after back-to-back quarters of solid performance, equities were primed for consolidation and a pullback. At this point, given the stability around credit spreads (still narrow) and positive global economic growth prospects, data suggests the uptrend that started in October 2022 is still intact.

That's not to say there aren't potential problems lurking about. For example, inflation has not been tamed to levels that would seemingly satisfy the Fed. Recent inflation reports show that modest upside pressures, especially in services, remain. This has led to the Fed delaying rate cuts, which the markets were banking on at the beginning of the year. For a sense of how the interest rate backdrop has changed, consider that investors were pricing in at least six rate cuts as we entered 2024 versus today's outlook, which is for just one rate cut, likely occurring toward the end of the year. Nonetheless, we currently do not envision the Fed suddenly taking a more hawkish approach to monetary policy—it's more that dovish moves are being delayed, hence the term "higher for longer."

All in all, models calling U.S. and international economic activity are at levels denoting positive growth, with the odds of a global slowdown heading significantly lower. However, models tasked with evaluating inflation pressures indicate that upside pressures may be building. To be clear, our models are still in the "moderate disinflation" zone. However, the model's direction has been slowly transitioning toward a more neutral inflation message.

History shows that during periods when growth is rising, and inflation is neutral, U.S. equities (S&P 500) gained at a +16.8% annualized rate (since 1972). What about periods of rising growth and rising inflation? On average, U.S. equity gains were more muted but still good at +9.2%. What macro backdrop do we not want to see? Economic growth is falling, and inflation is falling. Historically, U.S. equities have declined at a -15.7% annualized rate with those conditions in place.

Last month, we wrote, "And while U.S. elections are still over seven (now six) months away, the results will most certainly impact the investing landscape. For example, when one contemplates each party's conflicting appetite for higher taxes and continued deficit spending, the ramifications for sector and industry rotation are potentially enormous." Well, the first "trial balloon" was recently floated by the Biden administration, calling for the expiration of the Trump tax cuts in December 2025, a 44.6% capital gains tax rate and a 25% tax on unrealized gains. Of course, trial balloons are just that, trials—they're testing the waters. It is highly unlikely that those punitive rates will see the light of day, but it does, in our view, signal intent.

In an effort to quantify the ramifications of higher taxes, we note that from 1914 through 2020, during low-tax environments when inflation was between 0% and 4% (as it is now), the average P/E (price-to-earnings ratio) for the S&P 500 was 20.1x, which is very close to the current forward P/E on the S&P 500 of 20.7x. However, during high-tax environments with inflation between 0% and 4%, the average P/E dropped to 16.3x, which would equate to a -21.2% decline in equity prices (all things being equal). Obviously, we'll be keeping an eye on new tax proposals and subsequent trial balloons.

Earnings season is in full force, and the good news is that during April, 18 of the 19 companies we hold in the portfolio reported and beat analyst expectations, while 1 met expectations. Below are highlights from a few of the companies reporting earnings in April.

Chevron (CVX): In the earnings call, CVX reported good profitability and a focus on lower carbon emission projects. ROCE (Return on Capital Employed) was 12.4%, with $6 billion returned to shareholders (dividends/buybacks) and production up 12% year over year (due to an acquisition and growth in the Permian Basin). CVX is developing solar-to-hydrogen production and has launched a $500 million clean energy fund. CVX has been working down its debt (from $44 billion in 2020 to about $21 billion currently), and debt-to-equity is just 13%. CVX has been investing heavily in new production. Management notes that if Brent Crude averages $60 a barrel, CVX would expect $4 billion of free cash flow in 2025 and $5 billion in 2026. Brent Crude is currently trading at around $82. The dividend yield is 3.76%.

Kinder Morgan (KMI): KMI noted that the demand for power data centers (AI-related) is expected to increase 13-15% compounded annually through 2030. Utilities are projected to benefit, especially those powered by natural gas. During the quarter, earnings per share (EPS) increased 13%, and Cash Flow (EBITDA) was up 7%. The balance sheet is sound, with positive debt coverage ratios and an announced increase in the dividend this quarter. Looking ahead, KMI will once again benefit from LNG exports once the Biden administration's pause is lifted. KMI's pipeline/terminal business is also growing. Price/Free Cash Flow is just 10.5x, with Free Cash Flow margins over 25%. The dividend yield is 6.14%. KMI was the one company to meet, not beat, earnings expectations.

