# SCHAFER | CULLEN
CAPITAL MANAGEMENT

**Enhanced Equity Income**
Q4 2019 Commentary

## Market Review:

US equities advanced sharply in the 4th quarter of 2019, with the S&P 500 finishing up +9.1% and the Russell 1000 Value up +7.4%. The quarter capped off a remarkable year for stocks, as the S&P 500 returned 31.5% for the year, the best performance for the market since 2013. Two key themes that propelled stocks higher throughout the year continued in the 4th quarter, including accommodative policy by the Federal Reserve ("Fed") and progress in the US-China trade war. After the Fed cut interest rates in October for a third time in 2019, the Trump and Xi administrations in December agreed to a phase one trade deal.

Information Technology and Healthcare were the best-performing sectors, both finishing the quarter up +14.4%. While the strong quarter merely extended the banner year for Technology, which finished up 50.3% for 2019, Healthcare had been significantly lagging the broad market coming into October. The rally in Healthcare stocks appeared to be driven in part by the political landscape, as candidates advocating for sweeping changes in the healthcare system dipped in polls for the Democratic Presidential primary. Financials (+10.5%), and particularly bank stocks, benefitted from the risk-on sentiment and a slight steepening in the Treasury yield curve. The Communication Services sector was up +9.0%, as the internet and technology-heavy Media & Entertainment industry advanced +10.5%, while the Telecom industry gained only +3.7%. Defensive, higher-yielding sectors lagged in the quarter. Real Estate (-0.5%) was the only sector with negative returns, while Utilities were up only +0.8% and Consumer Staples returned +3.5%.

Given that the 4th quarter marked the end of the 2010's, it is worth noting the market's performance over the decade. Still recovering from the 2008 financial crisis at the beginning of 2010, the S&P 500's performance benefitted from a relatively low starting point. It further benefitted from a recession-free decade, now in unchartered territory as the longest economic expansion in US history. Over the decade, the S&P 500 returned 256%, or 13.5% on an annualized basis. Following roughly a decade of Value outperformance in the 2000's, the 2010's were marked by Growth's outperformance over Value, as the Russell 1000 Growth index returned 15.2% annualized versus 11.8% for the Russell 1000 Value. The outperformance of Growth can be further narrowed to a handful of stocks, as the acronym "FAANG[2]" was coined and those stocks returned approximately 21% annualized. Information Technology returned 17.5% annualized over the decade, while Healthcare was the second-best performing sector at 14.8% annualized, and Energy suffered from a rout in the WTI oil benchmark, from above $110 in 2014 to below $40 in 2016 and the sector returned only 3.3% annualized. Finally, it is worth noting that S&P 500 EPS growth averaged 10.2% over the decade, while revenue growth averaged only 4.4%, reflecting the increase in profit margins and the impact of share repurchases.

With widespread concerns about a potential slowdown in the economy earlier in the year, the Fed responded with its third rate cut in the 4th quarter, bringing interest rates to a range of between 1.5% and 1.75%. Following the announcement, Fed Chair Jerome Powell said "the current stance of policy is likely to remain appropriate," as long as the economy expands moderately and the labor market stays strong. In addition to the rate cuts, the Fed injected further liquidity into financial markets through overnight repurchase agreements, following significant dislocation in the repo market in September. The

accommodative policies from the Fed come at a time when the US economy appears to be strong. The Commerce Department reported US GDP growth of 2.1% for the 3rd quarter, compared with 2.0% in the 2nd quarter.

