CORNERSTONE
INVESTMENT PARTNERS, LLC

Small Cap Market Review

Q1 2023

Soft Landing Hopes vs Hard Landing Fears

For much of the past year, as was also the case during the first quarter, markets have been choppy as investors perceived the odds of a soft landing versus a hard landing change. The bulls point to how moderating inflation data and easing commodity prices will support stable growth. On the other side, the bears worry that structural components of inflation remain sticky, and ultimately aggressive tightening by the Fed will result in economic weakness. During the quarter there was a shift in favor of growth stocks, as expectations for future interest rates fell. **But the reality is it remains too early to really tell, and the Fed's tools are blunt instruments at best with a long lag between action and the economic result. Instead, more time is simply needed for the market to ascertain the eventual outcome.**

A Banking Collapse of Confidence

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 significant deposit inflows they received during 2021 and 2022 were invested in longer-duration securities without any interest rate hedges. When rates increased (and 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 Banks must balance duration risk between their investments and their liabilities, especially deposits that may be withdrawn on demand.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 its 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.

Cornerstone's Proprietary Bank Analysis Suggests Solvency Risks Are Not Systemic

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 discretionary small cap strategies to be underweight banks recently, especially avoiding any banks with significant issues in their investment securities.

Combining Valuation and Fundamental Analysis Will Help Navigate The Way Forward

The macro landscape appears highly uncertain today. Inflation remains high but has been moderating, and the combination of interest higher rates and expected tighter bank lending standards are likely to slow the economy, putting further downward pressure on inflation. But at the same time, the unemployment rate remains historically low and wage growth robust, creating a difficult environment for the Federal Reserve to maneuver. **What this means to us practically, is we continue to be laser focused on fundamentals to ensure that we are confident our companies can withstand a sustained period of economic hardship.** This means companies with low leverage, a proven ability to reduce costs, and strong free-cash-flows. As we noted last quarter but wish to reiterate, we are continually examining our portfolio and our convictions to ensure that we hold stocks trading at material discounts to our conservative assessments of their worth. We continue to confirm that our portfolio remains composed of high-caliber companies at discounts to the market. We remain excited about our stocks over a multi-year time horizon but recognize that the rest of this year contains elevated uncertainty.