EquityCompass

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Commentary, Review & Outlook

Developing A First-Rate Intelligence: *Recognizing Price Versus Value*



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> ***"The test of a first-rate intelligence is the ability to hold two opposed ideas in the mind at the same time, and still retain the ability to function."***
>
> —F. Scott Fitzgerald, "The Crack-Up" [1]

Commentary

In 1936, the American novelist F. Scott Fitzgerald wrote a three-part autobiographical essay titled "The Crack-Up." It was Fitzgerald's way of sharing his personal challenge of becoming an author—often wondering whether he would be successful or fail and perish. Whenever putting pen to paper, Fitzgerald knew he had to *"retain the ability to function"* as a writer even when faced with *"two opposing ideas."*

It is believed that individuals who hold two related but contradictory thoughts suffer from what is called cognitive dissonance. In his book, *A Theory of Cognitive Dissonance*, psychologist Leon Festinger proposed "ideas" could either be consonant or dissonant. Consonant ideas logically flow from one another, while dissonant ideas contradict. Festinger believed individuals were highly motivated to avoid or resolve cognitive dissonance due to the psychological discomfort it caused. This, he explained, forced people to adopt a defensive mechanism.[2]

The mental ability to see both sides of an argument and still function rationally is rarer than many may assume. Perhaps no greater example is the challenge of being an investor in the midst of a bear market. During a bull market, investing is largely a consonant idea—invest in a good company and the share price rises—a harmonious relationship. It's in agreement. However, during a bear market, investing can present a dissonant idea—despite investing in a good company, the share price declines—a conflicting relationship. It's disconfirming.

Individuals who trade the market over the short-term, as opposed to investing for the long-term, seem to suffer less from cognitive dissonance. Momentum-based traders typically buy stocks during a bull market and sell stocks in a bear market. One of the few times traders may experience cognitive dissonance is when the stock market declines soon after buying or rises in price soon after selling. In either case, the defensive mechanism would be to reverse the trade.

Unfortunately, buy-and-hold investors can be subject to periodic bouts of cognitive dissonance, which occur most often during a bear market. The question becomes, what defensive mechanism can investors adopt when stock market prices move against their portfolio of companies? We believe the answer lies in the most rudimentary aspect of what it means to be an investor.

For short-term traders, stock price takes precedent—business valuation is secondary. The debate over market inefficiency is irrelevant. Conversely, for long-term investors, business value is paramount—stock price takes a back seat. Investors realize price and value are not *always* the same, recognizing the stock market is frequently efficient but not *always*.

A big challenge for investors is how to navigate the market while *"holding two opposing ideas"*—price and value. For investors to pass *"the test of a first-rate intelligence"* requires the ability to put long-term business value at the forefront of their thinking, while at the same time understanding

(1) Fitzgerald, F. Scott, "The Crack-Up," Esquire, February, 1936, p. 41.

(2) Fistinger, Leon, A Theory of Cognitive Dissonance, Stanford University Press, Stanford, California, 1957.

short-term quotational loss is not the same thing as permanent capital loss. The benefit of focusing on business value over short-term price change is that it works to dilute the dreaded feeling of *"holding two opposing ideas."* We believe, this, in turn, can help reduce cognitive dissonance and increase the *"ability to function"* both rationally and profitably in the stock market.

Review

The U.S. stock and bond markets suffered historic losses in 2022. Inflation was the culprit—specifically, the fastest rise in inflation in over 40 years. This forced the Federal Reserve (Fed) to raise interest rates throughout the year at the fastest pace since 1980. The mathematics of pricing stocks and bonds in relation to interest rates is straightforward—when interest rates rise, the prices of both stocks and bonds decline.

Each of the major stock indices finished the year with the worst performance since the 2008 Financial Crisis. The Dow Jones Industrial Average finished the year down 6.86% having bounced back from the bear market low of -20.95%. The S&P 500 Index, firmly in a bear market territory at the end of the third quarter after declining 23.87%, recovered slightly in the fourth quarter finishing the year at -18.11%. By far the worst performing equity index for 2022 was the technology, growth-centric NASDAQ Composite, down 32.54%.

