Day Hagan Smart Value Strategy Update

April 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

Equity returns in March were strong as investors continued to factor in expectations for the commencement of an easing cycle. This was the fifth consecutive month for higher markets. NDR notes that this is "a feat achieved for only the seventh time since 1926. After the previous six cases, the S&P 500 has risen every time in April. However, for the entire second quarter, the index has risen only 50% of the time. From March 31 through the end of the year, the index has risen all six times by an average of 11.4% versus 6.1% for all years. The message is that after short-term momentum fades, the market could consolidate gains, but history suggests any pullbacks would be in the context of an ongoing uptrend and not the start of a bear market."

Given the strong gains, there are some concerns that the market may be overbought. JP Morgan observed that "the S&P 500 wrapped up a stellar start to the year, rallying more than 10%. This quarter's gain comes on the back of a strong gain to end 2023. Putting the two together, this was the first time in more than 10 years and only the 8th time since 1950 that the S&P 500 had consecutive quarterly gains of at least 10%. In nearly every other instance, the index was higher a year later, with an average return north of 10%. The only time the index wasn't higher, it was exactly flat a year later."

The U.S. macroeconomic backdrop remains constructive, with positive economic growth, diminishing odds of a recession, and strong employment. However, we do have concerns that inflation pressures may reignite based on our view that investor liquidity is still robust and several price measures and select commodity sectors are showing signs of strength. In fact, the Energy sector was the best-performing sector last month, with the Materials sector not far behind.

Since 1972, during periods of increasing economic growth accompanied by disinflation, the S&P 500 has gained an average annual return of 28.8%. During periods of increasing economic growth and a neutral inflation outlook, the annualized return falls to 16.8%—but it is still quite good. In contrast, during periods of contracting economic growth and disinflation (prices falling as economic growth falters), stocks declined at a -15.07% annualized rate. Hence, our focus on the expected path for economic activity and inflation. (Source: NDR) The latest readings from the models show that the U.S. economy is still on a moderate growth track, and inflation trends are moderately disinflationary.

During the month, we made some adjustments to the portfolio: We trimmed Meta (META) and Williams Sonoma (WSM), which had become overweight due to their significant appreciation since purchase. Nonetheless, even after reducing the positions, we now hold full positions in both companies. We will continue to trim should the stock prices further exceed Fair Value and would potentially look to add if an opportunity arises.

We diversified the profits back into three well-known companies that have historically exemplified defensive characteristics, quality, and significant cash generation: Pepsi (PEP), Starbucks (SBUX), and Deere (DE). Below are points from our Trade Notification, sent out on March 14:

Pepsi (PEP):

- PepsiCo, Inc. engages in the manufacture, marketing, distribution, and sale of various beverages and convenient foods worldwide. The company operates through seven segments: Frito-Lay North America; Quaker Foods North America; PepsiCo Beverages North America, Latin America, Europe, Africa, Middle East, and South Asia; and Asia Pacific, Australia and New Zealand, and China Region.
- Over the past five years, PEP has invested heavily in advertising, marketing, and infrastructure to become more technologically efficient in manufacturing, distribution, and e-commerce. We view Capex spending positively, providing a runway for greater profitability over the next few years. Since 2019, organic revenue growth has averaged 7% per year in North America and 10% per year internationally, with both levels exceeding company expectations.
- Standard metrics show strong profitability and financial strength: Free cash flow margins are 8.7%, ROE is 50.9%, and ROIC (return on invested capital) at 12.83% is well above WACC (weighted average cost of capital) of 6.15%. The dividend yield is 3.08%. The balance sheet shows over $10 billion of cash on the books and free cash flow of $7.9 billion last year.
- Looking through an Economic Value Added (EVA) lens, we note that PEP has strong and rising profitability, upper quartile and improving cash margins, lean inventories, top-tier vendor funding, efficient PP&E utilization, and a very high advertising-yielding growth advantage.
- Given PepsiCo's pullback over the past year (it was down more than 16% since last May), we are taking this opportunity to purchase a quality company at a reasonable price.

Starbucks (SBUX):

- Starbucks Corporation, together with its subsidiaries, is a roaster, marketer, and retailer of coffee worldwide. The company has three geographic segments: North America, International, and Channel Development.
- SBUX has been under pressure since peaking in July 2021 and was down nearly 27% from those levels. Much of the weakness has been attributed to its China operations (SBUX has 16,466 stores in the U.S. and 6,795 in China). However, in the most recent quarterly earnings report, SBUX noted better ticket growth in North America and higher transaction growth in China. China is also in the midst of enacting additional stimulus to support economic activity. This bodes well for growing revenues.
- Standard metrics show strong profitability and financial strength: The free cash flow margin is 11.96%, and ROIC, at 16.26%, is well ahead of WACC at 7.98%. The dividend yield is 2.41%. SBUX generated $3.7 billion of free cash flow last year, ending with $3.6 billion in cash.
- From an EVA perspective, SBUX shows strong and accelerating profitability, lean and shrinking capital requirements, above-average and accelerating cash margins, light SG&A expenses, and efficient PP&E asset utilization. Sales growth has been the sticking point, and as described above, absent a recession, we view recent improvements in China, along with better-than-expected U.S. growth, as a starting point for renewed revenue advances.
- Like PEP, we are taking this opportunity to initiate a position in a quality company at a reasonable price.

Deere & Co. (DE):

- Deere & Company engages in the manufacture and distribution of various equipment worldwide. The company operates through four segments: Production and Precision Agriculture, Small Agriculture and Turf, Construction and Forestry, and Financial Services.
- DE recently reported its Q1 2024 fiscal earnings last month, beating both earnings and revenue estimates. During the call, management noted that "Fundamentals in the end markets that we serve remain supportive of equipment replacement demand. Ag fundamentals, while down from the record highs of the last few years, have returned to mid-cycle levels." They also point out that "The U.S. fleet age remains above 20-year averages for both tractors and combines."
- Like PEP and SBUX, DE is a solid cash generator. Its free cash flow margins are 7.46%, and its ROIC of 13.77% is well ahead of its WACC at 7.69%. The dividend yield is 1.42%. DE generated $4.1 billion of free cash in 2023, ending with a cash balance of $7.6 billion.
- From an EVA perspective, DE is showing solid long-term growth trends, robust profitability, accelerating cash margins, shrinking capital requirements, contracting SG&A expense, improving PP&E utilization, and positive returns from its substantial R&D spending.
- We are taking this opportunity to purchase DE at prices seen in 2021.

Reducing Meta and Williams Sonoma and initiating positions in Pepsi, Starbucks, and Deere combined to tilt our portfolio a little more toward value and defensive characteristics.

The portfolio's current sector weightings are Information Technology (13.8% portfolio weighting vs. 9.3% benchmark), Health Care (3.3% vs. 14.0%), Financials (20.8% vs. 22.5%), Communication Services (10.1% vs. 4.6%), Industrials (13.0% vs. 14.3%), Consumer Staples (7.4% vs. 7.6%), Consumer Discretionary (9.1% vs. 4.9%), Real Estate (1.5% vs. 4.5%), Energy (5.5% vs. 8.4%), Materials (2.0% vs. 4.8%), and Utilities (3.4% vs. 4.7%).

From a portfolio perspective using more standard metrics, the median Forward Price/Earnings multiple is 16.7x (versus 28.2x for the "Elite 8"), with the portfolio's average Cash Flow Yield now an attractive 7.7%. The dividend yield is approximately 2.4%.

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 learn more about our approach.

Sincerely,

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Disclosure: The aforementioned positions may change at any time.

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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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