Alphabet (GOOGL): Management discussed the positive trends in Search, YouTube, and Cloud. For example, Google is implementing "Circle to Search," where a user circles something that interests them on an Android device, asks a question, and receives an AI/LLM-generated response. Many don't realize that GOOGL is a pioneer in AI, with initiatives going back to 2016. YouTube continues to be a streaming leader, with over 1 billion hours of content viewed daily. AI is also being implemented to support content providers. Google Services revenues were up 14% y/y, with YouTube ad revenue up 21%. Alas, while Gemini was a bit of a dud, GOOGL is moving quickly to shore up the disappointing release. We view it as a hiccup rather than a structural problem. While valuations are getting a bit rich, we note the current forward P/E is 21.9x, not much higher than the S&P 500's 20.7x. With GOOGL, an investor gets better cash flows, better revenue growth, significant buyback support, and even a dividend yield, which is now 0.48%.

Merck & Co (MRK): MRK beat earnings and raised guidance, in part due to stronger Keytruda sales. Revenues increased 9%, which included the hit from the devaluation of the Argentine peso. Keytruda (oncology) sales increased by 24%, with off-label uses expanding. MRK's pipeline continues to deliver, with management declaring, "Across our deep pipelines, we have significant clinical momentum in a range of therapeutic areas." The stock price has been spiking higher, causing current valuations to approach our determination of Fair Value. While the forward P/E is 15.1x (below market), our appraisal of MRK's Economic Profitability shows that investors are currently pricing in a rational level of Economic Margin and sales growth. Bottom Line: MRK is on our watchlist. The dividend yield is 2.3%, at the low end of its 10-year range.

Meta Platforms (META): META absolutely blew away earnings and revenue growth expectations on the upside, noting that 3.2 billion people use at least one of its apps daily. The company is also continuing to grow its AI and Metaverse offerings. However, the stock dropped as the earnings call began due to META disclosing its plans to significantly increase its capex and energy expenses targeting AI. We happen to view the news as positive, given that META's return on invested capital (ROIC) is currently 29.8%, indicating that management has a history of making rational, shareholder-enhancing investments. Meta's forward P/E is 21.9x, not much higher than the market's 20.7x, Economic Profitability is solid, and Economic Margin expectations are, in our view, achievable. We trimmed the position in mid-March when the stock was trading at much higher levels, but we wouldn't hesitate to add back if the data supported increasing exposure.

Owens Corning (OC): OC divides its business into three segments: roofing (the largest segment), insulation, and composites. OC expects roofing and insulation to grow low to mid-single digits, with composites down low double digits. OC is in the process of acquiring Masonite (the door maker) as it seeks to diversify. Although OC is trading near 52-week highs, investor expectations remain relatively subdued. The forward P/E ratio is 11.7x, with free cash flow margins over 14%, and Price/Free Cash now 11.1x -- illustrating strong profitability. Investors are currently pricing in a rational level of future Economic Margins and sales growth. OC is sitting on over $1.25 billion in cash, with free cash flow generation over the past year of $1.4 billion.

Masco Corporation (MAS): While revenues decreased slightly (3%) from the heady post-COVID housing levels, MAS has improved efficiencies to increase its adjusted gross margin by 210 bps to 35.7%, grew earnings by 8%, repurchased 2.1 million shares, and maintained full-year guidance. The plumbing products segment's revenues decreased, but operating profits increased. The decorative architectural products segment declined on both measures as pricing normalized. MAS, overall, has strong profitability, with an ROIC of 32% vs. a cost of capital of around 10.5%. The forward P/E is 16.8x, with a dividend yield of 1.7%. Debt levels have been consistent for over a decade, and over $1 billion in free cash has been generated over the past 12 months.

