Day Hagan Smart Value Strategy Update

JANUARY 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 December, the DH Logix Smart Value Portfolio was down -3.90%* net of fees vs. the benchmark Russell 1000 Value Index down -7.54% and the S&P 500 Total Return down -18.11%. For further comparison, the Nasdaq 100 was down -32.38% for the year. Interestingly, bond performance, based on the Bloomberg U.S. Aggregate Bond Index, shows the former safe haven down -13.1%. Longer-term bonds have fared even worse, with the Bloomberg 20+ year U.S. Treasury down -31.09% by end of year. It is probably not lost on anyone reading this letter that 2022 was an unusually difficult year.

The portfolio's year-to-date Beta was 0.76, illustrating that the portfolio outperformance was achieved while experiencing 24% less volatility risk than the index. The portfolio's Jensen's Alpha for 2022 was +12.34 through December, indicating that excess return was achieved relative to the risk we are taking in the portfolio. Upside capture for the year was 103% vs. downside capture of just 0.65%. Our view is that this is testament to our focus on companies supported by quality, profitability, and margins of safety. We believe these types of companies provide positive risk vs. return opportunities regardless of where we are in the economic, business, and inflation cycles.

This year's outperformance follows the previous year's (2021) gain of +30.92%* net of fees vs. +24.92% for the Russell 1000 Value Index benchmark. Viewing overall risk-return, the portfolio has outperformed its benchmark, generated positive alpha (risk-adjusted return), and exhibited lower beta (volatility) over the 1-, 3-, 5-, and 10-year timeframes, as well as since inception.

We note that 2022 was a year for the record books. For example: 1) U.S. financial markets were buffeted by the most aggressive monetary tightening cycle in 40 years. 2) It was the worst year on record for the Bloomberg Barclays U.S. Aggregate Bond Index (down -13.1%). 3) Long-term U.S. Treasurys declined -29.3%. 4) It was only the sixth time since 1926 that both stocks and bonds declined in the same year. 5) Both U.S. stocks and bonds fell by more than 10% for the first time on record. 6) All international regions were down in U.S. dollar terms. 7) And if it felt like a volatile year, it was--based on several volatility measures, it was the most volatile on record. There were 8 corrections of 5% or more—twice the average—and 2022 ties 1974 and 2020 for second place after the 2008 bear market.

Yet, as we begin 2023, the financial world has changed and our overarching view is that, ultimately, it will be for the better. Easy-money policies have reversed, Modern Monetary Policy (MMT) has been debunked, and companies providing value to their customers will be rewarded. Investors can once again rely on the basics of investing: Macro factors, fundamentals, technicals, and positioning. This plays directly into our wheelhouse.

Clearly, the global financial markets' transition has been uncomfortable. Nevertheless, it appears that we are closing in on the end of the tightening cycle and are prepared to take advantage of opportunity. We do, however, remain cognizant of the litany of potential geopolitical risks, the possibility of reignited zero-Covid policies and the rise of potential variants, and the chance of central bank policy errors.

Turning to individual stock holdings, the portfolio holdings remained static in December. From a sector perspective, our current weightings are Information Technology (16.6% portfolio weighting vs. 8.6% benchmark), Health Care (18.9% vs. 17.0%), Financials (19.4% vs. 20.3%), Communication Services (9.3% vs. 7.3%), Industrials (6.3% vs. 10.3%), Consumer Staples (4.2% vs. 7.2%), Consumer Discretionary (5.9% vs. 6.1%), Real Estate (2.4% vs. 4.5%), Energy (4.0% vs. 8.8%), Materials (0.0% vs. 4.1%), and Utilities (6.8% vs. 5.5%).

From a portfolio perspective, the median Forward Price/Earnings multiple is 13.3x, with the portfolio's median Free Cash Flow Yield coming in at an attractive 7.5%. The dividend yield is 2.4%.

Interestingly, when evaluating several of the current portfolio's standard metrics relative to 10-year median values, we see that the portfolio's current median Price/Cash Flow is 11.5x vs. a 10-year median of 27.1x. The portfolio's current median Price/Tangible Book is 2.1x vs. the 10-year median of 5.2x. From this view, in aggregate, we are currently able to own our portfolio of companies at less than 1/2 of the average valuations over the past 10 years.

From a "growth vs. value" perspective, we submit that "traditional" metrics defining value versus growth have become somewhat muddled. (If you've followed the Russell Value and Growth index rebalancing over the years, you've seen myriad tech stocks move from the growth classification to value and back to growth again.) We think that consistency matters, and over the past decade, the factors that have led to outperformance are Quality, Valuation, Efficiency, Profitability, and Cash Generation. We continue to focus on those and other historically attractive factors and seek to maintain a relatively diversified portfolio.

As we embark upon 2023, don't hesitate to let us know if you'd like to dig into our methodology and look "under the hood" with us. We wish you a happy and prosperous new year, both personally and professionally.

Sincerely,

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Regan Teague, CFA®, CFP®
Rob Herman, MBA
Jeffery Palmer, CIPM
Steve Zimmerman, MBA
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Note: As the market environment evolves, Day Hagan Smart Value remains a strategy that has provided a consistent approach to valuation, with an emphasis on quality and risk management. Our track record speaks for itself with both attractive upside and modest downside capture, in the name of long-term outperformance. If you would like to schedule a virtual meeting, just let us know.

Disclosure: The aforementioned positions may change at any time.

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There is no guarantee that any investment strategy will achieve its objectives, generate dividends, or avoid losses.

***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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