DAY HAGAN
SMART VALUE

Day Hagan Smart Value Strategy Update

July 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 June, the portfolio was up +5.06%* net of fees vs. the benchmark Russell 1000 Value Index Total Return, +5.04%. For the three-year period from 6-30-2020 through 6-30-2023, the portfolio gained at a +14.21%* annualized rate (net of fees) vs. +14.09% 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*. Upside capture comes in at 81.4% vs. downside capture of just 67.8%. 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.

As we described in last month's letter, the stock market continues to be led by just a handful of stocks; specifically, the top 10 companies in the S&P 500 accounted for 95% of the index's year-to-date performance. Perhaps even more interesting to investors seeking value, we note that dividend-paying stocks had their worst first-half performance relative to non-dividend-paying stocks since 2009, and it was the fourth-worst period in 50 years. As you can see, much of the underlying weakness in equities is being masked by a few large companies. And for those companies that are leading in performance, many don't pay dividends and are trading at historically elevated valuations. For example, NVIDIA (NVDA), the AI semiconductor chip darling, is now trading at over *40 times its annual revenues.*

This reminds us of a famous quote from Scott McNeely, former CEO of Sun Microsystems. In 2000, as the dot.com mania was in full bloom, Sun Micro's stock price spiked to a value that equaled ten times the company's annual revenues. A couple of years later, after reality and gravity took hold, he had this to say, *"At ten times revenues, to give you a 10-year payback, I have to pay you 100% of revenues for ten straight years in dividends. That assumes I can get that by my shareholders. That assumes I have zero cost of goods sold, which is very hard for a computer company. That assumes zero expenses, which is really hard with 39,000 employees. That assumes I pay no taxes, which is very hard. And that assumes you pay no taxes on your dividends, which is kind of illegal. And that assumes with zero R&D for the next ten years, I can maintain the current revenue run rate. Now, having done that, would any of you like to buy my stock at $64? Do you realize how ridiculous those basic assumptions are? You don't need any transparency. You don't need any footnotes. What were you thinking?"*

The stock subsequently cratered from over $60 to less than $5 as investors realized that hope isn't an investment strategy and that valuations matter—even for quality companies.

We also view the current weakness in many stocks as resulting from a repricing of earnings expectations. The estimated S&P 500 earnings decline in the second quarter (ending in June) is -6.8%. If this proves to be correct, it will be the largest quarterly earnings decline since the second quarter of 2020—as the pandemic lockdowns accelerated. The expected decline for Q2 earnings was -4.7% as of March 31, so expectations have continued to sour. Interestingly, only two sectors saw increases in their earnings expectations: Information Technology and Communications Services. As you might expect, the largest stocks in those sectors are Apple, Microsoft, Meta, and Alphabet.

We also wrote last month that, "We continue to own Meta and Alphabet. At this juncture, outside of the FANMAG stocks we own, the others continue to appear extended based on our multi-factor approach to valuation. To be clear, should any of the other FANMAG stocks achieve our standards for purchase, we will happily include them in the portfolio.

"Those standards include investing in quality companies that exhibit positive economic profitability, strong balance sheets, solid cash generation, sustainable profitability, and margins of safety. This, by many definitions, is a more value-oriented approach.

"By many indications, value stocks are poised for relative strength. Ned Davis Research points out that the percentage of stocks outperforming the S&P 500 is at a record low and on pace for the fewest stocks beating the index on record (since 1973). Following those periods of narrow leadership, S&P 500 returns have been below average, and value and high quality have outperformed growth. Relative valuations are also supportive, with the NDR Large Cap Growth Equity Index Forward Price/Earnings ratio now 35.9x and the NDR Large Cap Value Equity Index Forward P/E nearly two-thirds cheaper at a relatively low 12.2x. This compares to 19.1x for the S&P 500."

From a portfolio perspective, the median Forward Price/Earnings multiple is 14.1x, with the portfolio's median Free Cash Flow Yield coming in at an attractive 7.3%. The dividend yield is 2.4%. The current portfolio's median Price/Tangible Book is 2.7x vs. the 10-year median of 4.9x. From this view, in the aggregate, we are currently able to own our portfolio of companies at just 55% of the average tangible book valuation over the past ten years.

