CORNERSTONE
INVESTMENT PARTNERS, LLC

Large Cap Market Review

Q4 2023

"I think I'm pretty good at long run expectations, but I don't think I'm good at short-term wobbles. I don't have the faintest idea what's going to happen short-term."
Charlie Munger

The phrase "May you live in interesting times," is sometimes more of a curse than it is a blessing, like the Atlanta favorite, "Bless your heart." The Russell 1000 set of indices began on January 1st, 1984, and just recently turned 40. Of those 40 completed years for the Russell style indices, 2023 represented the 2nd largest annual period of value underperformance on a total return basis versus growth, with the Growth index up 43% and the Value index up 11%. And just one year ago in 2022? It was the Value index's turn, with the year also representing the 2nd largest period of relative outperformance, with just the names reversed, as the Growth index was down 29% and the Value index down only 8%.

Net, the last two years have been a complete rollercoaster, with a decade's worth of mean reversion occurring immediately one after another. However, from the end of 2021 through the end of 2023, the two indices are less than 200 basis points apart on a total return basis. Many managers have gotten in trouble during these interesting times. They see short-term market movements, or medium-term cycles, fleeting as they always are, as permanent in nature. Instead, **by focusing on a singular philosophy, a disciplined process, and an aligned team, we seek to take advantage of the market's variability to identify opportunities for our portfolios.**

Our investment philosophy states that stock prices are more volatile than the fundamentals which determine value. We believe a company's value is driven by its underlying future fundamentals (since at its core the value of any asset is the collection of its future cash flows and the likelihood of achieving them), and our opportunity comes by identifying those stocks where the market price today suggests that investors are overly pessimistic about that future. In large cap, we believe those future fundamentals are driven by the embedded nature of a company's past track record, and our fundamental research, which is where we spend the majority of our time and effort, goes towards understanding that. Finding those opportunities is not just looking for low prices in terms of a multiple of sales, earnings, or equity value, although that certainly makes it easier. A low-priced company just getting by in a volatile and highly cyclical industry, or one with limited opportunity due to a changing market structure and weak competitive positioning, is cheap for a reason. On the other hand, a company with strongly embedded characteristics facing relative price weakness due to clear and assessable external or internal reasons, could be an exciting opportunity. Discerning between the two is **why we believe fundamental analysis matters and will continue to matter**. This is particularly true today, as a concentrated market driven by a few high-priced momentum-oriented securities suggests a higher risk that success is measured on a relative basis, not an absolute one.

For all of this rigamarole, the S&P 500 and the Russell 1000 Value indices ended up significantly in 2023, rising 26% and 11%, respectively, and both closed around all-time highs. It was the fourth-best return of the S&P 500 in the last 20 years. Inflation started to fall, while the economy broadly remained strong and unemployment is still at historically low levels. Yet these returns were highly concentrated, with the S&P 500, a cap-weighted index, outperforming its equal-weight version by 1,200 basis points and only three sectors (Technology, Communications, and Consumer Discretionary) outperforming the market as a whole. The top ten companies by market capitalization as of December 31, 2022, returned 62% on a price basis; the remaining ~490 companies in the S&P 500? 8%. In one of the best-performing years for the market, approximately 74% of individual securities in the S&P 500 *underperformed* the index. All of these data points represent historically abnormal levels. **It suggests that equity managers, who select from a broader universe than just the top ten companies in the S&P 500 and often can't own those companies at their weights in the index, faced an incredibly strong headwind this year to even come close.**

While it is natural to feel optimistic when the market moves higher, there remain some legitimate causes for concern today, and we believe active stock picking remains critically important to identifying opportunities amid mixed macro signals.

First, the market is pricing in two things that seem fairly oppositional to us. One being significant interest rate cuts, and the other being significant earnings growth. **While the Fed dot plot signals three interest rate cuts by the end of 2024, the market is pricing in seven cuts. This doesn't mean that the market is wrong, just that it expects the Fed to continue to shift in the direction of more cuts more quickly than the Board of Governors expects themselves.** However, what we find a bit puzzling is that EPS growth expectations for the broad market are still quite robust with estimates for 2024 EPS growth in the low double digits. A world in which earnings grow double digits does not feel like one that is likely to warrant seven rate cuts. Second, the consumer is still spending in excess of savings. While there remains a buffer built up during COVID, eventually resources get exhausted, and spending is curtailed. We are already seeing signs of strain in some pockets of the market, such as in lower-quality auto loans, where delinquency rates are steadily moving higher and 60+ day delinquencies are now the highest on record.

Offsetting these concerns are some improvements in the near-term outlook. Inflation has moderated, with the latest readings closer to 3%, and the trend is supportive of continued moderation. The economy is expected to avoid a recession with GDP estimates remaining positive throughout 2024 and recent economists' surveys on the probability of a recession show a clear reversal. Second, interest rate cuts during 2024, assuming the economy remains robust, would be supportive of equities on a relative basis as short-term fixed income no longer looks as appealing. Lastly, while valuations overall look fairly full, many of the largest stocks are trading at higher than average multiples, thus lifting aggregate valuation readings. **The median stock still trades at a reasonable level.**

Times are always interesting in the stock market – it's one of the reasons we love what we do. And it's interesting times like these that cause us to focus even more closely on executing our philosophy and process with the continued effort and discipline needed to succeed for our clients. **Thank you for your trust in us.**

Sincerely,

The Cornerstone Investment Team