Day Hagan Smart Value Strategy Update

January 2024

Summary

The DH Smart Value Portfolio continues to invest in companies producing excess returns through positive economic profitability, supported by solid balance sheets (quality), significant cash generation (profitability), and trading with considerable margins of safety (valuation). We believe these factors will continue to provide rational opportunities for the foreseeable future. Using our consistent and differentiated investment approach, the DH Smart Value Portfolio is focused on outperformance, seeking higher total returns with lower volatility.

Strategy Update

From a headline perspective, 2023 should rightfully be described as a good year for the broader financial markets, the U.S. economy, and employment. And why not? After the drubbing the markets took in 2022 (recall that the S&P 500 was down over 18%), 2023 was arguably the polar opposite and certainly provided a better overall experience for investors.

Looking below the headlines, however, a longer-term perspective is in order. For example, while 2023 was a positive year for equities, those gains only brought most markets back to where they were at the beginning of 2022. Specifically, the S&P 500's closing price on January 4, 2022, was 4,793. As of today's writing, January 4, 2023, the S&P 500 is 4,704. *That's a decline of -1.85% over the past two years.* And what about those FANMAG (Meta, Amazon, Netflix, Microsoft, Apple, and Alphabet) stocks that everyone is crowing about? During the same two-year timeframe, the collective return is up just 0.47%.

While that may seem like a bit of a letdown, we actually view it constructively. From our perch, we see the markets as having consolidated for two years, setting a very long-term (secular) base that is conducive to further upside. We also note that several major macroeconomic shifts have occurred, supporting this view: 1) Fed policy is no longer hawkish. In fact, Chairman Powell has even introduced the possibility of rate cuts should inflation continue to descend. 2) Inflation is moderating, though still above Fed target levels. We think the Fed is fighting yesterday's inflation battle and soon will turn its attention to the deficit and the attendant interest expense. Frankly, the current trajectory of debt cannot continue without dire consequences, which leads to 3) Interest rates have likely peaked for this cycle. This is bullish for consumers and corporations but may be even more important for those managing our country's balance sheet. Interest expense on U.S. sovereign debt now exceeds the cost of defense spending. This is untenable. We're not saying that Treasury yields can't revisit the October 2023 highs, but it is unlikely that rates will surpass those levels given the current term structures in place. Regarding potential interest rate trends in 2024, it boils down to a tug-of-war between a path of lower rates due to the aforementioned factors versus a path of higher rates should supply accelerate as the Fed raises money to cover deficits and interest expense. In other words, we'll be closely monitoring upcoming Treasury auctions.

This isn't to say that risks have abated. They have not. We are concerned that geopolitical risks remain high and could cap any softening in Fed policy. Escalation in any of the Russia/Ukraine, Israel, or China/Taiwan wars/conflicts would be disruptive. For example, Houthi pirates attacking ships in the Red Sea have already caused shipping delays, supply chain shortages, and higher costs for transportation of goods—in fact, shipping rates have already doubled. Importantly, this is only a small cadre of militants. A broadening out into a more direct conflict with Iran is also on our watchlist. The bottom line is that there are always black swan risks swirling around, with these in particular garnering our attention.

The stock markets are now pricing in a soft landing, where inflation is tamed without the onset of a recession. Investors currently expect the first rate cut as early as March, with six more rate cuts following. We see this as a bit optimistic, but it would likely be a significant tailwind if rate cuts occur in response to better inflation numbers, not because the economy is faltering.

Turning to corporate earnings, according to FactSet, current forecasts are for 11.7% earnings growth in 2024, resulting from 5.5% revenue growth. (However, the bulk of the earnings growth is expected to occur in the fourth quarter, adding a bit of uncertainty.) All of the S&P 500 sectors are expected to show increased earnings. FactSet highlights Health Care, Communication Services, and Information Technology as likely to see double-digit growth. A soft landing and healthy earnings growth provide an opportunity for the markets to continue higher.

From a style, capitalization, and sector perspective, as we enter 2024, our models suggest that mean reversion is likely to play a role. In 2023, traditional large-cap growth significantly outperformed, with traditional large-cap value trailing. The performance spread between the two was the second-largest since 1979, further expanding the valuation spread. At the end of the year, the forward P/E for large-cap growth equities was 31.5x compared to just 13.7x for value. To be clear, value isn't the only metric important to a market segment's relative performance. The expected one-year earnings growth for large-cap growth is 26.4%, while large-cap value earnings are expected to increase by just 5.6%. Our Smart Value approach balances both valuation and profit growth. Currently, our models are still leaning toward risk-on sectors over defensive. We are also expanding into more cyclical names. However, we will not hesitate to reallocate should this dynamic shift. Last year, the Tech, Communications Services, and Consumer Discretionary sectors outperformed, with the defensive Utilities, Energy, and Consumer Staples sectors posting negative returns. For perspective, the 2023 performance spread between the Tech and Utilities sectors was 69.3 percentage points!

