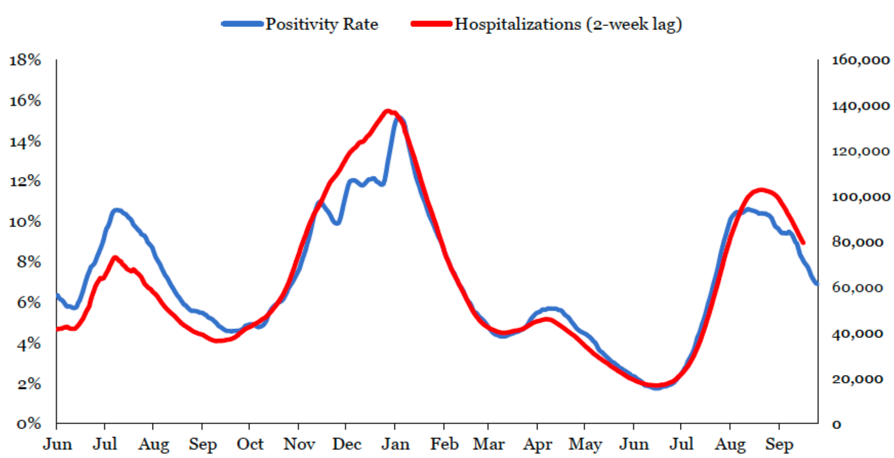
Value Equity
Q3 2021 Commentary

Market Review:

US equities experienced a volatile 3rd quarter but finished roughly flat, as the S&P 500 was up +0.6% while the Russell 1000 Value declined -0.8%. Stocks rallied for much of the quarter, with the S&P 500 posting seven consecutive months of gains through August. However, this was followed by a sharp pullback in September on concerns regarding the Delta variant of Covid-19, continued supply chain disruptions and the impact on global growth, and shifting Fed policy, among other uncertainties. At the beginning of the quarter, the US economy appeared to be on track for a strong reopening in the fall. Although the Delta variant quickly altered that reality, new cases and hospitalizations began to roll over in August, which bodes well for a recovery and reopening as we enter 2022 (Figure 1).

Figure 1: US Covid Trends



Source: Strategas, Quarterly Review in Charts, 10/4/2021.

Financials was the best performing sector, up 2.7%. Several banks and insurers posted strong quarterly earnings and a late quarter jump in interest rates and rotation into Value stocks benefited the sector. Utilities (+1.7%) was the 2nd best performing sector, rebounding slightly after being the worst-performing sector in the first half of the year. Communication Services was the next best performing sector, driven by gains in Media and Entertainment stocks while Telecom lagged. Industrials (-4.3%) was the worst-performing sector, as transportation stocks were hit particularly hard by the Delta variant's impact on travel as well as rising labor costs. Materials (-3.5%) also lagged, as commodities producers were heavily impacted by the drop in commodities prices largely due to concerns surrounding China's economy.

On the policy front, Fed Chair Jerome Powell indicated the central bank may begin tapering its monthly bond buying program by year end. Powell also said the economy has much ground to cover before reaching maximum employment, so despite elevated levels of inflation, interest rate increases are not imminent. On Capitol Hill, the Senate passed a roughly $1 trillion infrastructure package and a separate $3.5 trillion budget proposal. Both policy measures, if passed, will further lift inflation expectations and potentially drive interest rates higher.

Performance Analysis:

The Value Equity strategy composite returned 0.5% (gross of fees) and 0.4% (net of fees) for the third quarter of 2021 versus -0.8% for the Russell 1000 Value and 0.6% for the S&P 500.

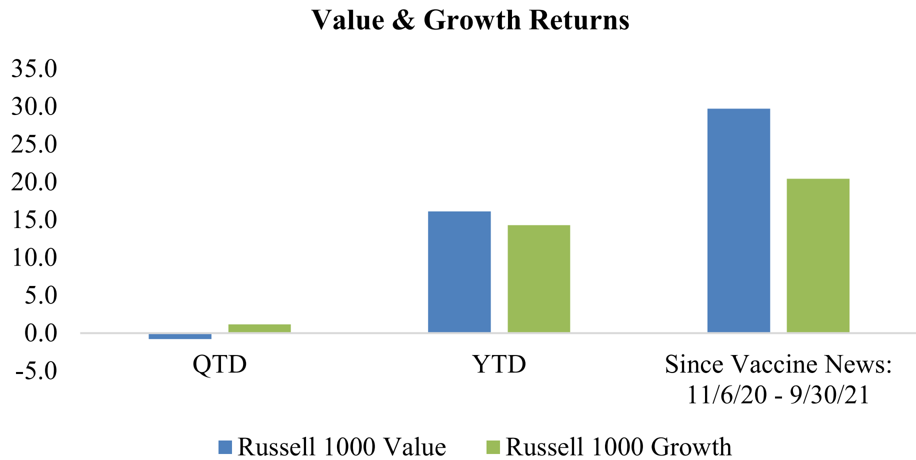
Figure 2: Value Equity Returns vs. Benchmark

