CORNERSTONE
INVESTMENT PARTNERS, LLC

January 2022

The holiday season serves as an opportunity to reflect and consider both the prior year and our hopes for the future. Looking back, the market continued to perform well in response to striking economic improvements that have driven both positive and negative effects. Companies and entire industries have had to react to volatility across their value chain, from raw materials to equipment to labor to freight, and their efforts have been inspiring. The S&P 500 was up 29% and the Russell 1000 Value Index up 25% during 2021, with both benchmarks rising well above pre-pandemic levels.

The S&P 500 and Russell 1000 Value Indices Were Both Strong Performers During 2021

Source: Factset

There are both near-term and lasting effects of the pandemic, and we are heartened to see that as we emerge out of the nearest-term impacts, market trends are highly encouraging for our actively-managed, value-oriented approach.

Overall, there are four types of stocks we see in today's market:

(1) **Expensive stocks trading on hopes, dreams, and well-crafted stories.** These are exemplified by the rise (and fall) of SPACs and include many other companies, often with limited profitability, that argue they are focused on big end markets (or potentially big end markets). In riskier markets, some highly defensive companies can be included here. They have a place, but there are asset classes designed for the risk-return profile of these companies and managers who have built their decision-making processes to assess these types of right-tail opportunities. We are not that manager. Instead, a crucial part of our investment philosophy is that the best indicator of a large-capitalization company's future fundamental performance is its proven historical track record. At best, many of these companies have limited track records, and at worst, those track records are unattractive, volatile, and a roll of the dice. In the absence of hitting a seven, it is unlikely that the fundamentals of these companies will justify their current valuations for many years.

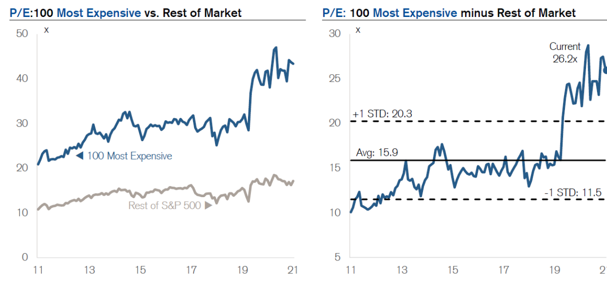
(2) **Expensive stocks with solid fundamentals.** These are exemplified by some of the market leaders today. We are keenly aware of these companies, not only because of their media presence and historically large share of key benchmarks, but also because we have often owned a number of these companies throughout our value-oriented portfolios in the past. When they are attractively valued (which many may well be again), we rush to purchase them because they possess strongly embedded characteristics, improving earnings and return profiles, and unique market positioning. Often they are the most challenging stocks to debate among the investment team, because we want to own them at the right price. Here, our proprietary Fair Value Model, core to Cornerstone's investment process, serves as a forcing mechanism to ensure that we start and end with a clear and objective view on valuation.

(3) **Cheap stocks with solid fundamentals.** This situation drives us to come to work every day, and while these are somewhat harder to find these days, there are examples throughout various sectors. There are reasons why these stocks are mispriced, but often those reasons are temporary in nature, driven by headlines, macroeconomic, or cyclical factors. And investors can and do overreact to them, leading to the primary component of our investment philosophy, that "Stock prices are more volatile than fundamentals that determine value."

(4) **Cheap stocks with risky fundamentals.** Here the question is not "Is the company cheap?" but instead, "how cheap is it?" We have purchased companies like this, but need valuation to provide significant levels of conservatism in order to be comfortable owning them in the portfolio. Cornerstone looks for companies with strongly embedded characteristics, so when there are problems with a company, for example, with high levels of leverage, market share losses, significant cost inflation, or management uncertainty, our research efforts to understand the company and its industry are imperative.

Over the past several years, the market has been led by the expensive stocks, both in the first bucket and the second. For example, the P/E of the 100 most expensive stocks in the market have traded at a 16 multiple point premium to the rest of the market. Today, they are at 26 multiple points.

<u>The Most Expensive Stocks Are At Historically High Valuations Compared To The Rest of The Market</u>



Source: Credit Suisse

Since the 1950s, inexpensive stocks have significantly outperformed high P/E stocks after similar historical runs, with a 20 point swing over the next five years after the Nifty Fifty in the 1970s and Tech Bubble in the 2000s.

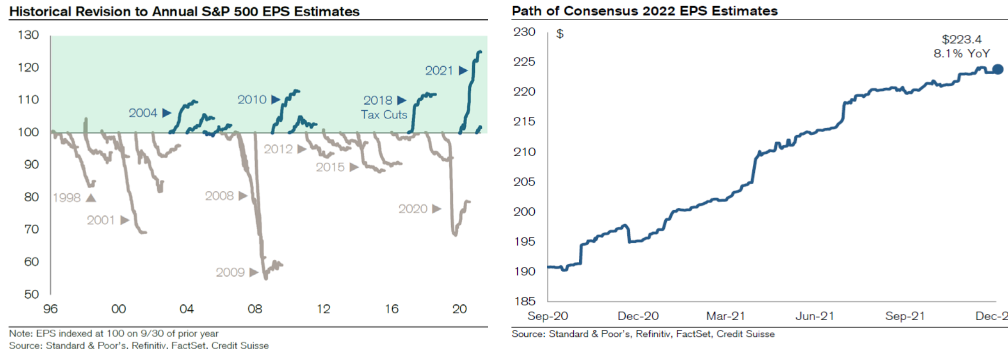
<u>Relative Performance of High Priced Stocks Is At Rarified Levels Often Associated With Severe Cyclical Shifts</u>

Source: Ken French Data Library as of 11/30/21

We have argued for more than a few quarters now that companies in the first bucket are likely the first to show cracks in the system as rates rise, forecasted terminal values fall, and capital shifts towards more reasonable valuations. Weaker stock performance among many of those companies, particularly SPACs, proved that view correct in 2021 and is certainly what we have seen so far over the first few weeks of 2022.

