CORNERSTONE
INVESTMENT PARTNERS, LLC

Large Cap Market Review

Q1 2024

"We think, each of us, that we're much more rational than we are. And we think that we make our decisions because we have good reasons to make them. Even when it's the other way around. We believe in the reasons, because we've already made the decision."

Daniel Kahneman

Our investment philosophy is that "stock prices are more volatile than the fundamentals that determine value." As a concept, it sounds simple – investors are, at their core, people; people have different opinions, and those opinions get reflected in stock prices. If those opinions were wholly rational, then we could count on the weighing machine, and our philosophy would only be, "stock prices are *different* than the fundamentals which determine value." However, even if we were right that a stock is undervalued or overvalued, there would be nothing pushing price and value to converge. The reality is that people aren't wholly rational, which leads to cycles of fear and greed and stock price volatility. **It is this *volatility* that allows us to take advantage of dislocations in price and value.**

Nobel Prize winner Daniel Kahneman unfortunately passed away in late March. Along with his long-term academic partner Amos Tversky, he developed prospect theory, the core of what we now consider to be the field of behavioral economics. Behavioral economics is the study of why people make economic decisions the way they really do rather than the way they think they do. **At Cornerstone, understanding the blind spots and biases that lead to irrationality and seeking to mitigate them as best as possible is essential to who we are as a firm and are at the core of our "Cornerstone Advantage."**

The story in 2024 has so far felt a bit like déjà vu all over again. The broad market has roared higher as a nearly perfect recipe of falling recession fears and continued hopes of interest rate cuts have provided significant support. The market continues to favor large cap (S&P 500 Index: +10.6%) and growth (Russell 1000 Growth +11.4%) stocks over small (Russell 2000: +5.2%) and value (Russell 1000 Value: +9.0%) stocks. Much of this is understandable, as the fundamentals of many of the biggest AI and GLP-1 beneficiaries are uniquely attractive today. As always, however, no matter how good the fundamentals are, if you pay too high a price, you are more likely to lose eventually, and inversely, even the worst business can provide an excellent return if purchased at the right price. With only 295 securities in our 800-stock large cap investible universe undervalued in our Fair Value Model* on an absolute normalized basis, one of the lowest levels since before the Global Financial Crisis, our opportunity set appears to lie somewhere in between today. **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.

Today, several positive drivers of sentiment appear set to continue supporting the market. First, we are in an election year, which has historically resulted in supportive price action for the broad market, with 20 of the past 24 election years providing a positive return, with the average S&P 500 return of +11.6%. There is obviously an incentive for the incumbent party to enter the election with a robust economy and stock market, so strong performance in these years does make sense. Additionally, the market has rallied historically since US Federal Reserve interest rate policy pivots and yields peak. Lastly, we have seen GDP expectations continue to move higher, now topping 2.2% growth for 2024, up from a low of 0.6% in September, providing a more conducive backdrop for corporate earnings growth.

In December, we wrote that rate cut expectations (at one point, the market was pricing in 6-7!) were possibly stretched, and in the absence of significant economic weakness, the data might not support a re-accommodative policy as soon as people thought. That perspective turned out to be correct, as we have seen two meetings so far, but rates have not changed, and the market is now pricing in only two cuts for the year.

Of course, it is easy to feel comfortable during a bull market, but there are always existing and emerging risks to monitor. Existing risks include what appears to be a full valuation for the broader market. This can be measured using traditional metrics like P/E and other measures like looking at the ratio of market cap to GNP, which currently sits at 2.6x. More important to us is our proprietary Fair Value Model, which has a 35+ year history of identifying attractively-valued stocks. As of March 31, it suggested that the US market was somewhat overvalued. Another existing risk is that lower-end consumers continue to feel the pinch of higher rates. Only recently have non-mortgage interest payments (things like credit cards or auto loans) exceeded mortgage payments. Looking at the trends on credit cards, we see that the lowest quartile of borrowers is now experiencing rising delinquencies. With the highest reading since 2008 for consumers expecting lower rates next year, consumers may be expecting the Fed to bail them out, and recent shifts in rates into April make that less likely. This expectation drives action, like buying a house with the aim of refinancing later, which has the potential to disappoint if expectations are not met.

In response to this market, investors are being increasingly thoughtful about fundamentals. The Magnificent Seven are no longer monolithic. While these stocks, in aggregate, have continued to perform well, recently fundamentally-weaker Apple and Tesla were down 11% and 29%, respectively, for the quarter.

This market environment, in particular, forces us to consistently assess our and other investors' rational and irrational decisions. It has been said that individuals are rational, but groups are irrational. Since Kahneman proved that people are themselves irrational, what can we do? **In response, we believe it is the combination of people, philosophy, and process that supports long-term success for our clients.** On people, it is not just intellectual horsepower, curiosity, and effort – those are table stakes. It is the breadth of our team providing a range of opinions and perspectives, our flat structure and years of working together ensuring trust in each other's dissenting evidence, and our focus on executing our process consistently over time. On philosophy, it is not just having a philosophy, although that can unfortunately often be rare. It is the timeless nature of our philosophy, how it is rooted in both theory and reality and how well it informs our processes. Lastly, on process, it is not just a funnel on a PowerPoint page, but how we integrate the Cornerstone Advantage into everything we do and the discipline to execute it every day. We continue to focus on executing our philosophy and process with the effort and discipline needed to succeed for our clients.

Thank you for 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.*