September 30, 2021	QTD	YTD	1 Yr	3 Yr	5 Yr	10 Yr
Value Equity (gross)	0.5	14.1	29.8	9.5	12.1	13.5
Value Equity (net)	0.4	13.6	29.2	9.1	11.6	12.9
Russell 1000 Value Index	-0.8	16.1	35.0	10.1	10.9	13.5
S&P 500 Index	0.6	15.9	30.0	16.0	16.9	16.6

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

The strong US equity market returns this year have been broad-based with most style and capitalization indices participating in the rally. Value has outperformed Growth in 2021 and is ahead by more than 9% since Pfizer's successful Covid-19 vaccine trial announcement last Fall (11/6/20) (Figure 3). However, Growth stocks began to regain leadership in the second quarter. This extended into the third quarter, with the Russell 1000 Growth up +1.2%, slightly outperforming the Russell 1000 Value, which declined -0.8%.

Figure 3: Equity Style Indices Performance (YTD)



Source: SCCM Research, Bloomberg, 9/30/2021.

Performance by valuation quintile in the S&P 500 mirrored the spread with the highest Price/Earnings quintile outperforming the lowest Price/Earnings quintile by 140 basis points (Figure 4).

Figure 4: Performance by Valuation Quintile

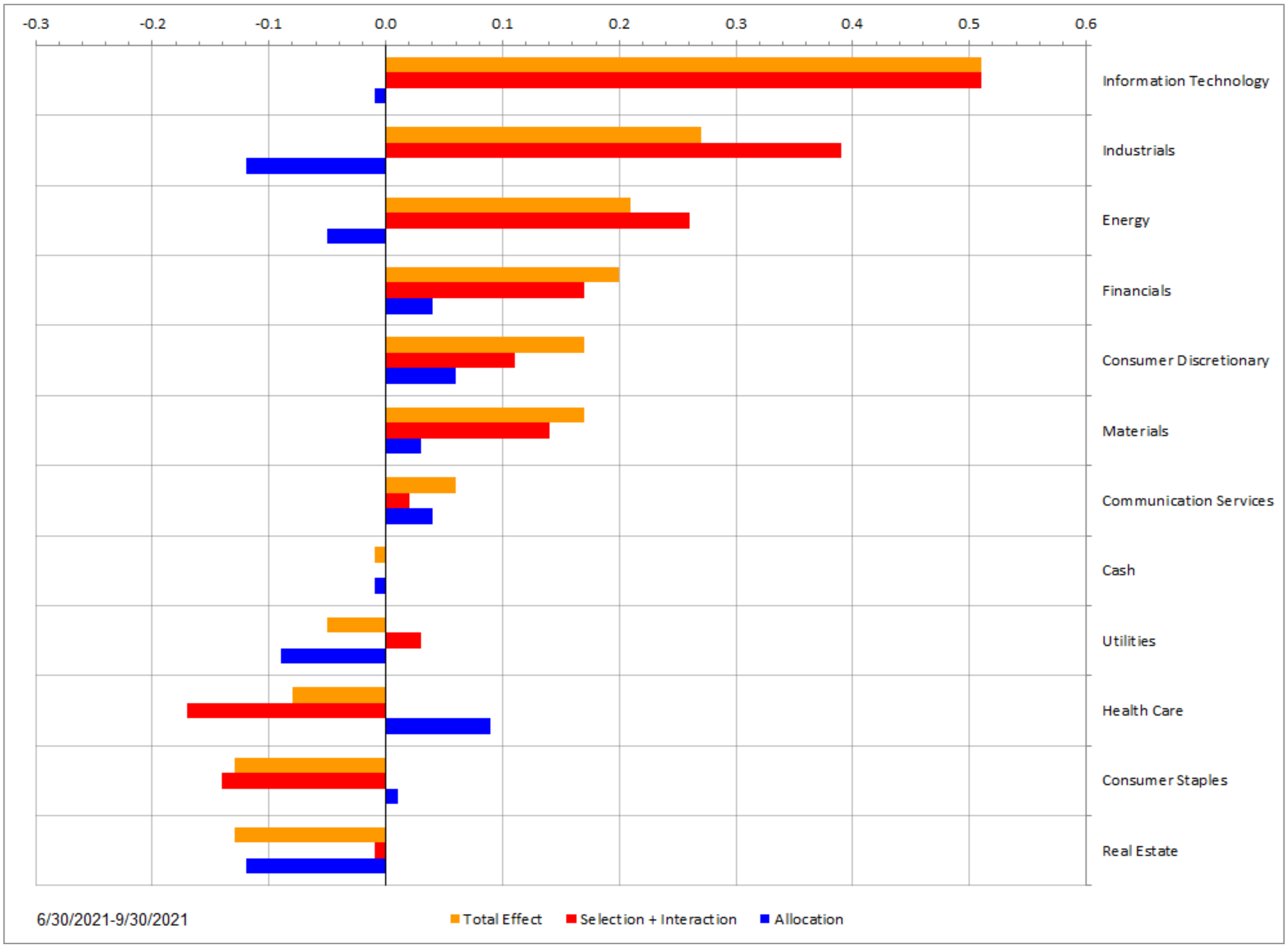
S&P Relative Forward P/E Quintiles		Q3	YTD	Weight in S&P 500	Forward P/E Ratio	Dividend Yield
High P/E	11.94 To 1.54	0.2	7.4	23.4	47	0.4
	1.54 To 1.08	2.7	22.3	32.9	26	0.9
	1.08 To 0.81	-2.8	11.2	15.9	19	1.5
	0.81 To 0.60	-1.8	15.9	16.6	14	2.5
Low P/E	0.60 To -5.30	-1.2	17.8	11.1	10	3.3