Small and mid cap stocks also posted negative returns. The S&P MidCap 400 Index dropped 13.06% for the year along with the S&P SmallCap 600 Index, which declined 16.10%.

The outperformance of value stocks over growth continued throughout 2022. The Russell 1000 Value Index declined 7.54% besting all the broader indices while the Russell 1000 Growth Index declined 29.14% for the year. The relative outperformance of value over growth was the widest in over 20 years dating back to the 2000 technology bear market.

By far, the best performing broad equity index was the S&P 500 Low Volatility High Dividend Index which posted a positive 0.93% return for the year. Low beta, low volatility, high dividend-paying stocks were favored in 2022—a trend that has continued since 2021.

Parsing the internals of the S&P 500 Index in 2022, only two sectors posted positive returns for the year. Energy was up 63.69% on the heels of the Russian-Ukrainian war, which immediately hampered the supply of oil and gas. Utilities—comprised of low volatility, high dividend stocks—posted a modest positive return, up 0.66%. The remaining nine stock market sectors all declined for the year. Sectors that posted a negative return but outperformed the S&P 500 Index include Consumer Staples (-1.39%), Health Care (-2.44%), Industrials (-5.97%), Financials (-11.08%), and Materials (-12.81%). The sectors that underperformed the S&P 500 Index in 2022 include Real Estate (-26.83%), Information Technology (-28.41%), Consumer Discretionary (-37.19%), and Communication Services (-40.04%).

Overseas, the MSCI ACWI ex-USA Index declined 14.29% for the year. The larger developed foreign markets that posted better relative returns include the FTSE 100 Index (United Kingdom) + 0.91%, IBEX 35 Index (Spain) -5.56%, Nikkei 225 Index (Japan) -9.37%, CAC 40 Index (France) -9.50%, and the DAX Index (Germany) -12.35%. The Asian markets that underperformed the broader benchmark include the Shanghai A Share Index (China) -15.10%, Hang Seng Index (Hong Kong) -15.46%, and the Kospi Index (South Korea) -24.89%.

Although equity markets endured their worst performance in over 10 years, there was no consolation within the bond market. Indeed, with interest rates rising, bonds suffered their worst absolute performance on record. For the first time in history—dating back 46 years—the Bloomberg U.S. Aggregate Bond Index (AGG) posted a loss greater than 10%, finishing the year with a decline of 13.01%. Municipal bonds were not immune to the impact of the Fed's aggressive interest rate increases. The 10-year AAA municipal bond yield more than doubled from 1.05% to 2.64% resulting in a price decline in the Bloomberg U.S. Municipal Bond Index (MBI) of more than 8% for the first time since 1981.

Outlook

"I don't think anyone knows whether we're going to have a recession or not, and if we do, whether it's going to be a deep one or not. It's...not knowable."

—Jerome Powell,
Chair of the U.S. Federal Reserve

At the December 14 press conference, following the last Fed meeting for the year, Jerome Powell was asked whether the U.S was heading for a recession. His answer, although factual, was less than satisfying. At best, the ability to predict complex adaptive systems is a probabilistic exercise. As of yet, science has not developed the mathematics to perfectly forecast the markets and economies.

In 2022, the Fed raised the federal funds rate 425 basis points in an attempt to slow economic growth—a strategy that seeks to lower inflation. Throughout the year, investors appeared to be gripped with fear that each interest rate increase might move the economy one step closer to a recession. If a recession were to occur, it would cause corporate profits to decline. And if corporate profits dropped, stock prices would most certainly follow.

