October 2022

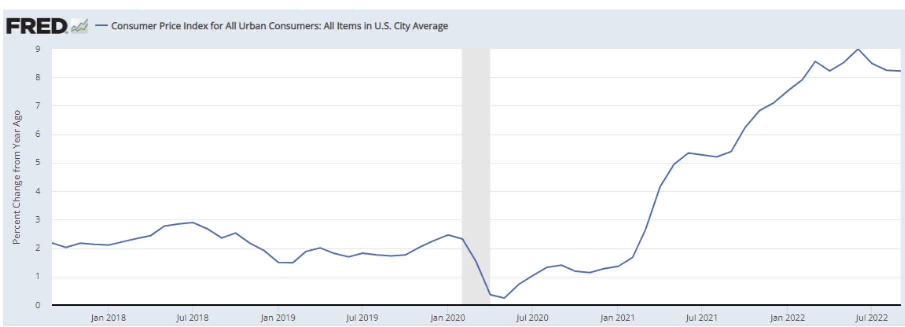
"But how do we know when irrational exuberance has unduly escalated asset values?"
Alan Greenspan, "The Challenge of Central Banking in a Democratic Society"

We opened our quarterly letter three months ago with the statement that history does not repeat itself, but it does rhyme. As this year has progressed, it has become increasingly evident that valuations for long-duration stocks were propped up by a combination of monetary and fiscal policy and emotional Fear of Missing Out ("FOMO"). It does cause us to think of the last similar period of aggressively rising rates at the turn of the century. There is no doubt that we are in a unique period for the market, and potentially have gone through a regime change. The S&P 500 and Russell 1000 Value Indices have fallen 24% and 18%, year-to-date, and each has been down three straight quarters. This market's version of irrational exuberance may have cracked, but the reasons we saw it have not yet gone away, creating significant opportunities for disciplined, process-driven stock selection.

The Fed Has to Raise

Inflation continues to run at elevated levels. The September Consumer Price Index (CPI) reading showed year-over-year growth of 8.3%, and while there are signs that rates will ease, as commodities such as oil, lumber, and copper have all fallen from recent highs, the rate of change remains stubbornly high.

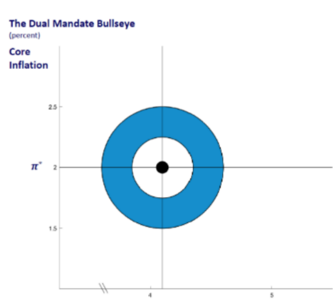
Inflation Remains Stubbornly High



Source: U.S. Bureau of Labor Statistics

The Federal Reserve (Fed) has a dual mandate to "foster economic conditions that achieve both stable prices and maximum sustainable employment," which means the Fed has a long-run inflation target of 2% and a longer-run normal rate of unemployment target of approximately 4%. Given current unemployment is below 4% and inflation is substantially above 2%, the Fed has no choice but to raise rates and likely continue to do so until real interest rates normalize.

The Federal Reserve Has A Dual Mandate to Manage Both Inflation and Employment



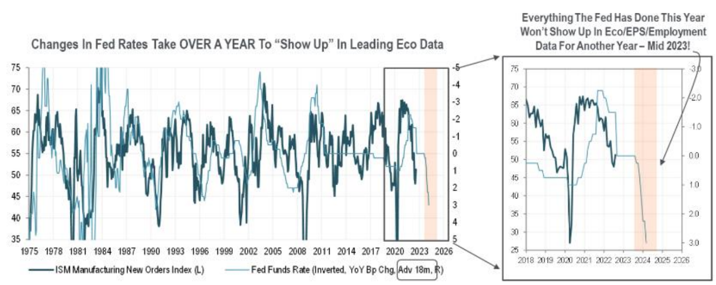
Source: Chicago Federal Reserve

The simple reality is that the range of outcomes feels quite wide today, as higher rates will eventually lead to some amount of demand destruction, but the path, severity, and duration of that outcome are unknown.

Economic Impacts take Time

While Finance 101 tells us what will inevitably happen, higher rates do not immediately flow through the system. There are many steps as higher rates drive individual decisions and filter through the economy. For example, a higher federal funds rate means higher mortgage rates, which in turn pressures home price affordability, and thus likely slows home price appreciation or causes a decline in home prices. These wealth effects then make their way through to the economy over time through reduced consumer spending and other impacts. We have already seen early warning signs, such as the Leading Economic Indicators Index (LEI) six-month growth rate turning negative or when comparing the 18-month forward federal funds rate to ISM manufacturing new orders.

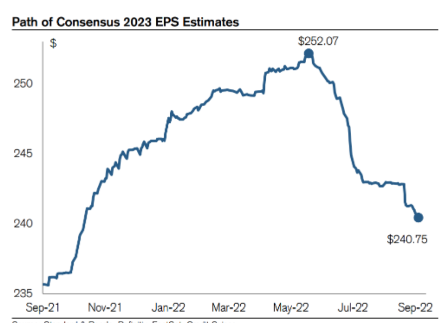
We Have Started to See Early Warning Signs For The Economy



Source: The Conference Board, Piper Sandler

While we have not yet seen Q3 results, there have been divergent perspectives on expectations for future earnings. The move so far in corporate earnings has not been dramatic, but as consumers and companies are getting pinched by inflation, FX headwinds are looming for foreign revenues that are being converted back to dollars, and a potential return to oversupply in some industries, it is increasingly likely that earnings will potentially trend lower for many companies.