Source: BofA Research, US Performance Monitor, 10/4/2021. Forward P/E and Yield as of 9/30/21.
Past performance is no guarantee of future results.

Underneath the seemingly benign performance gap between Value and Growth has been sharp swings in relative performance between the styles, reflecting the hesitancy the market has in embracing one style over the other. The narrative supporting Value stocks centers on the stronger rebound in earnings over that of Growth stocks – the growth rate of earnings of Value stocks over Growth stocks is currently 65% higher than average. In addition, Value stocks remain ~20% under-owned in active funds and trading at significantly cheaper valuations relative to historical levels, creating a meaningful opportunity for Value stock outperformance as mean-reversion narrows these disparities. The strength in Growth stocks has been fueled by the continuation of Central Banks' quantitative easing programs, with the Fed, ECB and BOJ balance sheets expanding by 60%+ in the last 18 months. The flood of liquidity has lifted valuation multiples disproportionally benefiting growth and momentum stocks. Alongside this driver, the rise of the Delta Covid-19 variant and fears of slowing economic growth pushed interest rates lower, driving flows into long-duration growth stocks.

Portfolio Attribution:

Attribution Effects – Value Equity vs. Russell 1000 Value 6/30/2021 – 9/30/2021



Source: SCCM/Bloomberg, 9/30/2021.

