CORNERSTONE
INVESTMENT PARTNERS, LLC

Large Cap Market Review

Q3 2024

"In tennis, perfection is impossible. In the 1,526 singles matches I played in my career, I won almost 80% of those matches. What percentage of the points do you think I won in those matches? Only 54%."

Roger Federer, 2024 Dartmouth College Commencement Address

We were discussing a stock in our large cap research meeting recently, and one of our partners stated that the odds of a particular event occurring were a coin flip. A coin flip is, for all intents and purposes, the ideal 50/50 bet. If someone tells you they have any clue of what the next result will be, they are as likely to be right as they are wrong. We fully recognize the difference between improbable and impossible. Flipping ten heads in a row is undoubtedly improbable (the odds are 0.0977%), but clearly not impossible.

July featured a significant reversal in market leadership from the first half of the year, which then held consistent throughout the rest of the quarter. The equal-weight S&P 500 outperformed the capitalization-weighted index, the Russell 1000 Value outperformed the Russell 1000 Growth, and small cap stocks (Russell 2000) outperformed large-cap stocks. This reversal can also be seen in factor returns. During the third quarter, the Momentum factor (measured over 12 months) lagged by 5.1%, and EPS Growth lagged by 5.0%, while Beta to High Yield spreads added 1.3% and low P/E added 1.0%. It seems that the reason for this reversal was related to expectations for interest rate cuts (and the 10-year Treasury yield significantly declining) and increasing confidence in a soft landing. Yield-seeking led historically low value-creation sectors like Utilities and Real Estate to lead the market, also supporting value benchmarks.

The debate over soft vs. hard landing now appears to favor a soft landing, and the market responded to that in a sizeable way during the quarter. The economy appears healthy, with 2Q Real GDP growth revised up to 3%, the Atlanta Fed GDPNow estimate for 3Q GDP holding around 2.5%, and broad market NTM earnings estimates continuing to move higher. As measured by the S&P 500, the broader market has now posted its best start since 1997, and while smaller cap stocks have not kept pace, they are still up double digits. During the quarter the Fed cut interest rates by 50 basis points at its September meeting. This decision was driven by continued moderation in inflation data and a labor market showing signs of slowing down.

If we compare large-cap stocks and small-cap stocks, we can see why there was a divergence in the quarter. In general, small-cap stocks are perceived to have more leverage, more exposure to domestic GDP, and a much higher percentage of the index is not profitable. So, as rates come down, these more highly levered and sometimes unprofitable companies are given a boost as funding costs decline and durations extend, and so their multiples expand faster. In response, many lower-quality companies across the capitalization spectrum saw significant returns. **While the portfolio is focused first on companies that are attractively valued, on the whole, we own higher quality, profitable, less levered companies that didn't receive the same level of multiple expansion during the third quarter. We would note that while these reversals that favor "junkier" companies can be sharp, they are generally not sustained. We are confident that the companies creating value will be rewarded over time.**

So where does the market go now that the Fed has started to cut interest rates? Remember James Carville's mantra from another presidential campaign 32 years ago, "It's the economy, stupid." The answer is likely "straightforward" as a function of whether the economy avoids a recession during the next twelve months. According to a chart from Goldman Sachs, the median S&P 500 performance when the economy avoids a recession during the next 12 months is up ~13%, and when the economy enters a recession down ~15%. With GDP growth continuing to be strong, the economic surprise index improving, and the first jobs report in October looking much better than expectations, current Federal Funds rate expectations have decelerated to a flatter path of only 50 basis points of cuts through the end of the year.

While the market appears to be pricing in a soft landing, there are always known and unknown risks that could alter that outcome. Recently, we have seen a few such risks, including the US East and Gulf Coast port strikes and the rising tension in the Middle East. While cooler heads prevailed fairly quickly soon after the end of the quarter, the port strike could easily have had a wide-ranging impact on the US economy and put the Fed in a more difficult situation. With the Israeli conflict broadening, oil prices have risen to over $80 a barrel, and 10-year Treasury yields are back over 4%. Next month's US Presidential election means every piece of data will be overanalyzed, over-discussed, and spun to fit each side's worldview, adding fuel to the fire.

We don't know what the economy will do over the rest of the year, and, based on the volatility of changing expectations for just the Federal Funds Rate, neither does anyone else. We think we know how to assess the combined fundamental and valuation opportunity of equity securities and build them into a portfolio designed to deliver attractive risk-adjusted returns over time. Looking at the Concentrated 30 institutional composite on a net of fee basis, our batting average, which represents the percentage of quarters in which the composite outperforms the benchmark, is 55% and 62% versus the S&P 500 and Russell 1000 Value, respectively, since the strategy's inception in September of 2001 through the end of June of this year. That means the relative performance of individual stocks and individual quarters will inevitably sometimes be right and sometimes be wrong. **What matters is the execution of a consistent and disciplined process to ensure that a slight winning edge can compound into an outstanding track record over a long enough time frame.**

Cornerstone believes that considering the behavioral aspect of investing is essential. The underlying premise of our investment philosophy is that stock prices and fundamental-driven valuations diverge at times due to the behaviors of others, and understanding and mitigating our own behavioral biases is core to our "Cornerstone Advantage." As investors and Portfolio Managers, how we respond to the 52% wins or 48% losses is incredibly important. Going back to the coin flip example, if you get ten heads in a row, what is more likely? Is it the 1-in-1000 outcome, or is the coin weighted? **We believe our "Cornerstone Advantage" will allow us to end up with a coin weighted in our clients' favor.** Investing is not binary, so it is imperative to ensure that our bad decisions today do not negatively impact our decisions tomorrow, and that our good decisions do not produce overconfidence. **The discipline to consistently move on from both losers and winners and learn from them is imperative to our long-term risk-adjusted performance, and we remain steadfast in our dedication to doing so for our clients.**

Sincerely,

The Cornerstone Investment Team

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