CORNERSTONE
INVESTMENT PARTNERS, LLC

Large Cap Market Review

Q4 2022

"It's not what you buy, it's what you pay. And success in investing
doesn't come from buying good things, but from buying things well."
Howard Marks, "The Most Important Thing: Uncommon Sense for the Thoughtful Investor"

Over the last 30 calendar years, the S&P 500 has only been down for six of them, three during the Tech Bubble, and one during the Global Financial Crisis. Investors always say that markets go up and down – and they do, given average intra-year drawdowns are almost 15% – but a year like this one is rare enough to cause market participants to pause, assess what happened, and look forward.

Over the last few years, investors have bought good companies regardless of price, since economic strength and “v”-shaped recoveries made them seem like no-lose bets, like housing before 2007. They’ve also bought bad companies regardless of price, since the “Fed Put” and sustained low interest rates have subsidized risk. What is more challenging is finding companies we want to buy at reasonable prices. Cornerstone's investment philosophy is that "Stock Prices are More Volatile Than The Fundamentals That Determine Value." As such, our investment process combines a focus on valuation with strong fundamental research. In a world where capital has a cost, you need both to succeed.

Valuations have started to matter again. The combination of higher interest rates and a more challenging economic environment was cold water in the face of a market burning with cheap capital (“What, you mean debt costs money?”). Since a growth stock is just a cyclical one that hasn't experienced a downturn yet, this change in investor mindset led to downside performance for those types of companies just as severe as the upside opportunity appeared. Good companies were priced for perfection, and we have been excited to see some valuations come down to earth. That has allowed us to look at firms that have been out of reach for the past few years – those that were bid up because their fundamentals seemed untouchable. When you learn how to build a DCF model, one of the first things you are taught is that the terminal value growth rate cannot be higher than the discount rate you are applying to it. Otherwise, that company will theoretically eventually represent the entire economy. Some stocks’ share prices implied that their investors thought it might actually occur.

Looking back on the last three years, it may yet be a period like the Nifty Fifty and the Tech Bubble – where the barbell of great companies and less-great ones seemed to balance out. And in both examples, the issue wasn't that the average company was doomed for failure. Most of the Nifty Fifty and the major Tech Bubble winners are still around in some form or another, and many (OK, maybe not Simplicity Pattern) remain some of the largest companies in the world today. It is just that they were too expensive. American Express took almost eight years (1981) to make up for the 1973/1974 crash. Since its trough just a year after

peaking, the stock is up over 200-fold. Similarly, it took 15 years (2000-2015) for investors in Microsoft to get back to bubble highs. If they had bought it a year later, they would be up 14x. **After the tide went out for both of those bubbles, value-oriented investing regained prominence, and we believe this period will be no exception.**

Fundamentals have started to matter again, as there were also a host of bad companies. Down markets, as painful as they can be, are healthy, as they expose the types of companies that can't stand up to the scrutiny of more concerned investors. Our late Partner Fred Wetzel used to constantly remind us about "Paper Tigers," and this year, whether levered consumer finance companies masquerading as disruptive auto retailers, under-diligenced start-ups foisted on SPAC investors, or pure frauds in the crypto space, those tigers have indeed shown their stripes. Other companies loaded up with floating-rate debt, and now that rates are rising, face an increasing allocation of cash flow to servicing that debt. Fundamental risk never goes away, and these are good examples of why Cornerstone focuses so much on fundamental research, **asking why stocks seem mispriced and whether a company actually has the embedded characteristics the market perceives it does.**

Last year, as a factor, Value had its best year relative to Growth since the Tech Bubble. The Russell 1000 Value was down 7.5% on a total return basis, while the Russell 1000 Growth was down 29.1%. The S&P 500 was somewhere in the middle, declining 18.1%. While that seems like a lot, we may have just scratched the surface. Since the Global Financial Crisis, Growth has beaten Value in ten of thirteen years, including the last five. A measure of the spread of Value versus Growth published by quantitative manager AQR suggests that the Value stocks remain historically cheap versus Growth (at the 94th percentile!)

While 2022 proved highly volatile and downwardly biased for the market, the year's final quarter saw stocks move higher as investors cheered slowing inflation data as a sign that peak inflation may now be in the rearview mirror. With CPI peaking at 9.1% in June and trending lower to 7.1% in November, there is good reason to believe that the worst inflation may be behind us. Lower oil prices, lower commodity prices, and the easing of recent supply chain pressures should help lessen the inflation rate in the coming months. Given this more positive backdrop, expectations for the path of interest rates from the futures market call for a peaking of rates sometime in the middle of 2023, with rates potentially even being cut before the end of the year. However, there remains a disconnect between the market and the current Fed Dot Plots, which suggest rates at a higher level than the futures market for both 2023 and 2024. As this year has shown, the trajectory for the markets in 2023 may hang in the balance based on who proves to be correct.

Rising interest rates force investors to focus on proven results rather than terminal value-driven models. While the move in interest rates from the bottom has been swift and painful for bond investors, 10-year rates remain no higher than they were in 2008, and other than a short period in 2003, they are still as low as they have been since the 1960s. Was the last decade the normal, or more likely, the abnormal?

The goal of the Federal Reserve's recent monetary policy actions is clear – less economic demand for goods and services lowers inflation – but it takes time to flow through the economy. We are quick to point out

that slowing inflation does not mean either that the problem has been solved (inflation rates remain at very high absolute levels), nor does it mean that we have felt the full effects of higher interest rates on the economy. For example, while we have started to see cracks in the housing market, home affordability remains at record lows as home prices are still significantly elevated versus pre-COVID levels. We have also seen leading indicators start to turn negative, the yield curve invert, and an increasing number of companies announce layoffs. All of these signs point to the possibility of more economic trouble ahead. Of course, the question is how bad it gets and how much pain is already priced in, as a fair bit of pain has been priced in already.

With forward P/E multiples for the market overall back at roughly average levels, it seems likely that the trajectory of earnings will be a more significant driver of stock prices next year. Over the last few months, we have seen estimates for 2023 and 2024 fall, but without many companies providing their outlook yet and realized 4Q operational results still ahead, visibility remains low. In addition to uncertainty around the economic outlook, currency exchange rates continue to play a significant role this year, given the dollar's strengthening. Lastly, 2023 estimates are also currently baking in slower EPS growth in the first half of the year and then stronger growth in the back half of the year, which always warrants extra caution, as it could be a recipe for disappointment if it reflects hope more than logic. As we might expect, the variability of earnings estimates remains quite wide, and therefore we could see a lot of adjustments as we head into 2023. What this means to us practically is that we continue to be laser-focused on fundamentals to ensure that we are confident our companies can withstand a sustained period of economic hardship. This means low leverage, a proven ability to reduce costs, and strong free cash flows.

As uncertain as the next year looks, we believe our active approach, one that focuses intensely on valuation and fundamentals, should provide investors with a strong opportunity for success.

At the firm level, two strategies hit major track record milestones this year. Our Diversified Small Cap Core Strategy turned 10 in June, and our All Cap 40 Strategy, which takes our flagship large cap Concentrated 30 and combines it with ten small and mid-cap equity securities, now has a 5-year track record. We'd be happy to discuss those strategies if they are of interest and appropriate. For the second year in a row, along with two other Atlanta-based firms, we are participating in a rotational college internship program focused on women and students from underrepresented communities. Last year, Virginia Tech student and Iraqi refugee Shahad Al Molhem joined us, working closely with the investment team. The application is now live, and if you know of any college juniors who may be a good fit for the program, we'd love to meet them.

Sincerely,

The Cornerstone Team

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