CORNERSTONE
INVESTMENT PARTNERS, LLC

Large Cap Market Review

Q1 2023

"How did you go bankrupt?" Bill asked.
"Two ways," Mike said. "Gradually and then suddenly."
Ernest Hemingway, "The Sun Also Rises"

In the public equity markets, risk is often incredibly slow to show up, and when it does, it happens all at once. The last six months have been a reflection of that. The market is constantly changing. Sentiments shift, factors come in and out of style (sometimes on the same day), and idiosyncrasies can derail even the best-laid plans. **You are probably not as smart as you (or others) think you are when things go well, and you are probably not as dumb as you (or others) think you are when things go poorly.**

Just as the market had settled in on expectations for a few more rate hikes, Silicon Valley Bank collapsed in a remarkably short amount of time. The root cause of Silicon Valley Bank's troubles is simple: a failure of basic interest rate (duration) risk management as the bank experienced significant deposit inflows it received during 2021 and 2022 were invested in longer-duration securities without any interest rate hedges. When interest rates increased (bond prices decreased), there was a massive hole on their balance sheet. Usually, unrealized mark-to-market losses are not a solvency problem, provided the bank's cash needs afford the luxury of a recovery in bond values, since the bonds are likely to mature at par. Banks must balance duration risk between their investments and their liabilities, especially deposits that may be withdrawn on demand. **By all accounts, Silicon Valley management failed in this basic function.** However, Silicon Valley was further unique in that almost all of their accounts were largely above the $250k FDIC insurance threshold, and highly concentrated in a single industry. **The resulting loss of confidence created a bank run, and with the growth of digital banking, this occurred far more rapidly than prior crises.**

Silicon Valley was not the only bank impacted in a short time by this crisis of confidence. Credit Suisse had to combine with rival UBS in a deal brokered by the Swiss government, Signature Bank was shut down, and First Republic required a deposit infusion. Investors looked at the situation with a combination of fear (that there would be contagion) and excitement (that the Fed would pivot). **That combination led to a massive shift in sentiment back to the same companies that were most impacted by last year's re-focus on valuation: mega-cap technology companies.** For the first quarter, contribution to total return from the companies in the S&P 500, the mega-cap FAANG+MNT stocks delivered the vast majority of the return. Traditionally defensive sectors like health care and utilities were avoided this quarter as investors shifted into mega-cap tech companies such as Apple, Alphabet, Amazon, and others as they were viewed as "safe havens". **During the first quarter fundamentals and valuation didn't matter to investors, which was a sharp reversal from last year, however, over the long run, we believe the opposite is true.**

Valuations Matter

At the end of the quarter, it was clear that Growth and Mega Cap dominated. **During the first quarter, the S&P 500 returned 7.5%, while the Russell 1000 Growth and Value returned 14.4% and 1.0%, respectively, a spread of 13.4%. That is the third-largest spread since 1979.** Taking a step back and looking over the previous six months, however, performance across investment styles was much, much closer. The Russell 1000 Growth index was up 1.8%, while the Russell 1000 Value index was down 2.3%, so only 4.1% apart. As part of our investment process, we rely on a proprietary valuation tool, the Fair

Value Model, that has over thirty-five years of live history, through a range of different market environments. While it doesn't work every time, its long-term results have been incredibly attractive, and when combined with our fundamental work, are powerful.

Fundamentals Matter

While we did not (nor would we try to) predict Silicon Valley Bank's failure, in some ways, this was not a complete surprise, as our fundamental work enables us to look below the surface. **Since our firm was founded, we have adjusted our proprietary Fair Value Model to mark-to-market both credit risk and securities values when evaluating banks. We recently published a thought piece on the topic on our website and if you would like a copy please reach out.** The goal of this analysis is to look at a normalized, apples-to-apples earnings profile for banks. Security valuation risk has not appeared to be particularly important relative to credit risk for the last decade, as we had been in a broad bull market for bonds since the GFC. The Federal Reserve's efforts to fight 40-year high inflation by increasing interest rates rapidly exposed this risk. This analysis in conjunction with other elements of our fundamental review has led our strategy to be significantly underweight banks recently, especially avoiding any banks with material issues in their investment securities. We also adjust their earnings for excess risky loans over their current reserves. While seemingly less important today with low charge-offs, that risk can and will inevitably change at some point in the future.

We write these letters at the end of the quarter, shortly before we enter earnings season for large cap companies. This year, we believe understanding broader fundamentals will become increasingly important. The S&P 500's forward price-to-earnings estimates have fallen 16% this quarter over the past year, and there are several economic indicators that are flashing red. While we do not know exactly what is going to happen with any individual name (and anyone who says they can certainly can't consistently), our fundamental work helps us understand what matters, and assess our companies and opportunities on a risk-adjusted basis.

Philosophies Matter

Who knew we would have an entire market cycle in less time than an NBA season? Not surprisingly, two (oppositional!) 5th percentile results in a row are unlikely to repeat again, so how you respond to those moments is what matters over the long run. Given this whipsaw, there were very few managers that outperformed in both quarters. In response, many managers may lose discipline**. For Cornerstone, it is a strict adherence to our investment philosophy, which we believe is timeless and has worked for over twenty years, that centers us in both periods of relative success and periods of relative weakness.**

Sincerely,

The Cornerstone Team

Past performance does not indicate future results. As with all investments, the possibility for profit is accompanied by the risk of loss