PepsiCo (PEP): Organic sales were up 2.7% during the quarter, vs. 2.3% consensus. Operating profits were up 5%. International operations performed well. Celsius sales have been strong. Pepsi showed sequential gains in volume trends, net revenue, operating profit margins, and EPS despite a product recall at Quaker Foods. Guidance was neutral. For a staples company, PEP's profitability is good, with ROIC at 13% and the cost of capital around 6.5%. Free cash flow margins are 7.9%. Debt coverage ratios are supportive, but the high level of debt is somewhat concerning. We note that recent debt issuance has been with around a 4.6% interest rate (issued through its Singapore subsidiary). The stock has rebounded nicely following our mid-March purchase, but the gains put it closer to our Fair Value calculation. While the stock historically has provided some defensive characteristics, we will not hesitate to exchange the position once it hits our target price.

United Parcel Service (UPS): Earnings beat expectations, but revenues missed as U.S. package revenue was down 5%, though international revenues were up 6.3%. UPS's supply chain solutions segment was also a bit weaker, with revenues down 5.3%. Most of this was anticipated, illustrated by the share price moving higher on the news. Full-year guidance was also encouraging. Concerns arose around UPS's increased labor costs, but management notes that the costs are front-end loaded with 46% of the annual wage and benefit increases in the first year. UPS has also been targeting efficiencies. For example, as the primary air cargo provider for the US Postal Service, UPS can scale air freight services without massive capital investment. UPS's share price has languished as the company sorted out labor disputes and invested in improving efficiency. Concerns over Amazon's encroachment is also impacting the stock price. We are expecting to see better results soon. If they don't materialize, we will likely exit the position in favor of a timelier holding.

Goldman Sachs Group (GS): GS had a terrific Q1, with investment banking (global M&A), sales, and trading supporting a substantial earnings and revenue beat. Net income was up 27.8% year on year. Return on Tangible Equity (ROTE) was 15.9%. Investment banking was up 33%, and the Fixed Income, Currencies, and Commodities division had revenues of $4.3 billion. This all comes on the heels of GS offloading a good portion of its asset management exposure last year. Standard metrics show that the Price/Tangible book ratio is in the middle of its 10-year range (1.17x), while Economic Profitability expectations are relatively stable. Given the return to their core competencies, investors are likely to assign a premium once again to this market-leading enterprise. The dividend yield is 2.53%, and the company continues to buy back shares, leading to a shareholder yield of over 8.7%.

Charles Schwab Corporation (SCHW): SCHW has had their work cut out for them, as investors "cash sorted" accounts from low-yielding deposit accounts to higher-yielding money market accounts, negatively impacting profitability and causing a disturbance in the banking sector during March 2023. Nonetheless, we purchased the stock near the lows as investors priced in an inordinate amount of pessimism. The company has slowly been working its way out of the doldrums, and the stock price has responded positively. The merger with TD Ameritrade is likely to generate significant cost efficiencies, adding to the bottom line over the next couple of years. We do have some concerns about valuation, as expectations have shifted from overly pessimistic to overly optimistic. With the stock approaching our Fair Value level, it is on our watchlist for possible replacement.

The portfolio's current sector weightings are Information Technology (13.6% portfolio weighting vs. 9.0% benchmark), Health Care (3.1% vs. 14.0%), Financials (21.8% vs. 22.5%), Communication Services (10.3% vs. 4.5%), Industrials (12.9% vs. 14.5%), Consumer Staples (7.4% vs. 8.0%), Consumer Discretionary (8.7% vs. 4.8%), Real Estate (1.4% vs. 4.4%), Energy (5.6% vs. 8.4%), Materials (1.9% vs. 4.8%), and Utilities (3.6% vs. 5.0%).

From a portfolio perspective using more standard metrics, the median Forward Price/Earnings multiple is 16.4x (versus 20.7x for the broad market), with the portfolio's average Cash Flow Yield now an attractive 8.2%. The dividend yield is approximately 2.4%.

The Smart Value portfolio strategy utilizes measures of economic profitability, balance sheet sustainability, cash flow generation, valuation, economic trends, monetary liquidity, and market sentiment to make objective, rational decisions about how much capital to place at risk, as well as where to place that capital.

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

Sincerely,

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