Our strong stock selection made ***Information Technology*** the largest contributor to relative performance for the quarter. The sector underperformed as the increase in interest rates led to a sell-off in long duration Growth stocks. Oracle (+12.3%) reported mixed earnings, but still managed to beat expectations on margins and EPS, encouraging investors with its growth in cloud that now represents 25% of its total revenue. Microsoft (+4.3%) posted strong earnings driven by 51% year-over-year revenue growth for its cloud computing platform, Azure. Microsoft also reported robust demand for its Windows operating system, and launched Windows 11, the first new version of that franchise in nearly six years. Cisco (+3.4%) held an Investor Day in September, at which it reiterated its strategy of growing software subscriptions and recurring revenue, particularly in areas of hybrid work technology and cybersecurity, which should lead to steady dividend growth. Our strong stock selection and underweight allocation within ***Energy*** benefited performance. The sector underperformed as it entered correction mode after being the top performer in the first half of the year, where it made up much of the losses experienced from COVID-19. ConocoPhillips (+12.2%) benefited from higher oil prices, driven by strong demand for both gasoline and diesel/distillate due to strength in consumer and shipping demand respectively. During the quarter, ConocoPhillips announced a $9.5B acquisition of acreage in the Permian Basin from Royal Dutch Shell. Our strong stock selection and overweight allocation within ***Financials*** contributed to relative performance. Chubb (+9.6%) reported strong 2nd quarter results with operating earnings 20% above consensus estimates, driven by strong growth in net written premiums and net investment income. The property and casualty insurance pricing environment remains very strong, with rates up double-digit percentages year-over-year. Morgan Stanley (+6.9%), JP Morgan (+5.9%), and Bank of America (+3.5%) all outperformed as several banks posted strong quarterly earnings and a late quarter jump in interest rates and rotation into Value stocks benefited the group. Our strong stock selection within ***Industrials*** contributed to relative performance. Canadian National Railway (+11.4%) has received increased interest from investors since TCI Fund Management filed an activist stake in the company in August, and has since unveiled a new, aggressive financial and operating plan that focuses on improving its operating ratio and increasing share buybacks. General Dynamics (+4.8%) is experiencing a robust recovery in its Gulfstream segment as business jet activity has steadily recovered from the Covid-induced lows; furthermore, despite concerns surrounding Defense budgets, the company is seeing strong demand for its Abrams tankers and Virginia and Columbia classes of submarines. Siemens (+3.1%) is seeing a broad demand recovery through all its segments, prompting management to raise full-year earnings guidance. Its digital industries division saw 14% organic revenue growth, smart infrastructure 14%, and Siemens Healthineers 25% growth, all largely due to the reopening of economies. Raytheon (+1.4%) benefited from a continued recovery in the airline industry. The company's Pratt & Whitney and Collins Aerospace subsidiaries were boosted from an increase in total flights, which has improved from early 2021.

Our stock selection within ***Consumer Staples*** detracted from relative performance. The sector lagged as many packaged food and spirits companies underperformed. Unilever (-6.5%) shares declined partly on concerns of commodity input cost inflation; yet the company reported strong underlying sales growth, particularly in faster-growing emerging markets. Mondelez (-6.3%), despite reporting strong quarterly earnings driven by price and volume fueled sales growth, declined on fear of upcoming pricing pressure. Management noted its ability to navigate ingredient inflation through hedges but warned of upcoming pressure that could impact gross margin as freight contracts roll over. Our underweight allocation in ***Real Estate*** detracted from relative performance. As the economic recovery gained momentum in the second quarter, real estate outperformed as the more cyclical sectors benefited from the reopening. The third quarter was more muted for the sector, with September erasing gains posted earlier in the quarter on fears of the Delta variant and the Fed tapering its support of the economy. Our underweight allocation in ***Utilities*** also detracted from relative performance. Though the sector declined sharply in September, Utilities still outperformed the market.

Portfolio Changes:

Purchases / Additions

American Express (AXP) is a global integrated payments company that offers charge and credit cards to consumers and businesses and operates a highly profitable merchant payment network. In addition to payment products, the company's commercial business offers expense management tools, consulting services and business loans. American Express benefits from a strong base of affluent customers with a higher-than-average spending rate, which has enabled the company to form valuable partnerships with vendors looking to gain access to those cardholders. With approximately 30% of total billings derived from travel and entertainment spending, we believe that American Express stands to benefit from a normalization of economic activity and a resumption of normal travel patterns. The company has a strong balance sheet, with sufficient capital to absorb any potential rise in impairments from historically low levels. Shares of the company trade at 18.5 times next year's earnings.

Packaging Corporation of America (PKG) is one of the largest containerboard manufacturers in the United States, producing more than 4.3 million tons of containerboard annually. The company's main operations include Packaging and Paper, which accounts for ~90% and ~10% of sales, respectively. PKG's focus on regional and local customers has enabled it to post industry leading margins (12.4% EBIT margin in 2020). With nearly 100% of the company's containerboard capacity converted at its box plants, PKG is more vertically integrated than its peers. We believe that Packing Corp will continue to deliver on robust demand in the packaging segment, driven by e-commerce and the rising requirement for packaging of different food types. Additionally, the company has been able to successfully implement price hikes to offset the impact of high operating costs, freight expenses and supply chain issues. Packaging Corp maintains a quality franchise and differentiated business model, with a strong balance sheet that provides flexibility for M&A, stock buybacks, and dividends. Shares of the company trade at 14.8 times next year's earnings.

