CORNERSTONE
INVESTMENT PARTNERS, LLC

Identifying Mispriced Stocks as a Relative Value Manager

May 2024

Executive Summary

- The definition of "Value" is not the same for everyone – we are a relative value manager.

- Our proprietary Fair Value Model helps us identify candidates for fundamental research in an efficient and unbiased manner.

- Multiples tell us little about mispriced stocks. Assessment of competitive advantage, future value creation prospects, and management acumen play key roles in assessing a potential mispricing.

- A long-term time frame is a critical attribute of a successful long-only equity manager.

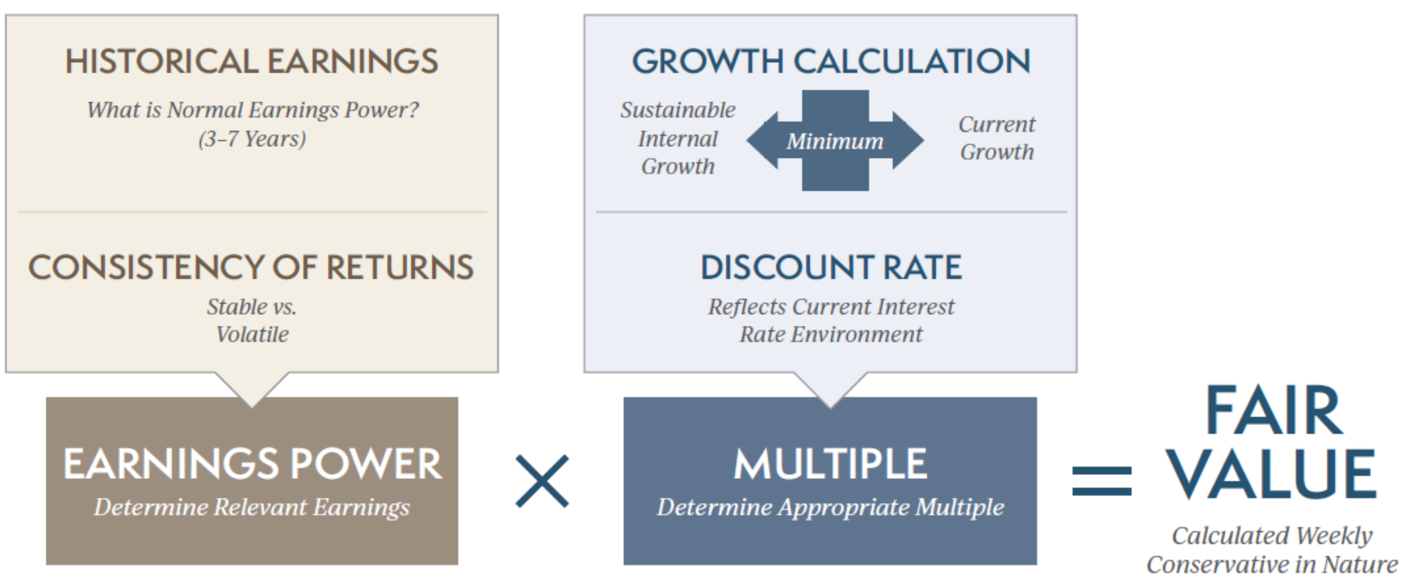
"Value" is Not the Same To Everyone

One of the most common behavioral biases in investing is an overreliance on heuristics. "This is a growth stock," "She's a value manager," or "Utilities are low-risk" are some that immediately come to mind. When assessing managers, the reality is much more nuanced. "Value" managers don't just buy the stocks with the lowest multiples and "Growth" managers don't just buy the those with the fastest earnings path. It is not just the benchmark that a manager chooses that defines their style, but instead how their process reflects a core investment philosophy and is informed by it. Cornerstone's philosophy is "stock prices are more volatile than the fundamentals that determine value." Thus, **we seek out those companies whose stock prices are attractive *relative to their value*.**

Cornerstone's Approach to Valuation as a Relative Value Manager

Our approach to relative value investing begins with our proprietary Fair Value Model ("FVM"). This tool takes an approach somewhat similar to a Discounted Cash Flow (DCF) valuation approach and calculates conservative estimates of intrinsic value over four different time frames on a weekly basis. We refer to the first estimate of value as our Normalized Value Estimate, which is the measure on which we place primary emphasis. We average reported earnings for companies over a range of years based on the volatility of their return on capital. To consider a full business cycle, companies with a more volatile return stream are averaged over a longer number of years, while those companies with more consistent returns are smoothed over fewer years. The minimum number of years is three, which embeds a level of conservatism into our approach. The FVM then calculates a sustainable growth rate for the company and discounts its future earnings stream (our proxy for cash flows) back to present value. What we are trying to do is find a reasonable, representative level of normalized earnings power on which to base a *conservative estimate of intrinsic value*.