Turning to portfolio activity last month, we purchased CF Industries (CF) and increased our PayPal (PYPL) position. At the same time, we sold Mosaic, Nutrien, and Bristol-Myers Squibb. Our new purchase of CF Industries was described in our 12-29-2023 Trade Notification as follows:

- CF Industries manufactures and sells hydrogen and nitrogen products for energy, fertilizer, emissions abatement, and other industrial activities worldwide. It is the largest nitrogen producer in North America. Its cost structure is tied to natural gas prices in the U.S., which remains toward the low end of a multi-year range, supporting strong profitability.
- When reviewing global competition, we note that CF's price-competitiveness is derived partially from the advantage that lower-cost U.S. natural gas production provides over other countries. For example, China and Europe pay higher prices for their raw materials, giving CF an advantage. As long as the price differentials remain intact, CF should benefit.
- CF has positive economic margins, solid free cash flow growth, and cash on hand that is nearly equal to long-term debt outstanding. In other words, the balance sheet is healthy. The Price-to-Free-Cash-Flow multiple is just 6.49x, and the Forward P/E ratio is below-market at 11.7x. The Dividend Yield is 2.00%, with a Shareholder Yield of 7.5% (Shareholder Yield = dividends + share buybacks + debt reduction).
- We want to maintain exposure to the Materials sector, and CF provides a low-cost entry point for a company generating positive economic profits.

Our sales were explained as follows:

- Specific to Mosaic and Nutrien, lower-cost phosphate producers are flooding the phosphate markets with product, taking market share even if it costs them to sell. We see this as a continuing problem, with more supply expected to hit the markets. We also note that profitability and cash flow generation are slowing as the spread between each company's Return on Invested Capital vs. their Weighted Average Cost of Capital is narrowing. At this point, we are exiting the positions until there is more clarity around supply versus demand.
- Regarding Bristol-Myers-Squibb, there is broad disagreement around whether BMY's recent acquisitions (Celgene and Karuna, in particular) will provide enough profit to offset the losses from the patent expirations on Opdivo (cancer treatment) and Eliquis (cardiovascular) in 2028. The relative underperformance of the stock indicates that BMY will likely remain under pressure to find new revenue sources. Our experience tells us that companies forced to make acquisitions tend to overpay, leading to unwelcome write-offs. We are going to stand aside for the time being until we get a look at calendar Q4 earnings results and hear management's views on replacing those revenues and profits.

From a portfolio perspective using more standard metrics, the median Forward Price/Earnings multiple is 14.7x, with the portfolio's median Free Cash Flow Yield coming in at an attractive 6.7%. The dividend yield is approximately 2.5%.

From a sector perspective, our current weightings are Information Technology (14.2% portfolio weighting vs. 9.2% benchmark), Health Care (3.8% vs. 14.9%), Financials (21.4% vs. 21.7%), Communication Services (12.8% vs. 4.7%), Industrials (11.2% vs. 13.5%), Consumer Staples (5.5% vs. 8.0%), Consumer Discretionary (7.5% vs. 5.0%), Real Estate (1.9% vs. 5.0%), Energy (5.7% vs. 8.0%), Materials (2.1% vs. 4.8%), and Utilities (3.7% vs. 4.9%).

Lastly, we would be remiss not to touch on the fact that 2024 is an election year. And we, like the rest of the country, believe this to be a crucial time. History has shown that election years are typically up years for the market but are often marked by significant volatility as the race heads to the finish line. Clearly, there is a lot at stake. We'll be delving more into election year probabilities as the year progresses, but suffice it to say that our job requires us to focus on the operating environment for financial assets rather than social preferences. In that vein, markets are likely to view a Republican resurgence as potentially more business-friendly. Stay tuned…

The Smart Value portfolio strategy utilizes measures of economic profitability, balance sheet sustainability, cash flow generation, valuation, economic trends, monetary liquidity, and market sentiment to make objective, rational decisions about how much capital to place at risk, as well as where to place that capital.

Please let us know if you would like to discuss the portfolio in more detail or would like to know more about our approach.

Sincerely,

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Disclosure: The aforementioned positions may change at any time.

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There is no guarantee that any investment strategy will achieve its objectives, generate dividends, or avoid losses.

Beta is a measure of the volatility, or systematic risk, of a security or a portfolio in comparison to the market as a whole. **Jensen's Alpha** is a risk-adjusted performance measure that represents the average return on a portfolio or investment, above or below that predicted by the capital asset pricing model (CAPM), given the portfolio's or investment's beta and the average market return. This metric is also commonly referred to as simply alpha.

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