CORNERSTONE
INVESTMENT PARTNERS, LLC

Large Cap Market Review

Q2 2024

"I've never seen a monument erected to a pessimist."
Paul Harvey

We published a video last year about the narrow breadth of the US stock market. This quarter's results are a prime example of how limited breadth can lead to extreme outcomes. The S&P 500 was up 4.3% for the quarter. There are approximately 500 companies in the Index at any time. Four of them represented more than 100% of that return. **Without Nvidia, Apple, Alphabet, and Microsoft, the S&P 500 would have been down for the quarter. In fact, only 27% of S&P 500 stocks beat the index this quarter.**

The equal weight large cap benchmark materially underperformed the capitalization-weighted benchmark during the quarter, with the S&P 500 Equal Weight ETF (RSP) falling 3%, or approximately 700 basis points below the S&P 500 itself. This effect translated across all factors, as only the top decile of the market cap factor was up with every other decile of every other factor down when using straight averages. **Only three of eleven sectors beat the S&P 500 (Technology, Communications, and Utilities), all of which are just the same bet on AI.**

Of course, concentration has been less of an issue in the Russell 1000 Value index (down 2% for the quarter), which does not have the reliance on a few securities that the Core and Growth indices have. For example, as of June 30th, the top ten stocks in the Russell 1000 Value index represented 17% of total weight versus the Core at 34% and the Growth at a shockingly high 62%. The S&P 500 has the highest concentration among its top 10 stocks since 1929. Perhaps not surprisingly, on a total return basis, the Russell 1000 Value benchmark performed quite similarly to the equal-weight S&P 500 over the last three years, with Value winning at 18% versus 15% for the equal-weight, and both losing significantly to the S&P 500's 33% outcome. As we've discussed in the past, the impact of passive flows into 401(k) investment vehicles and the fact that liquidity does not scale with market capitalization has led capitalization-weighted indices to become even more driven by money flow than they were designed to be. That trend can last for a longer time than one may think. **This suggests that the companies themselves in the benchmarks are not all that different in the end, but the impact of capitalization-weighting (versus equal-weighting in the case of certain benchmarks or conviction-weighting in the case of our portfolio) can make a large difference.**

The market as a whole is clearly getting more expensive. The forward P/E of the S&P 500 is around 21x (versus 16x on average over the last 20 years), as high as it has been in many years except during the pandemic and late 1990s boom. Also, our Fair Value Model suggests, *on the whole,* that the market is somewhat overvalued. The Russell 1000 Value and equal-weight S&P 500 indices are much lower, at 15-16x, much closer to their longer-term averages.

However, while there are seemingly obvious pockets of overvaluation, the underlying companies in the market appear healthy. First quarter announced EPS growth was up 6%, with estimates for the second quarter up 8%. Expected EPS growth this year comes from both revenue and margin. Even with interest rates up significantly, interest coverage ratios for large caps are around 8x, above long-term averages and reducing risk somewhat. Unemployment rates, while off their floor, remain at historically low levels. Historically, election years are favorable for the market, and a significant driver of this is higher government spending. Looking at the year-over-year change in government spending since 1959, the fourth year of a presidential cycle has seen a big spending boost, coming in roughly 4% ahead of the first three years' average government spending growth. Additionally, expectations for the Fed to cut rates have been increasing again over the last few months. After the number of implied Fed policy cuts over the next twelve months bottomed out in April at 1.8, the futures market now implies 3.5, which could support higher equity prices if it happens in a controlled manner.

There is a reason the largest companies are doing well. They are fundamentally winning. EPS for the top-ten stocks in the S&P 500 are expected to rise 22% on average from 2024-2025, while the index as a whole is expected to go up by a still substantial 14%. Year-to-date, 2024 estimates have risen 7% for the ten largest companies versus 1% for the index as a whole. EBITDA margins of the largest companies are almost double that of the Index. And the broader narrative around the innovative nature of many of these companies is admittedly exciting. However, these expectations for improving fundamentals could change. Capital expenditures related to AI may grow at a slower rate, relative market shares could change, GLP-1 demand or reimbursement rates may come down, or other idiosyncratic or macroeconomic issues could impact some of these companies disproportionally. That is why we don't blindly follow multiples, which by nature have two moving pieces (price AND earnings). What matters then are which ones to own and their weights in your portfolio.