It was a historic quarter on the geopolitical front. The US-China phase one trade deal rolled back certain US tariffs and cancelled new tariffs on roughly $156 billion in Chinese imports that were set to take effect on December 15th. Chinese concessions included increased purchases of farm goods and other US exports. The US, Mexico and Canada signed an amended USMCA trade deal to replace NAFTA, which included provisions aimed at creating manufacturing jobs in the US. Amidst all the trade developments, the House of Representatives voted to impeach President Trump for abuse of power and obstruction of Congress, only the third impeachment in US history. Senate Majority Leader Mitch McConnell is thus far insisting on a quick Senate trial, while Democrats in the House and Senate have demanded witnesses and further documents. Finally, the UK's Boris Johnson secured a historic general election victory as his Conservative Party won 364 of 650 seats in the House of Commons. The win sets the stage for the long-awaited Brexit on January 31st.

## Income and Options Summary:

Total income generated for 2019 in the representative account was 7.7 %; of this sum, 3.8% was generated by dividends and 3.9% by call premiums. During the 4th quarter, two companies in the portfolio declared dividend increases, averaging 24.3%. Of the 33 holdings at year end, 26 declared dividend increases with an average increase of 7.9% for the year.

Options premiums remained attractive during 2019, as the year featured periods of volatility within a general period of investor and speculator optimism. During December, only nine options positions were exposed within the strategy, reflecting extended efficiency in assignment exposure; only 162 positions were written during the year. 1131 contracts were written, of which 485 were assigned, yielding an in-line assignment rate of 43%.

Out-of-the-money margins on calls written increased to 2.6%, about 10% above historical averages. Calls were written at an average of nearly 18% static return and more than 66% total return, in further evidence of call premium quality and writing opportunity.

## Performance Analysis:

The growth style extended its dominance during the year, outpacing value by nearly 1000 basis points in the Russell 1000 indices; however, the composition of the returns was somewhat different in 2019. While the Information Technology sector continued to lead dramatically, the Consumer Discretionary sector was outperformed by four others in the S&P 500 Index. Solid returns in the Communications Services, Financials, Industrials, and Real Estate sectors helped propel the strategy to a good relative return. Healthcare and Financials were particularly strong during the 4th quarter.

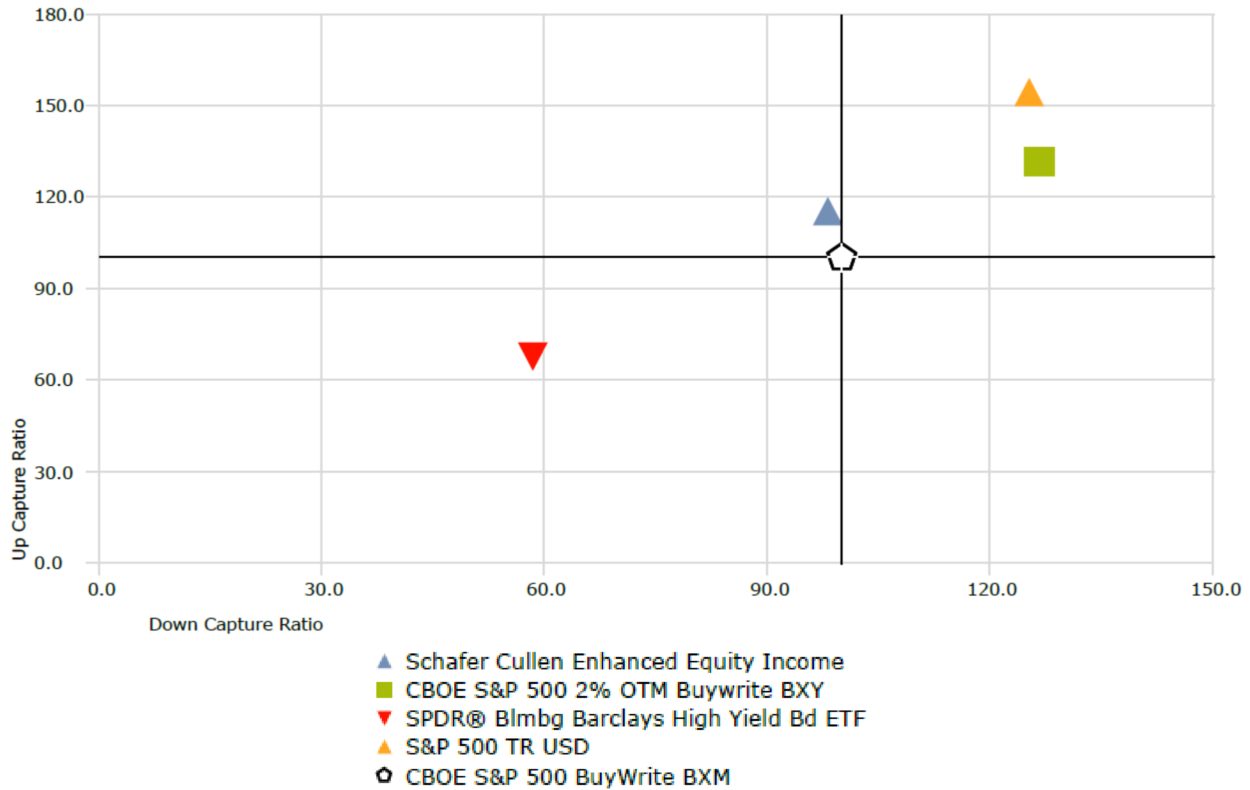
The strategy composite returned 6.6% net of fees during the quarter, outperforming its benchmarks, the S&P 500 Buy/Write Index (BXM), which earned 4.3% and the SPDR Barclays High Yield Bond ETF (JNK), which gained 2.7%. For the year, Enhanced Equity Income returned 17.8% net, compared with 15.7% and 15%, respectively. The year and the quarter in particular were illustrative of the capital return advantages of partial over full overlays during strong markets, even when their underlying investment style is disfavored.

