Day Hagan Smart Value Strategy Update

February 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

January gave the appearance of a good month for broader, large-capitalization equity market indexes, but underneath the surface, many stocks experienced a more difficult time. The Russell 2000 (small-cap index), the S&P 400 (mid-cap index), and the S&P 600 (small-cap index) all had negative returns for the month. Thematically, companies that investors typically view as quality, with a high percentage of revenues derived from within the U.S. and buying back their shares, performed well. Low-quality underperformed, with companies underpinned by speculative characteristics losing ground. For example, composite measures of recent IPOs, renewable energy stocks, short-squeeze reversal candidates, highly shorted expensive names, credit laggards, and companies with crypto exposure were down between -4.2% and -25.5% during the month.

The good news is that our focus is on quality U.S. companies, supported by solid profitability and lower valuations—not on speculative betting.

One factor defining quality is the ability of a company to achieve or exceed its earnings growth targets consistently. Given that we are in the midst of earnings season (companies are still reporting results from Q4 2023), we thought it would be instructive to discuss a few of the more interesting earnings reports.

From the end of 2023 through 2-2-2024, 17 of our portfolio holdings reported earnings. Only two did not meet expectations: Kinder Morgan (KMI) and JP Morgan (JPM). We'll start with those.

JPM missed expectations due to an FDIC special assessment of $2.9 billion to cover uninsured deposits exposed during the March 2023 banking crisis. Without the charge, JPM would have earned $3.97, which would have eclipsed expectations for $3.60. Even so, JPM continues to execute well throughout its retail banking, credit card, investment banking, and private wealth segments, with the stock recently reaching all-time highs. We do note that the Price/Tangible Book multiple is moving toward the high end of its 15-year range, giving us pause. If economic profitability also begins to trend toward potentially unrealistic expectations, we will trim or exit the position.

KMI missed by just one cent (earning $0.28) even though natural gas prices fell 60% from a year ago, and interest expenses were higher. It's important to keep in mind that KMI is a toll-taker and operates in four segments: Natural Gas Pipelines, Products Pipelines, Terminals, and CO2 from recovery to production. The decline in gas prices doesn't necessarily impact volume but can impact bonus payments on volumes transported. During the earnings call, KMI management forecasted 15% y/y earnings growth in 2024 (assuming Henry Hub natural gas prices average around $3.50/MMBtu). Moreover, in the fourth quarter, KMI opened up nearly $1 billion worth of new projects, which are now revenue generators rather than just capital expenditures. Furthermore, KMI's backlogs have grown to over $3 billion, presaging more opportunities ahead. With this in mind, both companies' misses were, in our view, within acceptable bounds.

We also had our share of positive surprises, led by Meta (META, formerly Facebook), which also happens to be our largest position. Meta's earnings surprise has been described as the "Best Report of the Season" and "The Must-Own of the Magnificent 7." (Source: SA) Not only did Meta jump over 21% on the beat (profits tripled in Q4), but it also announced the initiation of its first dividend ($2 annually per share). In fact, Meta's market capitalization increased by $196.8 billion dollars on that day alone – an all-time record single-day gain in market cap. (Source: Bloomberg) By paying a dividend, Meta opens itself up to purchase by dividend-focused funds; in other words, a whole new avenue of demand has just been established. The report detailed that Meta's revenues increased by 25%, with net income increasing to $14 billion from $4.65 billion a year earlier. Clearly, the advertising space is once again gaining traction. Meta also announced a dividend buyback of $50 billion. The bottom line is the report shows Meta firing on all cylinders. However, it is important to note that the position has become quite large in our portfolio and may be trimmed in the future.

Our purchase of Clorox (CLX) in late October is paying off as well. In our 10-25-2023 Trade Notification, we wrote, *"The stock price has been in decline, down -14.3% year-to-date and now at levels last seen in 2017. Moreover, the stock is down -48% from its peak in 2019. Part of the decline resulted from a cyberattack that led to a -25% drop in quarterly sales (about $500 million in revenues). Management has responded by beefing up network security. Our work indicates that the decline is overdone, and the current levels of pessimism are unwarranted. We are using this opportunity to initiate a position with a solid margin of safety."* The stock bottomed six trading days later. Following the February 1, 2024 earnings call, CLX increased by over 7% in after-hours trading. At the time, we had some concerns about CLX's exposure to Argentina (and the devaluation of the Argentine peso), but according to management, price increases and a move to more automated order processing around the world offset the devaluation. At this point, CLX is fast approaching our fair value target price and is under review.

All in all, the earnings season for our portfolio has been positive. We believe it is due in large part to quality stock leadership during times of uncertainty.

Periodically, we review our portfolio's sensitivity to macro factors. This provides a sense of what is moving our portfolio outside of individual company influences. Positive correlations occur when the portfolio is prone to move higher as the factor increases in value, while negative correlations show the portfolio declining as the factor increases.

Positive Correlations

- Commodity prices
- Crude oil
- U.S. dollar
- Emerging Markets
- Inflation (CPI)

Negative Correlation

- Euro and Japanese yen

As shown, increases in commodity prices, oil prices, the U.S. dollar, emerging markets, and inflation would be expected to positively impact the portfolio as long as the moves higher were tempered. In other words, the portfolio is positioned to potentially withstand and benefit from those factors increasing in value. Nonetheless, spikes in any of the factors resulting from an exogenous shock would have a negative effect. Perhaps the most important information to be gleaned is what's not shown, i.e., the portfolio has just a -0.02% correlation to 10-year Treasury bond prices. This means that the portfolio shouldn't be overly impacted if bond prices go down (interest rates go up).

From a sector perspective, our current weightings are Information Technology (14.7% portfolio weighting vs. 9.5% benchmark), Health Care (3.7% vs. 14.8%), Financials (21.0% vs. 22.1%), Communication Services (15.0% vs. 4.8%), Industrials (11.0% vs. 13.9%), Consumer Staples (5.6% vs. 8.0%), Consumer Discretionary (7.5% vs. 5.0%), Real Estate (1.7% vs. 4.8%), Energy (5.3% vs. 7.6%), Materials (1.9% vs. 4.7%), and Utilities (3.3% vs. 4.6%).

From a portfolio perspective using more standard metrics, the median Forward Price/Earnings multiple is just 13.9x, with the portfolio's average Cash Flow Yield coming in at an attractive 9.2%. The dividend yield is approximately 2.4%.

As we wrote last month, "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." It looks as though rate cut hopes were indeed overly optimistic. Recent comments from the Fed confirm that absent considerable economic weakness or a macro shock, rate cuts may not materialize until the second quarter at the earliest.

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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