Earnings Estimates Have Fallen from Peak Levels



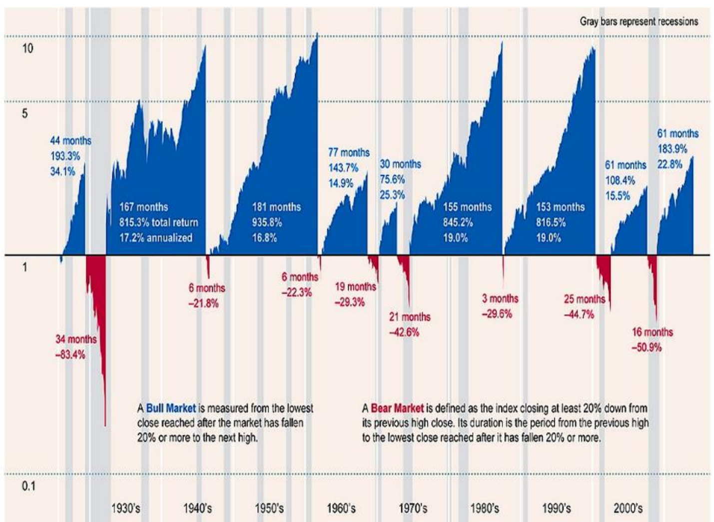
Source: Credit Suisse

What this means is that we are as laser-focused as ever on fundamentals and ensuring that our companies should be able to withstand a sustained period of economic hardship. This type of environment typically implies companies with low leverage, the ability to reduce costs, strong free cash flow, and other quality factors are in positions of strength, while story stocks at lofty valuations without cash flows may be in for more pain.

The Market Is Forward Looking

However, the market doesn't just respond to macroeconomic data points as they happen but instead is forward-looking. Given the move lower in stock prices, presumably, the market has already priced in a lot of bad news. Earnings multiples have compressed significantly, and sentiment has fallen, particularly for long-duration businesses and companies perceived as riskier and less profitable. At the same time, many high-quality companies are getting thrown into the same basket as the average and poor companies because of sector exposure or style heuristics. We have seen and taken advantage of opportunities, investing in high-quality companies that we believe are getting overly punished (for example, they may be part of an ETF facing indiscriminate selling) by the market, and have been excited by many of these opportunities. While we don't know the near-term path of the market going forward, after periods of substantial market declines, prospective returns over the next 3-5 years are typically quite strong.

Bear Markets Present Buying Opportunities

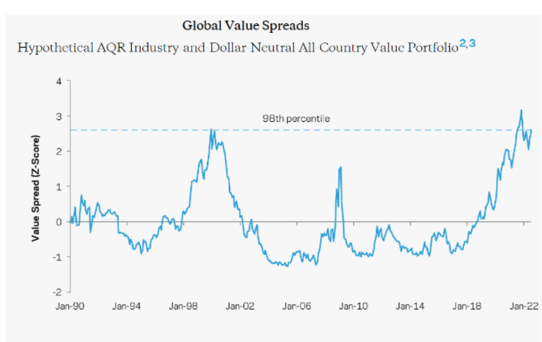


Source: Business Insider

Staying Vigilant and Patient

As we noted last quarter but wish to reiterate, we continually examine our portfolio to ensure that we hold stocks trading at material discounts to our conservative assessments of their worth.

Value-Oriented Stocks Remain Very Inexpensive Relative To Peers



Source: AQR

We confirm that our portfolio remains composed of high-caliber companies at discounts to the market. Meanwhile, market volatility continues to provide us with potential new candidates for the portfolio. In these periods of market emotion, executing a disciplined process provides clarity and illuminates opportunities. We remain excited about all of our stocks over a 2+ year time horizon but recognize that the next year contains elevated uncertainty. While uncomfortable, this uncertainty can set up significant opportunities for future returns.

Our Tag Line Reflects our Focus on Process

According to the SEC, there are 64 RIAs in the United States whose name starts with Cornerstone. Similarly, over 1,000 large-cap stocks are trading in the US, and each has a unique business model, brand, customers, competitive base, and management team. We are in a market environment that will amplify both the positive and negative aspects of our current and potential investments, and how we manage client portfolios will drive future success. As such, we are excited to announce our firm's new tagline, "**Process Beats Emotion**." We start with Process, an essential part of our firm and embedded throughout everything we do, from stock selection to organizational design. It ensures we do what we say and say what we do. Then, we compare that to Emotion, which is subject to biases, heuristics, and overreactions, yet drives much of the market. Particularly today, our focus on process helps us to beat emotion, as we remain disciplined in our fundamental approach to valuation and take advantage of these times when volatile stock prices open up opportunities.

Sincerely,

The Cornerstone Investment Team

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