There remain existing and emerging risks to be aware of. For example, we are watching the divergence between the high-end consumer, who broadly remains flush with home and market prices at record levels, and the lower-end consumer, who is pressured by continued inflation (remember that disinflation still involves rising prices). We have noted previously the deterioration in credit card delinquencies for this cohort, but another interesting data point is that lower-income households (the bottom 33% of the household income cohort) have significantly higher inflation expectations, which today hover close to 7%. This is likely driven by what they experience and where they shop, and rising prices for food, housing, and utilities are particularly impactful, so inflation feels even more severe. Consumption is the largest component of GDP in the United States, so we continue to follow up to see if these trends remain consistent or start to move upmarket.

This natural give and take in the market is why we consider ourselves relative value managers, as finding mispriced stocks requires more than a calculation. In May, our Partner and Senior Portfolio Manager Dean Morris wrote a thought paper titled "Identifying Mispriced Stocks as a Relative Value Manager." In it, he discusses how our definition of "Value" differs from that of other managers. While we are value-oriented managers, we don't just buy the stocks with the lowest multiples. For us, Cornerstone's philosophy is that "***stock prices are more volatile than the fundamentals that determine value***." Thus, we seek out those companies whose stock prices (as influenced by the market) are attractive relative to their intrinsic value (as influenced by their fundamentals). We do not shy away from higher multiple stocks if we feel, as reflected by our Fair Value Model* and fundamental analysis, that those multiples are warranted and likely driven by superior value creation for shareholders. If you consider a thought experiment to identify the issues involved in evaluating a deeply cyclical stock for purchase, these points become more apparent. Do you want to buy a cyclical stock when the P/E is high or when the P/E is low? When the P/E is low, it is generally an indication that earnings may be at a cyclical peak, and market participants expect them to roll over. When their P/E is high, earnings have usually been in decline. Earnings may be troughing with prior year growth comparisons becoming easier, and the industry may be about to enter a new upcycle. We'd love to send you the paper, or you can find it on our website, along with all of our recent thought papers.

On firm news, Rick van Nostrand, CFA, was promoted to Chief Investment Officer of Cornerstone. Rick is the longest-tenured member of Cornerstone's investment team, starting with the firm in 2005, and will continue in his role as Senior Portfolio Manager and Board Member. Rick has said, "I appreciate the vote of confidence from my fellow Investment Team Members and Board of Managers recognizing my contributions to the Firm, the Investment Team, and most importantly, our clients over the past nearly twenty years. I am humbled by the recognition from my peers." In addition to his many years with Cornerstone, Rick has previously worked at EARNEST Partners, Invesco, and McKinsey & Co. Rick earned an MBA from the Wharton School at the University of Pennsylvania, a BS from Southern Methodist University, and is a CFA charterholder. He calls Atlanta home with his wife and three daughters. Rick succeeds John Campbell, CFA as CIO. Each investment team member has worked with John either here or at Invesco for between one and two decades, and we thank him for his over 18 years of service to our clients and his efforts in building the firm into what it is today. We wish him well in any future endeavors. **It is important to note that the collaborative, team-driven approach behind our investment process makes this transition seamless, and there have not been, nor will there be, any changes to the investment philosophy or process.**

Additionally, our summer intern Akhil Mujumdar will be finishing his summer with us this month. He has been a great help to the investment team, and has researched and presented materials on both large and small cap securities. If he represents the student body from the University of Georgia, our state is in good hands.

With only 309 securities in our 800-stock large cap investible universe undervalued in our Fair Value Model* on an absolute normalized basis, our fundamental work remains paramount. We are always looking for great businesses but will not overpay, and for poor businesses, we demand an extreme level of discount and the right timing. As a result, our holdings today often exist somewhere more in the middle of that range, with the sweet spot being strong businesses trading at more modest discounts.

We continue to focus on executing our philosophy and process with the effort and discipline needed to succeed for our clients. Thank you for placing your trust in us.

Sincerely,

The Cornerstone Investment Team

**The Fair Value Model is Cornerstone's proprietary valuation methodology, which provides a weekly assessment of company valuations for our actively managed 800-stock investable universe.*

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