With regard to portfolio changes made last month, on June 13, we sold our positions in American Tower Corp. and UGI Corporation. American Tower is a REIT that was sold due to concerns about upcoming debt maturities having to be reissued at higher costs and their recent acquisition of CoreSite (a data center) not meeting expectations. UGI was sold due to the continued pressure on natural gas prices and a high dividend payout ratio that may lead to the dividend being reduced in the future.

We moved the proceeds of the sales into PayPal Holdings (PYPL) for the following reasons:

- PayPal Holdings was one of the first and is currently one of the leading digital payment platforms. It was founded in 1998 and operates in roughly 200 markets worldwide. Over the past 12 months, PYPL generated over $28 billion in revenue and $5 billion in free cash flow.
- Over the last seven years, the company has seen annual growth in the number of active accounts of 14%, total payments volume of 24%, net revenue of 26%, and free cash flow of 22%.
- The company has no debt maturing in the next twelve months. The roughly $10.4 billion of debt maturing in the coming years is more than covered by the $17.7 billion in cash the company currently holds. Overall, the company has the balance sheet flexibility to navigate economic weakness, should it arise, as well as make strategic investments and return cash to shareholders by repurchasing shares as opportunities become available.
- Since the stock's high in July 2021, shares are down roughly -80%, while the company's revenue has increased more than twelve percent. The valuation has moved into a zone that provides a significant margin of safety relative to history.

- Management has made prudent business investments which have resulted in a return on invested capital (ROIC) of 13.54% versus a weighted average cost of capital (WACC) of 8.73%. This attests to the company's profitability. In addition, the company has shown itself to be consistently economically profitable (EVA). Given the positive quantitative underpinnings, valuations indicate that investors are the most pessimistic they have ever been about PayPal's ability to grow and execute.
- Overall, management has proven to be prudent allocators of capital, as seen by the company's profitability metrics. Further, management is shareholder-friendly, returning cash back to shareholders through stock repurchases. The stock currently trades at a forward P/E of 12.8x and a price-to-free-cash-flow multiple of 12.68x. Moreover, the EVA-adjusted price-to-book value now resides at historically low levels, indicating that investors are pricing in very little by way of expectations. Given the aforementioned factors, we initiated a position in the stock.

On June 28, we took profits from our position in Micron Technologies and increased our cash position in the portfolio. The following points were conveyed in our Trade Notification at the time:

- We are exiting our position in MU as the business's operating environment continues to face macro headwinds. For example, the U.S. is sanctioning many of China's tech businesses, and in return, China is sanctioning U.S. tech. China recently concluded that "Micron's products posed a cybersecurity risk" and ordered that Micron products cannot be used in critical information infrastructure. MU management states that the impact is likely to result in a "high single-digit percentage decline" in revenues. The stock initially dipped and has since recovered (though the problem still exists), providing an opportunity to take profits.
- We'd also note that we may have been premature in concluding that a trough in memory (NAND) and storage (DRAM) semiconductors had occurred. When we added the position, valuations had improved dramatically, and profitability was stabilizing, providing a solid margin of safety for our entry point, which has, to date, worked in our favor. However, reports of increasing inventory levels (around 200 days vs. 150 days being optimal), the commoditized nature of the business, and stiff competition from the top 2 players in the industry (MU is #3) have us exiting before their upcoming earnings report.
- The position is nicely profitable at this point, up approximately 9.7%* since purchase in late January, vs. the SP500, up 8.9%, and the Russell 1000 Value Index, down -0.07% over the same timeframe.

Lastly, from a sector perspective, our current weightings are Information Technology (14.7% portfolio weighting vs. 9.0% benchmark), Health Care (9.6% vs. 15.6%), Financials (18.5% vs. 20.1%), Communication Services (12.5% vs. 5.1%), Industrials (11.6% vs. 13.4%), Consumer Staples (2.0% vs. 8.4%), Consumer Discretionary (6.4% vs. 5.3%), Real Estate (2.0% vs. 5.0%), Energy (3.6% vs. 7.9%), Materials (5.5% vs. 4.8%), and Utilities (4.1% vs. 5.2%).

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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