Sales / Reductions

Newmont Mining (NEM) was sold in the quarter. Gold prices have been range-bound in the past year as the market considers the Fed tapering its bond buying program, the potential for higher sustained inflation and other alternatives to fiat currencies. These factors are headwinds to gold as an investment asset. While Newmont has improved execution it is already reflected in its valuation with the stock trading at a premium to peers, at 16x forward earnings and 2.0x book value.

Market Outlook:

After a historic rally from the March 2020 lows, equity indices paused and consolidated gains as the market digested the impact of decelerating US growth, the surge of the Delta Covid-19 variant, new financial and regulatory concerns in China and Washington DC funding uncertainty along with heightened inflation and supply chain disruptions. Despite these issues, robust financial market liquidity and easy monetary policy conditions continued to provide downside support to markets.

Broadly, Technology benefited from the heightened concerns and lower rates while several cyclical sectors, Materials and Industrials, with greater ties to the economy took the brunt of market fears. While the correction from recent high price levels has been modest, market internals deteriorated as weakness has spread to a growing number of stocks - the average stock in the S&P has declined 12% from its 52-week high. The divergence in performance between Covid beneficiaries (Growth) and Recovery beneficiaries (Value) has widened considerably to near Q1 levels (Figure 5). As a result, the valuation spread between Covid beneficiaries and Recovery beneficiaries is back near record wide levels (Figure 6).

Figure 5: Covid Beneficiaries vs Recovery Basket Performance

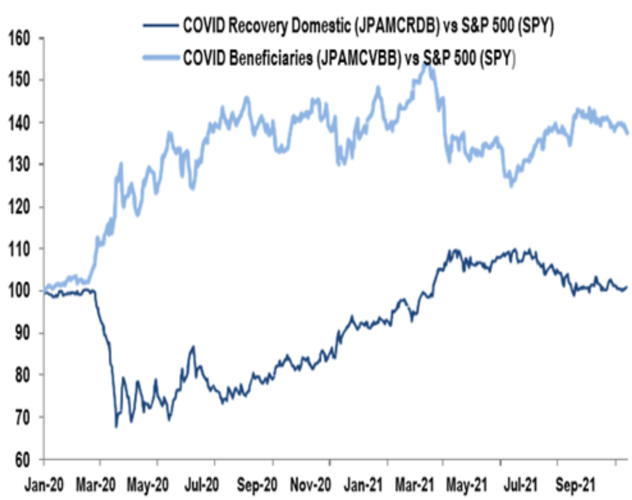
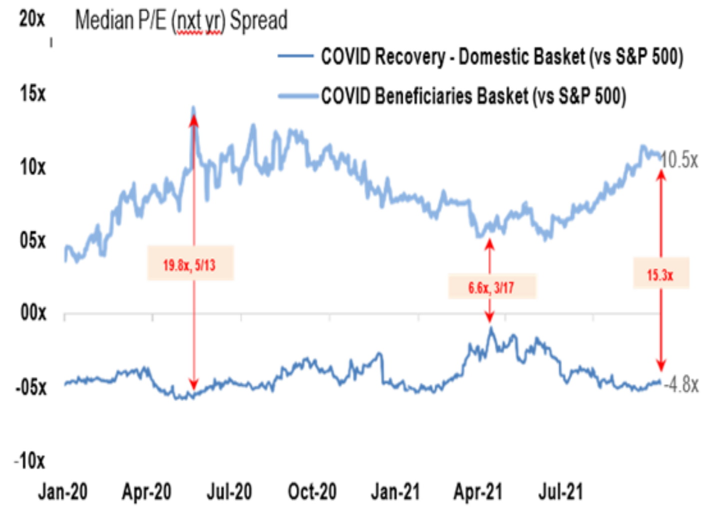


Figure 6: Valuation Spreads Between Covid Beneficiaries and Recovery Basket



Source: JPMorgan, US Equity Strategy, 9/15/2021.