Cornerstone's Normalized Value Estimate Calculation

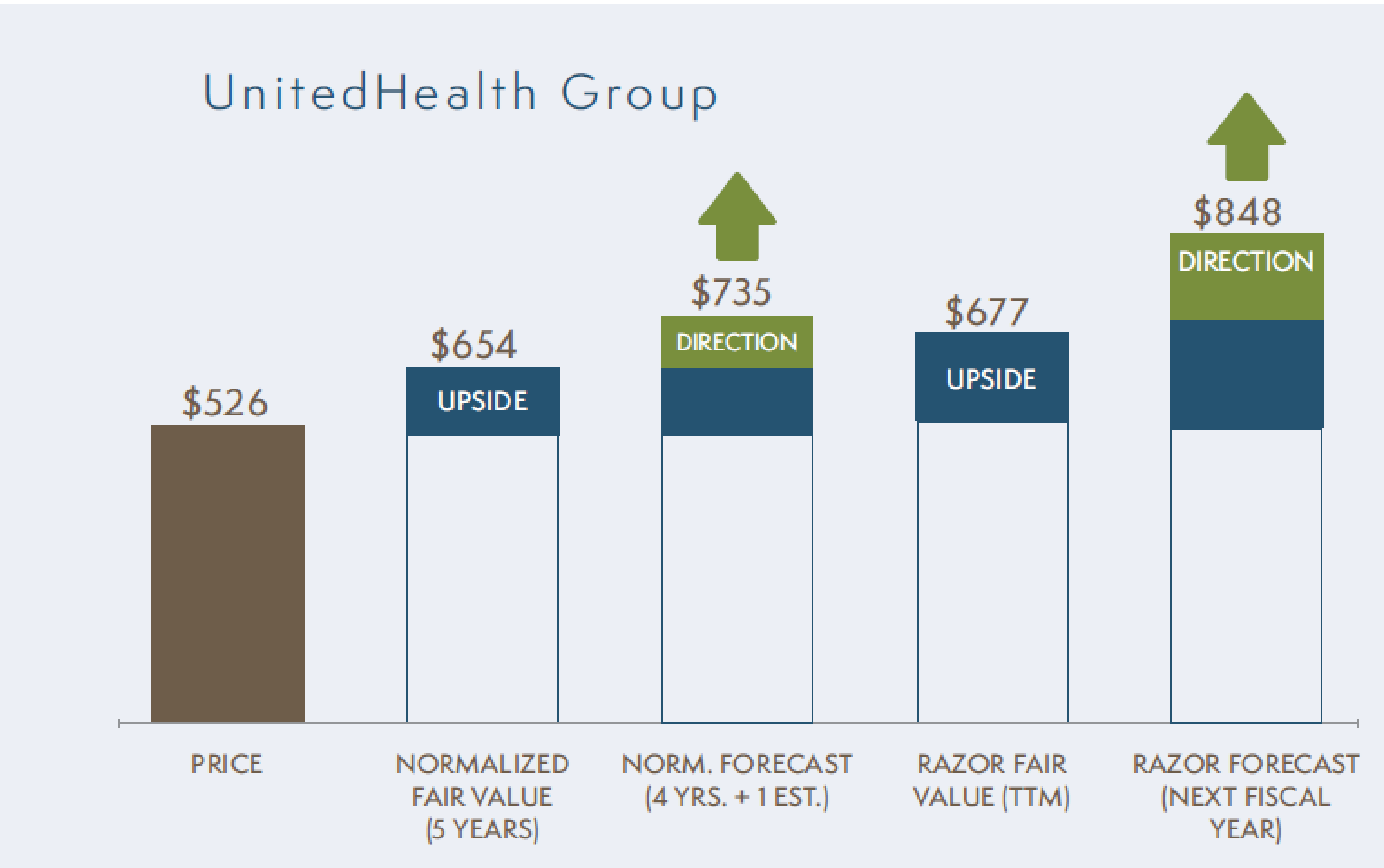


The second valuation measure is called the Normalized Forecast Value Estimate. It smooths earnings over one fewer years than the Normalized and adds the one-year forward consensus Wall Street Analysts' earnings estimates from sell-side analysts as the base earnings power. Think of this as answering the question "If the company executes as expected, "If the analysts' consensus estimates are correct and come to fruition, will the estimated value of the company go up or down over the next year?" Alternatively, "Are the company's operations expected to add to or detract from value this year?"

