DAY HAGAN SMART VALUE

# Day Hagan Smart Value Strategy Update

March 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

From seasonal and cycle perspectives, February is often one of the weakest months of the year for equity performance. However, that wasn't the case this time around, with equity markets around the globe continuing higher as investors focused on better-than-expected global economic activity and hopes for easier central bank policies.

There have been notable changes in the macroeconomic backdrop over the past few months. On the plus side, recession concerns have diminished, global economic growth has been better than expected, inflation pressures are waning, credit conditions are favorable for businesses and consumers, and there is still hope for easier monetary policy before the end of the year (nine out of thirty-four central banks that we cover lowered rates at their last meetings, most others held rates steady). On the negative side, valuations for developed markets are at the high end of the range (the MSCI All Country World Index forward price/earnings multiple is 17.4x, the highest reading in 20 years, excluding the post-2020 collapse in earnings), earnings forecasts are being lowered, geopolitical tensions remain high, and U.S. election-year strains are growing.

These market influences are flowing through to our U.S. equity models and indicators. Measures of short-term momentum, breadth, overbought/oversold, and relative strength, along with reduced rolling downside volatility, point to a continuation of the uptrend. Positive macro-focused indicators show that credit spreads remain narrow (indicating a lower probability of a major financial dislocation), investors continue to overweight risk-on areas of the market (meaning investor demand is solid), and the Global Recession Probability Model confirms that the odds of a global slowdown are relatively low. Indicators evaluating sentiment and earnings are a bit more problematic. Sentiment measures show that investors have reached levels of extreme optimism, which, from a contrary opinion perspective, has historically been a headwind. And, as mentioned earlier, earnings may be under pressure, with the earnings estimate revision breadth and MSCI earnings growth breadth factors both on sell signals. Lastly, global manufacturing is still in a slump, which is partially to blame for Emerging Market underperformance (though the services side of the global economy is doing well). The net result of these factors is a positive outlook for equities over a longer-term time horizon.

Drilling down into the portfolio's sector exposures shows that our largest weightings are in Information Technology, Financials, Communication Services, and Industrials. The good news is that these happen to be the strongest-performing sectors within the S&P 500 year-to-date (up +10.3%, +7.0%, +10.8%, and

+6.0%, respectively, source: Bloomberg). Following is a short review of factors impacting each of these sectors:

**Information Technology:** Earnings season for Q4 2023 has just about concluded, with 92.8% of S&P 500 companies reporting. The good news is that 77% of S&P 500 companies outperformed expected earnings, with the highest percentage of beats occurring in the Information Technology sector at 87.5%. Nonetheless, it appears that the high earnings expectations for the sector may have temporarily peaked in Q4 2023, as 70 instances of downward earnings revisions for the upcoming Q1 2024 period (vs. 43 increases and 54 unchanged) have been reported. We view this as the direct result of the Fed seemingly playing down the prospects for a near-term rate cut, meaning that rates could stay higher for longer. This presents a negative overhang for long-duration assets, which can especially impact Technology-related companies. Interestingly, we note that full-year 2024 and 2025 earnings estimate revisions for the sector have increased 25.7% and 28.4%, respectively, over the past 4 weeks. In other words, while the sector's earnings growth trajectory may pause, investors are fully expecting a return to red-hot earnings growth toward the end of this year. And those earnings better come through, as valuations are at the high end of a 20-year range. The Price/Forward Earnings multiple is 26.4 times, nearly two Standard Deviations above average. The Price/Cash Flow multiple is 25.5x, also near all-time highs for the period. At this point, our technical (price-related) indicators for the sector are mixed, with measures of momentum, intermediate-term overbought/oversold conditions, and long-term breadth positive. Indicators evaluating <u>short-term</u> overbought/oversold conditions and short-term breadth are diverging, meaning that while the long-term trend remains intact, the near-term could see an increase in volatility. Looking ahead, valuations are high, but if earnings growth achieves expectations, the sector can continue higher. Furthermore, AI is still capturing attention and investors are still "buying dips", and as a high-duration sector, should rates finally relent and start to move lower, tech-related stocks could benefit. We continue to view the sector positively for long-term growth potential. Still, at this point in the cycle, we are finding fewer and fewer companies that meet our strict valuation and balance sheet criteria. Companies owned in this sector include Cisco, Cognizant Technologies, Amdocs, IBM, and Qualcomm.