**Figure 1: Enhanced Equity Income Returns vs. Benchmark**

| | Q4 | YTD | 1 Yr | 3 Yr | 5 Yr | Since Incept* |
|---|---|---|---|---|---|---|
| **SCCM Enhanced Equity Composite (gross)** | **6.9** | **19.2** | **19.2** | **8.4** | **7.3** | **9.6** |
| **SCCM Enhanced Equity Composite (net)** | **6.6** | **17.8** | **17.8** | **7.2** | **6.1** | **8.4** |
| S&P 500 Buy-Write Index (BXM) | 4.3 | 15.7 | 15.7 | 7.6 | 7.0 | 7.2 |
| SPDR Barclays High Yield Bond ETF (JNK) | 2.7 | 15.0 | 15.0 | 5.8 | 4.8 | 5.5 |

**12/31/2010. Performance for periods greater than 1 year is annualized.* ***Past performance is no guarantee of future results.***

**Figure 2: SCCM Enhanced Equity Income Since Inception Downside Capture[1]**




Source: SCCM/Morningstar Direct, 12/31/2019.

## Portfolio Changes:

### *Purchases / Additions*

A new position in **Conagra Brands (CAG)** was established in the quarter. Conagra is a packaged food and snacks company with a steady organic growth profile in the +1-3% range thanks trends favoring frozen meals and gluten-free snacks. The company's operations are highly diversified with 36 key brands spanning frozen meals, grocery and snack products. Frozen and refrigerated meals appeal to value oriented customers with key brands such as Marie Callender's and Hungry Man while other brands such as Healthy Choice are marketed to middle-income consumers. Also, Conagra's Grocery & Snacks segment includes a number of notable brands such as Pam cooking spray, Reddi-wip whipped cream, Orville Redenbacher's popcorn and Hunt's ketchup.

Conagra has found new growth avenues since the acquisition of Pinnacle Foods in late 2018. This ~$8.0 billion deal brought in more frozen brands such as the Birds Eye Frozen Vegetables business. Here, the overlap with Conagra's existing frozen meals business has presented synergies in terms of costs and revenues as the company's shelf space has greatly expanded with respect to grocery-store customers. This acquisition also brought in leading gluten-free brands such as Glutino and Udi's. Here, the company gains exposure in fast-growing segments of the packaged food industry such as gluten-free cookies, fruit bars and bread.