We call the third valuation estimate the Razor Value Estimate, which uses the trailing twelve month's EPS as the base earnings power. What do the company's most recently achieved results indicate for the valuation opportunity and the current level of value creation?

The final valuation estimate is the Razor Forecast Value Estimate. This measure uses consensus analyst estimates as the base earnings power. This is the method that Wall Street and many professional investors focus most heavily on. It relates directly to forward P/E multiples.

Normalized Fair Value Estimate with Additional Measures



Multiples Tell Us Little About a Stock's Mispricing

We do not think of these measures as being price targets. We think of them as indicators of a potential mispricing. Taking a comprehensive view of the four measures, we look for their direction as a composite to identify whether companies are building value over time and whether the current valuation opportunity is favorable and sufficiently large to compensate for any issues the company may be facing. If you think of traditional yardsticks of value such as P/E, P/B, or P/S, they tell you little about mispricing, despite representing simplified DCFs on their own. If a company trades at a low P/E, it simply means that the market does not value its prospects very highly relative to its earnings today. If a company trades at a high P/E, it means that the market values its prospects more favorably relative to its earnings today. In neither case does it indicate that the stocks are mispriced – they could be under, over, or fairly valued in either case, despite one being cheaper than the other as an objective measure. Nor does it indicate much about the risk involved in choosing between the two stocks. Analysts could be overestimating earnings for the lower multiple stock and underestimating earnings for the higher multiple stock.

We are not a deep value manager; we are a relative value manager and do not shy away from higher multiple stocks if we feel, as reflected by our Fair Value Model and fundamental analysis, that those multiples are warranted and likely driven by superior value creation for shareholders. If we expand our thought experiment to consider the issues involved in evaluating a deeply cyclical stock for purchase these points become clearer. Do you want to buy a cyclical stock when the P/E is high or when the P/E is low? When the P/E is low, it is generally an indication that earnings may be at a cyclical peak and market participants expect them to rollover. When their P/E is high, earnings have usually been in decline. Earnings may be troughing with prior year growth comparisons becoming easier and the industry may be about to enter a new up cycle.

A Mispricing Is More Than a Calculation

We use our Fair Value Model to identify stocks which may be undervalued. We then use it as a construct to help assess whether a stock is mispriced and undervalued as opposed to merely trading at a low valuation that may mean it is priced fairly for its industry, management acumen, and the company's challenges. An evaluation of the company's past operating record is the best way of making this determination. Some companies have better business models, are in industries with more positive competitive dynamics, and have superior management. These companies tend to build more value for shareholders over time and are awarded higher earnings multiples by the market. Among the portfolio's current holdings there are several companies that have superior and transformative management teams paired with favorable industry characteristics. Broadcom led by Hock Tan, Elevance Health led by Gail Boudreaux, and Microsoft led by Satya Nadella are three examples. A final factor to consider is durability. How long is a period of building value at an above average pace likely to last? If it is based solely on strong leadership, management succession issues become paramount in that determination. The emergence of competitive threats, maintaining technological advantage, and the ability to maintain a dominant industry position are among the factors that need to be considered. The longer the period of outsized economic rents that the market ascribes, the higher the earnings multiple will be.

The Advantage of a Long-Term Time Frame

We believe the three most important attributes of a successful equity manager are a strong valuation discipline, an unbiased investment process that fosters open inquiry to assess candidate stocks against current holdings, and having a longer time frame than what is driving a stock's current share price. Once we have identified stocks that are mispriced, undervalued, and fit our investment process, we tend to think over an eighteen month to two-year time period in terms of how long it may take for a valuation gap to close. The market can often focus on no more than one or two quarters. The better the performance track record, the longer the time frame you can embed in your approach. The two tend to reinforce one another. One should not confuse activity with action, as experience has taught us that it pays to be deliberate.