It's not an overstatement to say the tension between the markets and the Fed has reached fever pitch. Investors appear to have been spending less time thinking about individual stocks and more time worrying about the economy and the stock market. It's as if everyone has become a macroeconomic trader. JPMorgan recently reported only 10% of trading flows have come from fundamental stock investors, while the other 90% has been a combination of passive, systematic quantitative, and macro discretionary trading.[3] In other words, 90% of the market trading volume is in the hands of individuals who have been focused on macroeconomics and the near-term direction of the stock market, while only 10% can be attributed to fundamental investors seeking to profit from the difference in stock price and the intrinsic value of the business.

With inflation and Fed policy dominating news flow, investors have rolled into an "all-or-nothing" market, where the economic fundamentals of stocks seem to matter less than deciphering the big picture. Indeed, in 2022 there were 83 separate trading sessions in which 400 stocks within the S&P 500 Index all moved in the same direction[4]—the second highest rate in the last 25 years. The market's lockstep moves—up one day and down the next—have caused heightened levels of anxiety among investors. The American Association of Individual Investors (AAII) reported 2022 was the first year in the history of their survey that bullish investor sentiment was below the historical average every week of the year. For the record, AAII bullish sentiment is now the lowest since 1987.

However, the silver lining to all the bearishness could be that the stock market has already priced in worsening news. As we reported in our third quarter commentary, Gina Martin Adams, Director of Equity Strategy at Bloomberg Intelligence, believes the year-end 18% deficit in the S&P 500 has already priced in a 15% decline in corporate earnings.[5] It is worth noting, the decline in S&P 500 forward 12-month earnings estimates, which peaked on June 15, 2022, is now down only 5%. This is not to say corporate earnings can't go lower. Analysts have been known to be late in lowering their earnings forecasts. However it does imply the market may have already priced in a good deal of bad news.

Over the past two years, value stocks have substantially outperformed growth. In fact, the relative outperformance of value over growth is now the highest since the post 2000 technology bear market. The rise in interest rates and the deceleration of revenue and earnings following the outsized economic gains achieved during the pandemic have now reset the prices of many growth stocks. In our opinion, high-quality, seasoned growth stocks are now the most mispriced part of the market. According to Morningstar, the cheapest sectors in the market are Communication Services, Consumer Cyclicals, and Information Technology[6]—all havens for growth stocks.

This observation is in no way a recommendation that investors should sell value stocks. We continue to believe selective high-quality, dividend-paying stocks offering yields superior to

(3) Reller, David M., "Even God Couldn't Outperform," 2022 JPMorgan Macro Quantitative & Derivatives Conference, June 16, 2022.

(4) Wang, Lu, "As Roads Split in 2022, One Trade Made All the Difference," Bloomberg News, December 30, 2022.

(5) Martin Adams, Gina, Michael Casper, "S&P 500 Has Priced an Earnings Recession," Bloomberg Intelligence, October 5, 2022.

(6) Cox, Matt, "58 Wide-Moat Exemplary Capital Allocators on Sale," Morningstar, January 6, 2023.

bonds, along with the added benefit of providing growth of income and underlying capital appreciation are attractive both for equity allocation and as a supplement for fixed income portfolios. However, with the historically-wide relative outperformance of value stocks over growth, coupled with the likelihood many may have sold out of growth stocks during this difficult market, it is likely some investors may now be underweight growth relative to value. In our opinion, this presents an opportune time to rebalance portfolios.

At EquityCompass, we have long believed a barbell approach to portfolio management is the best long-term strategy. Owning the best of the best—the best high quality, dividend-paying value stocks paired with the best secularly-advantaged growth stocks can allow investors to participate in the market's gains no matter the direction of the economy.

Although inflation has likely peaked and is now moderating, the Fed has indicated it will remain vigilant in its fight to tamp down inflation back to its 2% target. In order to do so, market expectations are for the Fed to raise the federal funds rate another 75 basis points in the first half of this year in pursuit of this goal. Even so, it appears we have reached a peak in long-term interest rates which governed stocks throughout 2022. Put differently, if long-term interest rates have peaked, we believe much of the headwinds that punished stocks last year may be lifting.