Overall, we are pleased with the way Conagra management has executed on its plan to drive healthy growth in organic sales above the peer group while delivering on cost targets and reducing debt. We believe Conagra Brands is positioned well for long-term growth thanks to its exposure to parts of the market with better secular growth prospects and less competition. Conagra was purchased at a forward P/E multiple of 12.5x and with a dividend yield of 3.1%.

### *Sales / Reductions*

**Kimberly Clark (KMB)** was sold from the portfolio in October, due to valuation and price appreciation.

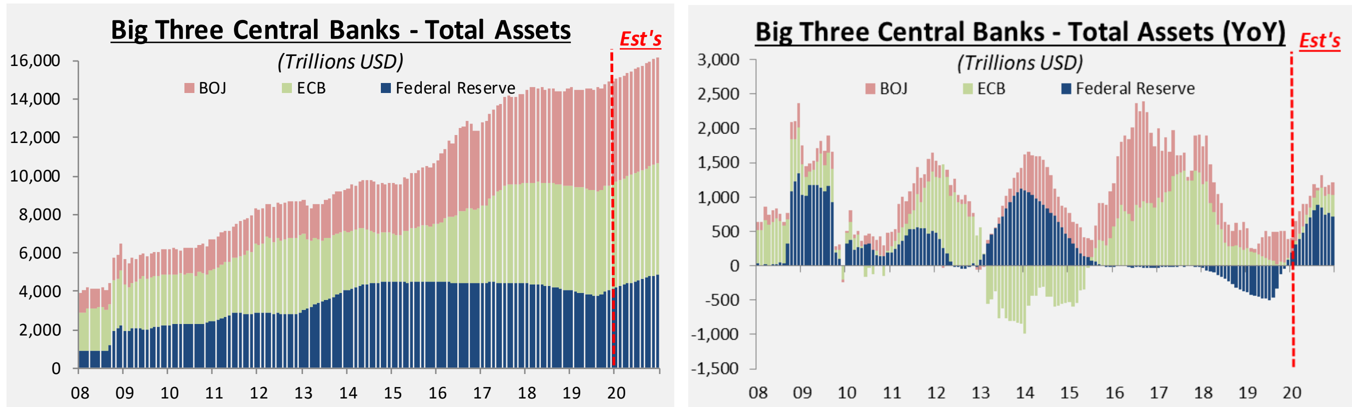
## Market Outlook:

US equity markets posted their second best year of returns in 2019 since the financial crisis as markets began to price in an economic rebound in 2020. Wall Street consensus expects further gains as global central banks collectively continue to expand their balance sheets, the US-China phase one trade deal serves to reduce the economic impact of tariffs and improve business confidence, and election years have historically delivered above-average market returns. In addition, analysts are optimistic, with corporate earnings expected to rise 10% year-over-year in 2020. Bullish views are also supported by the shift in Fed communication stating the committee is willing to let inflation run above target levels, reducing the risk of rate hikes and tighter liquidity.

The late 2019 market rally was in part driven by the resumption of global central bank balance sheet expansion which began in earnest in October 2019. The three largest central banks (Federal Reserve, ECB, and BOJ) continue to expand their balance sheets at the rate of $100B per month, which has served to suppress volatility with the 30-day realized volatility for the S&P 500 reaching one of the lowest readings on record. The low volatility environment has driven quantitative and systematic strategies to rebalance out of fixed income and into riskier assets, driving equity prices higher. The impact of renewed Fed balance

sheet expansion can be seen in the significant acceleration in money supply growth with US M2 growth accelerating from 3.8% year-over-year in April 2019 to 7.6% in December 2019.