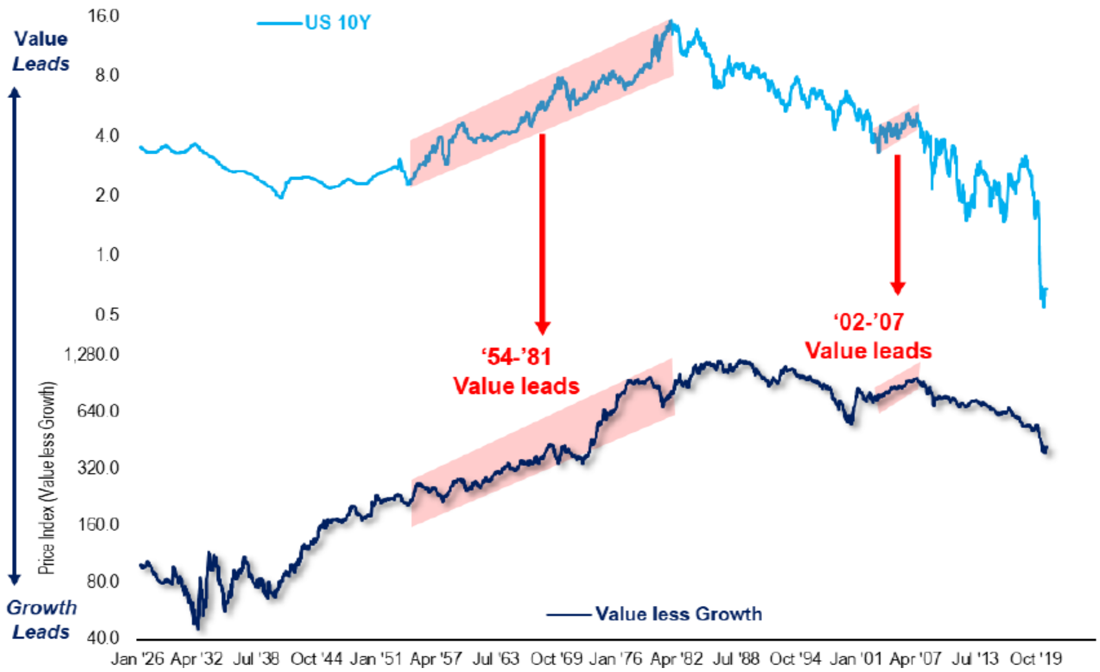
As these recent macro concerns abate, Value stocks should see a lift from an underweight positioning and attractive valuations, especially as these wide valuation disparities narrow. Economic headwinds are now turning to tailwinds, potentially ushering in sustained global growth. The rise of the Delta variant, hampering full reopening, appears to have peaked and as the pandemic lingers on, world populations will increasingly be immunized via vaccinations or antibodies eventually bringing more permanency to the recovery. The deceleration in US economic data, in part caused by rising Covid cases, has set the proverbial "bar" lower for positive surprises. The Citigroup Economic Surprise Index is currently reading levels near the bottom 10% of historical levels potentially propelling equities higher on stabilizing headlines going forward (Figure 7). Lastly, while supply chain disruptions may linger, negatively impacting pockets of companies, over time operations should normalize thus serving to prolong the economic cycle.

Figure 7: Economic Surprise Index

Source: Strategas, 9/30/2021.

The direction of interest rates, which had steadily declined due to economic concerns, institutional flows into Treasuries and record short positioning reversing, continues to drive equity style factor performance. Not to be ignored, algorithmic trading, which accounts for over 60% of US equity trading volume, now drives an estimated 50% of US Treasuries trading volume. Falling interest rates, driving flows into long-duration Growth assets, began to reverse at the end of Q3. Improving economic data, declining Covid cases and higher energy prices are but a few catalysts that could drive rates higher, bringing the herd-like momentum traders to reverse bullish Treasury positions. Importantly, value stocks have historically outperformed Growth stocks when long-term rates rise (Figure 8).

Figure 8: US 10-Year Yields and Value vs. Growth Relative Returns



Source: Fundstrat/Bloomberg, 9/29/2021.

In the current market environment, we believe investors should be more mindful of risk, not less. We believe the most effective way to manage risk is to adhere to an investment discipline focused on valuation and quality, which is the core tenet of our investment approach. Relative to fixed income and equity benchmarks, we feel the valuation of our portfolio remains attractive. The strategy trades at 16.2x 2021 earnings versus 21.9x for the Russell 1000 Value and 25.2x for the S&P 500.

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

Best Regards,
Schafer Cullen Capital Management, Inc.

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