With this being said, we counsel both stock and bond investors to brace for continued high market volatility. In the months ahead, there will be days when the economic data may attest the narrative of higher inflation and higher interest rates remains in place; other days the news may sway investors the economic story is indeed changing.

At EquityCompass, we believe if you can answer these two questions—***what do I own*** and ***why do I own it***—smartly and rationally, the pathway for higher investment returns may be made easier.

About the Author



Robert G. Hagstrom, CFA, is Chief Investment Officer of EquityCompass Investment Management, LLC and Senior Portfolio Manager of the Global Leaders Portfolio. He joined EquityCompass in April 2014 and launched the Global Leaders Portfolio in July 2014. Robert was appointed Chief Investment Officer in March 2019.

Robert has more than 30 years of investment experience. Prior to joining EquityCompass, he was Chief Investment Strategist at Legg Mason Investment Counsel, and before that, the Portfolio Manager of the Growth Equity Strategy at Legg Mason Capital Management for 14 years where he managed $7 billion in assets. Robert received "Honorable Mention" recognition in Morningstar's Domestic-Stock Fund Manager of the Year in 2007 while with Legg Mason.§

Robert is the author of ten investment books including The New York Times Best Seller, *The Warren Buffett Way*, widely considered to be the definitive book on the investment approach and strategies of Warren Buffett. The book has sold over one million copies worldwide and is translated into 17 foreign languages. In addition, Robert wrote, *Investing: The Last Liberal Art*, a multidiscipline examination of investing and decision making. His latest book, published in 2021, is *Warren Buffett: Inside the Ultimate Money Mind*. Robert earned his Bachelor's and Master's of Arts degrees from Villanova University. He is a Chartered Financial Analyst, a member of the CFA Institute, and the CFA Society of Philadelphia. Robert is also a member of the Global Interdependence Center.

§ Established in 1988, the Morningstar Fund Manager of the Year award recognizes portfolio managers who demonstrate excellent investment skill and the courage to differ from the consensus to benefit investors. To qualify for the award, managers' funds must have not only posted impressive returns for the year, but the managers also must have a record of delivering outstanding long-term performance and of aligning their interests with shareholders'. The Fund Manager of the Year award winners are chosen based on Morningstar's proprietary research and in-depth evaluation by its fund analysts. For more information about Morningstar Awards, visit https://go.morningstar.com/Morningstar-Awards.

About EquityCompass

EquityCompass Investment Management, LLC ("EquityCompass") is a Baltimore-based SEC registered investment adviser offering a broad range of portfolio strategies and custom plans for individuals, financial intermediaries, and institutional clients in the U.S. Formally organized in 2008, EquityCompass provides portfolio strategies with respect to total assets of approximately $4.5 billion as of December 31, 2022.* EquityCompass is a wholly owned subsidiary of Stifel Financial Corp.

The EquityCompass team of professionals represents deep industry experience in security analysis, capital markets, and portfolio management. We are committed to a consistent investment process that relies on enduring principles, sound empirical reasoning, and the recognition of a dynamic investment environment with a global reach.