**Figure 3: Central Bank Balance Sheets**




Source: Wolfe Research, 2020 Outlook, 12/16/2019.

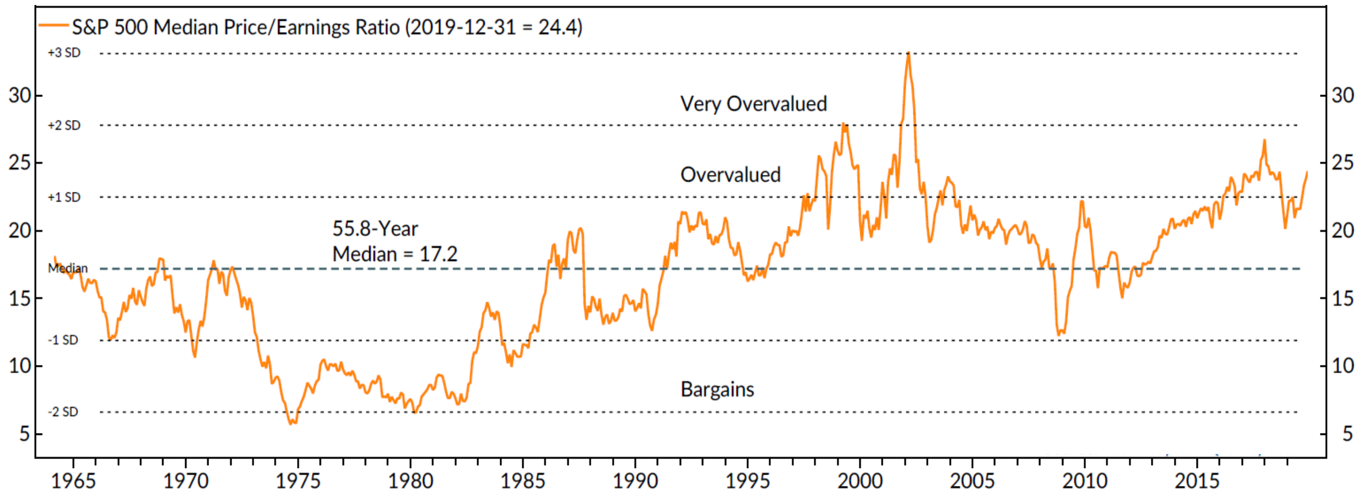
The continued rise of passive investing and momentum have driven the S&P 500 to be further concentrated, with the 10 largest companies now representing 25% of the index, similar to record levels reached during the Tech Bubble. While this in and of itself does not signal risk, it does highlight the concentration and crowding in trillion-dollar market capitalization companies that will eventually face growth challenges.

**Figure 4: Market Cap of 10 Largest S&P 500 Companies as % of Total S&P 500 Market Cap**

Source: BofA/ML, Strategy Snippet: Liquidity Concerns, 12/11/2019. Dates in study 1/1986-10/2019.

Elevated market valuation and bullish investor sentiment are challenges for the equity markets ahead. The S&P 500 median Price/Earnings ratio is 24.4x while the Price/Sales ratio is 2.4x, higher than the peak of the dot-com bubble. These heightened levels have been partially justified by low inflation, low rates and global monetary stimulus. While valuation levels can remain elevated and can further expand, earnings will likely be an increasingly important factor for returns. Interestingly, during periods of EPS acceleration, P/E multiples have typically fallen at a 9.1% rate (Ned Davis Research, The Case for P/E Contraction in 2020, 12/17/19).

**Figure 5: S&P 500 Median Price/Earnings Ratio**




Source: Ned Davis Research, 12/31/2019.

Thank you for your continued support. Feel free to reach out to us if you have any questions.

Respectfully,
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[1]The upside/downside capture ratio measures the ratio of the upside and downside of an investment vs a benchmark.
[2]FAANG is an acronym for the market's five most popular stocks: Facebook, Apple, Amazon, Netflix and Google.

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