Does that mean that the equity market itself is overvalued? Or just those riskier expensive names? First, looking back since 1928, annual performance of the market has not been correlated, so a strong year like 2021 does not imply that 2022 will be weaker. Secondly, a correction in a subset of the market does not necessarily create a correction in the market as a whole. We make no call about the valuation of the market as a whole, but sales and earnings in 2021 for both the S&P 500 and the Russell 1000 Value Indices were well above pre-pandemic levels, and forward estimates for these benchmarks continue to rise. Importantly, despite COVID-19 fears, the economy remains on solid footing.

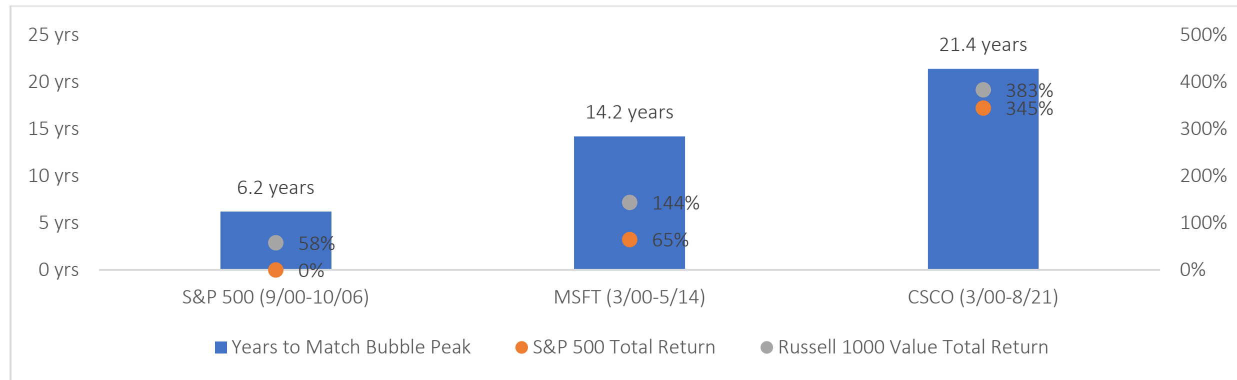
Earnings Estimates For 2021 and 2022 Have Continued To Rise



Source: Credit Suisse

When we say something is cheap or expensive, it refers to a company's relative position vis a vis the rest of the market. It took around six years for the S&P 500 Index to recover its post Tech Bubble highs on a total return basis. It took Microsoft over twice as long. Cisco just got there in August. And during those six, fourteen, and twenty-one-year time frames for the S&P, Microsoft, and Cisco to match their prior highs, the Russell 1000 Value Index rose approximately 60%, 145%, and 385% on a total return basis, respectively.

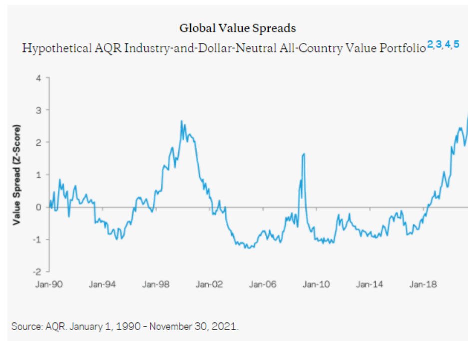
It Took Many Years For Even High Quality Stocks To Recover Tech Bubble Highs



Source: Cornerstone Investment Partners, Factset

We will not compromise our valuation discipline, even in the face of often great stories and compelling business models, and believe that active management will distinguish itself. We believe valuation wins out in the end, and our portfolios remain invested in solid, attractively-valued businesses with strongly embedded characteristics. And the opportunity for value continues to be highly compelling, with value spreads hitting levels at or above those during the Tech Bubble.

Value Spreads Are At Historical Highs



Source: AQR

At the end of the day, there's a lot we don't know, but are excited about recent market sentiment shifts and we believe there remain many attractive investment opportunities in the future. We look forward to discussing our portfolios and firm with you.

On a more personal note, we are saddened to acknowledge the death of our former Partner Fred Wetzel, Jr., who passed away in December at the age of 88.

Fred Wetzel, 1933-2021

He was a friend, mentor, and the original architect and designer of our Fair Value Model. Over his decades of experience as an equity research analyst, Fred made an immeasurable impact at seminal Atlanta firms such as Citizens & Southern National Bank, Montag & Caldwell, Invesco, and of course, Cornerstone. In the late 1980s, he developed the concepts that eventually led to the Fair Value Model, at first manually inputting data from weekly Value Line reports he received in the mail. The Fair Value Model has been core to our investment process ever since the firm was founded and Fred continued to look forward to reading those Value Line reports until his retirement at the end of 2016, when he was 82. One of the earliest CFA Charterholders (1972!), he truly loved stocks and investing with a passion matched only by his love for his wife Maria, children, and grandson. One of Fred's favorite lines, which seems particularly apropos today, was "*You know what a growth company is? A cyclical stock whose earnings haven't declined yet*." We will miss Fred's infectious laugh that could be heard clear from the other side of the office and the deep passion for the work we do.

Sincerely,

The Cornerstone Investment Partners Team

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