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The Dow Jones Industrial Average (DJIA) is an unmanaged, price-weighted index that consists of 30 blue chip U.S. stocks selected for their history of successful growth and interest among investors. The price-weighted arithmetic average is calculated with the divisor adjusted to reflect stock splits and occasional stock switches in the index. The S&P 500 Total Return Index tracks both the capital gains of the stocks in the S&P 500 Index over time, and assumes that any cash distributions, such as dividends, are reinvested back into the index. Looking at an index's total return displays a more accurate representation of the index's performance. By assuming dividends are reinvested, you effectively have accounted for stocks in an index that do not issue dividends and instead, reinvest their earnings within the underlying company. The S&P 500 Low Volatility High Dividend index measures the performance of the 50 least-volatile high dividend-yielding stocks in the S&P 500. The index is designed to serve as a benchmark for income-seeking investors in the U.S. equity market. The NASDAQ Composite Index, comprised mostly of technology and growth companies, is a market value-weighted index of all common stocks listed on NASDAQ. The S&P MidCap 400® provides investors with a benchmark for mid-sized companies. The index covers over 7% of the U.S. equity market, and seeks to remain an accurate measure of mid-sized companies, reflecting the risk and return characteristics of the broader mid-cap universe on an on-going basis. The S&P SmallCap 600® seeks to measure the small-cap segment of the U.S. equity market. The index is designed to track companies that meet specific inclusion criteria to ensure that they are liquid and financially viable. The Russell 1000 Growth Index measures the performance of those Russell 1000 index companies with higher price-to-book ratios and higher forecasted growth values. The Russell 1000 Value Index measures the performance of those Russell 1000 index companies with lower price-to-book ratios and lower forecasted growth values. The MSCI ACWI ex USA Index captures large and mid cap representation across 22 of 23 Developed Markets (DM) countries (excluding the U.S.) and 25 Emerging Markets (EM) countries. With 2,330 constituents, the index covers approximately 85% of the global equity opportunity set outside the U.S. The Korean Composite Stock Price Index (KOSPI) is a market capitalization weighted index comprised of 200 of the largest and most liquid issues traded on the Korean Stock Exchange. The IBEX 35 is the official index of the Spanish Continuous Exchange. The index is comprised of the 35 most liquid stocks traded on the Continuous market. It is calculated, supervised and published by the Sociedad de Bolsas. The equities use free float shares in the index calculation. The Nikkei 225 Stock Average is a price-weighted index composed of Japan's top 225 blue-chip companies traded on the Tokyo Stock Exchange. The Hang Seng Index is a market capitalization-weighted index of the largest companies that trade on the Hong Kong Exchange. The index aims to capture the leadership of the Hong Kong exchange and covers approximately 65% of its total market capitalization. The CAC 40 Index is a market-capitalization weighted index of the 40 largest and most liquid companies traded on the Paris Bourse stock exchange. The FTSE 100 is a market-capitalization weighted index of UK-listed blue chip companies designed to measure the performance of the 100 largest companies traded on the London Stock Exchange that pass screening for size and liquidity. The Shanghai A-Share Stock Price Index is a capitalization-weighted index tracking the daily price performance of all A-shares listed on the Shanghai Stock Exchange that are restricted to local investors and qualified institutional foreign investors. The DAX (Deutscher Aktienindex) Index is a blue chip index in Germany tracking the performance (including dividends) of the 30 most actively traded stocks on the Frankfurt Stock Exchange. The Bloomberg U.S. Aggregate Bond Index is a broad-based flagship benchmark that measures the investment grade, U.S. dollar-denominated, fixed-rate taxable bond market. The index includes Treasuries, government-related and corporate securities, MBS (agency fixed-rate pass-throughs), ABS and CMBS (agency and non-agency). Indices are unmanaged, do not include fees and expenses, and it is not possible to invest directly in an index. The Bloomberg U.S. Municipal Bond Index measures the performance of the U.S. municipal bond market. It is composed of approximately 1,100 bonds; 60% of which are revenue bonds and 40% of which are state government obligations. The AAII Sentiment Survey offers insight into the opinions of individual investors by asking them their thoughts on where the market is heading in the next six months and has been doing so since 1987. All index returns are shown on a total return basis and assume that all cash distributions, such as dividends, are reinvested. The volatility of the indices identified in this report may be materially different from the volatility of the model portfolios presented by EquityCompass. Indices are unmanaged, do not reflect fees and expenses, and are not available for direct investment.

*Total assets combines both Assets Under Management and Assets Under Advisement as of December 31, 2022. Assets Under Management represents the aggregate fair value of all discretionary and non-discretionary assets, including fee paying and non-fee paying portfolios. Assets Under Advisement represent advisory-only assets where the firm provides a model portfolio and does not have trading authority over the assets.

PAST PERFORMANCE CANNOT AND SHOULD NOT BE VIEWED AS AN INDICATOR OF FUTURE PERFORMANCE.

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