CORNERSTONE
INVESTMENT PARTNERS, LLC

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“History never repeats itself, but it does rhyme.”

As we close the first half of 2022, we saw a very different market than what we saw through most of 2020 and 2021, and stock market results reflect it. The S&P 500 was down (-16.1%) for the quarter and the Russell 1000 Value was down (-12.2%). Year-to-date, these losses extend to (-20.0%) and (-12.9%), respectively. These are large drawdowns, no doubt, but note that each benchmark remains above pre-pandemic levels.

During periods of market stress, investors often draw parallels to other similar periods and assume that history repeats itself. As we have pointed out for the last few quarters, extended low rates and rising multiples set up an environment where riskier and more speculative assets were likely overextended. High inflation, rising rates, and geopolitical uncertainty have led consumer confidence to fall, particularly pressuring lower-income consumers with rising non-discretionary costs. This waning confidence, combined with the end of both fiscal and monetary policy support, leads to a more uncertain macroeconomic environment than many investors have experienced in more than a decade. Investors abhor few things more than perceived uncertainty and have responded swiftly and viciously with a massive shift in their appetite for risk. Many high-flying growth companies, recent IPOs, highly levered, and money-losing companies have been crushed. During this same period, value stocks have significantly distinguished themselves. Additionally, bonds have not been the safe haven they have been in the past. Combining the pullback in stocks and bonds, the most recent drawdown is the largest destruction of wealth in modern market history. It’s as though the market is questioning how to price risk with the end of the “Fed Put.”

We’re not going to make a call whether we are in or are entering a recessionary environment. We’re not macroeconomists, and even the pundits of the dismal science don’t know. What we do know is that what happened in 2000 was different than what happened in 2008, which was different than what happened in 2020, which was different than what is likely to occur in the future. While they are different, as our initial quote suggests, recessions do rhyme. Durations shrink, valuations fall, and expectations for future earnings eventually need to come in to meet them. Traditional equity market valuations have hit long-term average levels, indicating solid prospective return expectations. However, this year, Wall Street consensus estimates have remained remarkably stable, and do not seem to reflect the real risk to earnings from better-known headwinds like FX and commodity costs, before considering demand concerns.

However, in the face of the seeming doom and gloom, there are some positives.

Equities have historically outperformed bonds during periods of high inflation. From 1900-2011, during high inflation years (4-10%), the average annual real market returns of equities outperformed bonds by approximately 5.3% and delivered positive returns. During periods of severe inflation years (10+%) equities continued to outperform bonds by approximately 4.9%. While not all companies will be able to respond to increasing inflation, quality franchises with pricing power and fixed costs are positioned to handle this environment through the cycle, and fundamental research will be increasingly important.

Some factors may soften the economic blow. Households are entering this period from a relatively strong financial position, with US household holdings of cash and cash equivalents at all-time highs, allowing them to withstand more pain than usual. While housing affordability has come down, mortgages and refinancings signed over the last few years are often fixed and at low interest rates, further reducing systemic risks to the consumer. Technology industry layoffs notwithstanding, the unemployment rate remains low and jobs numbers are solid.

The market's recent performance suggests significant fear in the market, and short-term fear can often lead to long-term opportunities. However, looking back over the ten worst years for the US stock market, the future turned out to be much better than feared. In only two of the years, both of which occurred during the 1930s, the market did not recover its losses within five years. Instead, on average, the market was up 35% over that period.

Valuations overall have fallen, but there remains a significant divergence between cheap and expensive stocks, which we can see with both traditional valuation methodologies and our proprietary Fair Value Model. We believe this market provides an opportunity for active management broadly and more specifically for our approach given our valuation discipline and fundamental analysis of companies trading at conservative valuations. We believe this approach will be more fruitful than relying on the Fed to subsidize risky assets and risky behavior in perpetuity.

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 attractive discounts to our conservative assessments of their worth. We continue to confirm that our portfolio remains composed of high-caliber companies at discounts to the market, and have been excited to uncover some new opportunities this quarter that have been shaken loose by the recent market volatility. This allows us to continue to be patient and wait for the right opportunities to present themselves without assuming undue risks. Despite the elevated uncertainty presently seen in the market and likely present into the foreseeable future, we are excited regarding the prospects for our portfolio. While potentially uncomfortable at times, this uncertainty can set up significant opportunities for future returns.

We believe that environments like today, when the market is stressed, put even greater reliance on the combination of valuation and fundamentals that drives the work we do at Cornerstone – **what you own matters.**

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.