CORNERSTONE
INVESTMENT PARTNERS, LLC

Small Cap Market Review

Q1 2024

Deja Vu

The story so far in 2024 has felt a bit like deja vu. The broad market has roared higher as a nearly perfect recipe of falling recession fears and continued hopes of rate cuts have provided significant support. **However, the market continues to favor large cap and growth stocks, leaving their small and value brethren in the dust.** Much of this is understandable, as many of the biggest AI and GLP-1 beneficiaries are large cap growth stocks and uniquely attractive. Additionally, large cap stocks as a whole are often less reliant on capital markets for funding, so higher rates and the resulting higher interest cost is less of an issue- in fact, for those with net cash balances, it can be a source of higher earnings. 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. **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. That has proved rewarding thus far.

Can The Market Continue Higher?

Today, a number of positive drivers of sentiment appear set to continue supporting the market. First, we are in an election year, and that alone 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 logical 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.

Remaining Vigilant During Good Times

Of course, it is easy to feel comfortable during a bull market, but there are always existing and emerging risks to be aware of. 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. 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.

Avoiding Complacency

We continue to manage our portfolio and positions in the same steady way, and recognize that smaller capitalization stocks still remain at historically inexpensive levels versus large cap. We look for mispriced opportunities, good companies, and reasonable balance sheets. We remain laser-focused on fundamentals to ensure that we are confident our companies can withstand a sustained period of economic hardship but at the same time participate in strong markets. 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 discounts to our conservative assessments of their worth, and we remain excited about our stocks over a multi-year time horizon.

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

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