**Financials:** If the Fed does in fact enact a slow easing cycle, defined as less than five cuts in a year, then Financials would also be expected to benefit (source: NDR). Following up on the bank upheavals last March, many banks have now shored up their liquidity and are better positioned to meet cash-sorting activities. And the recent steepening of the yield curve helps to support profitability. Unlike the Technology sector, we note that for Q1 2024, earnings revisions for the Financials sector have been net positive, with 78 increases and 50 decreases over the past four weeks. Overall, earnings revisions for the sector's 2024 outlook have increased 18.1% over the past 4 weeks. Price-related measures of momentum, trend, volatility, and downside volatility are all positive. Looking at the operating environment for financials, the Citi Economic Surprise Index for the G10 shows economic releases coming in better than expected, with positive Business Credit Conditions, and credit spreads for Investment Grade U.S. Financial Institutions also supportive. At this point, the main detractors are loan growth levels still relatively low (though positive), and while the yield curve has been steepening, it hasn't yet turned positive (based on the 10-year minus 6-month Treasurys). Companies owned in this sector include Blackrock, Bank of New York, Goldman Sachs, JP Morgan, Morgan Stanley, PayPal, Schwab, and SEI Investment Corporation.

**Communication Services:** This is the sector where several of the "Magnificent 7" reside. Currently, we own two: Meta and Alphabet (Google). We also own IPG Photonics within the sector. While we've enjoyed the price gains, valuations are becoming an issue, especially with Meta. It's on our watchlist for a potential reduction in exposure. Meta's forward P/E is now 24.3x, which is at the high end of its historical range. The company's profitability is sound, its Return on Invested Capital (26.3%) outpaces

its Weighted Average Cost of Capital (WACC) and Free Cash Flow margins are 32.5%. However, much of that appears priced in at current levels. Our quantitative models for the Communications Services sector have reversed, with measures of valuation, earnings revisions, credit spreads, overbought/oversold conditions, deviation from trend, long-term momentum, and relative volatility turning cautious. We also track Internet sales versus Retail Sales, and that measure indicates a slowing in online purchases.

**Industrials:** The Industrials sector is cyclical and historically has reacted primarily to changes in the level of economic activity. In other words, a better economic outlook has historically provided a constructive floor for industrial companies. With the Citi Economic Surprise Index positive and U.S. GDP growth still tracking above trend (and beating expectations), the sector has been benefitting from those tailwinds. In fact, most economists expected a recession last year (2023), but it never materialized. Investors then moved to a consensus of "Soft Landing," which also has yet to be seen. At this point, it seems the herd has moved to a "No Landing" consensus, which may be a bit optimistic. As we wrote last month, "It looks as though rate cut hopes were indeed overly optimistic. Recent comments from the Fed confirm that absent considerable economic weakness or a macro shock, rate cuts may not materialize until the second quarter at the earliest." Our macro-focused quantitative models currently point to moderate economic growth and continued disinflationary pressures here in the U.S. Furthermore, the recent improvements in and around Europe, along with China's pursuit of stimulative policies hoping to reignite growth, are also positive for the sector. Our Industrials sector model improved significantly in March, with measures of momentum, trend, volatility, valuation (cash flow yield), and the trend of the U.S. dollar on buy signals. Companies owned in this sector include Landstar Systems, Masco, Owens Corning, UPS, and Werner Enterprises.

Our current sector weightings are Information Technology (14.7% portfolio weighting vs. 9.6% benchmark), Health Care (3.5% vs. 14.6%), Financials (20.9% vs. 22.2%), Communication Services (14.7% vs. 4.7%), Industrials (11.0% vs. 14.2%), Consumer Staples (5.5% vs. 7.7%), Consumer Discretionary (8.2% vs. 5.1%), Real Estate (1.7% vs. 4.7%), Energy (5.3% vs. 7.7%), Materials (1.9% vs. 4.7%), and Utilities (3.3% vs. 4.5%).

From a portfolio perspective using more standard metrics, the median Forward Price/Earnings multiple is 16.3x (versus 28.2x for the "Elite 8"), with the portfolio's average Cash Flow Yield coming in at an attractive 7.8%. 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 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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