Value Equity
Q1 2022 Commentary

Market Review:

The 1st quarter of 2022 was tumultuous for US equities, marked by global geopolitical tension, accelerating inflation, ongoing supply chain disruptions, rising interest rates, and lingering challenges from the Covid pandemic. The S&P 500 declined 4.6%, while the Russell 1000 Value was down 0.7%. The indices were down significantly more during quarter; at its lowest point the S&P 500 was down approximately 13% before rallying in the final weeks of March.

In late February, Russia launched a military attack in Ukraine following months of threats and failed diplomatic attempts at de-escalation. Beyond the devasting human toll it has taken on Ukraine, the invasion raised geopolitical tensions, resulting in several rounds of economic sanctions against Russia, price shocks across commodity complexes, and further supply chain complications. The extreme price moves in oil and gas markets, precious metals such as nickel, and soft commodities such as wheat, contributed significantly to inflation, resulting in higher costs for consumers and corporations. The normalization of prices will depend on how quickly the Ukraine invasion is resolved, production responses to supply shocks, and how quickly alternatives can be deployed.

The Consumer Price Index (CPI) reached a 7.4% annual rate in February, a four-decade high.[1] The Fed's preferred measure of inflation, the core personal consumption expenditures (PCE) index, rose 5.4% in February, the sharpest 12-month increase since 1983.[2] In response, the Federal Reserve raised the federal funds rate by 25 basis points, ending the accommodative rate policy begun at the onset of the Covid pandemic in 2020. Chairman Jerome Powell indicated the Fed is prepared to raise rates by 50 basis points at a time to combat inflation, which he described as much too high. Long-term bond yields also appreciated, with the 10-year Treasury yield increasing to 2.4% from 1.5% at the start of the year. The rate increases have already resulted in higher borrowing costs for consumers, including mortgage rates at their highest levels since 2018.

Higher multiple Growth stocks significantly underperformed lower multiple Value stocks, largely due to the prospect of rising interest rates and slowing economic growth. In the quarter, the Russell 1000 Growth returned -9.0% while the Russell 1000 Value returned -0.7%. Energy (+39.0%) was by far the top performing sector, as the WTI oil benchmark increased 30%, ending the quarter at $100 per barrel after reaching $123 in early March. Prices spiked following the imposition of sanctions against Russia, which is the world's third-largest oil producer. Utilities (+4.8%) and Consumer Staples (-1.0%) were the next best performing sectors, driven by a flight to safety and higher-yielding areas of the market. Communication Services (-11.9%) was the worst performing sector, hit by a substantial decline in the shares of media and entertainment companies. Consumer Discretionary (-9.0%) was the second worst performer, due in part to an anticipated pullback in demand for consumer goods. Information Technology (-8.4%) also lagged as high multiple stocks saw significant multiple contraction.

[1] https://www.bls.gov/news.release/cpi.nr0.htm
[2] https://www.bea.gov/news/2022/personal-income-and-outlays-february-2022

Performance Analysis:

The Value Equity strategy composite returned -1.0% (gross of fees) and -1.1% (net of fees) for the first quarter of 2022 versus -0.7% for the Russell 1000 Value and -4.6% for the S&P 500.

Figure 1: Value Equity Returns vs. Benchmark

March 31, 2022	QTD	YTD	1 Yr	3 Yr	5 Yr	10 Yr
Value Equity (gross)	-1.0	-1.0	10.0	11.2	11.1	11.7
Value Equity (net)	-1.1	-1.1	9.4	10.7	10.6	11.1
Russell 1000 Value Index	-0.7	-0.7	11.7	13.0	10.3	11.7
S&P 500 Index	-4.6	-4.6	15.7	18.9	16.0	14.7

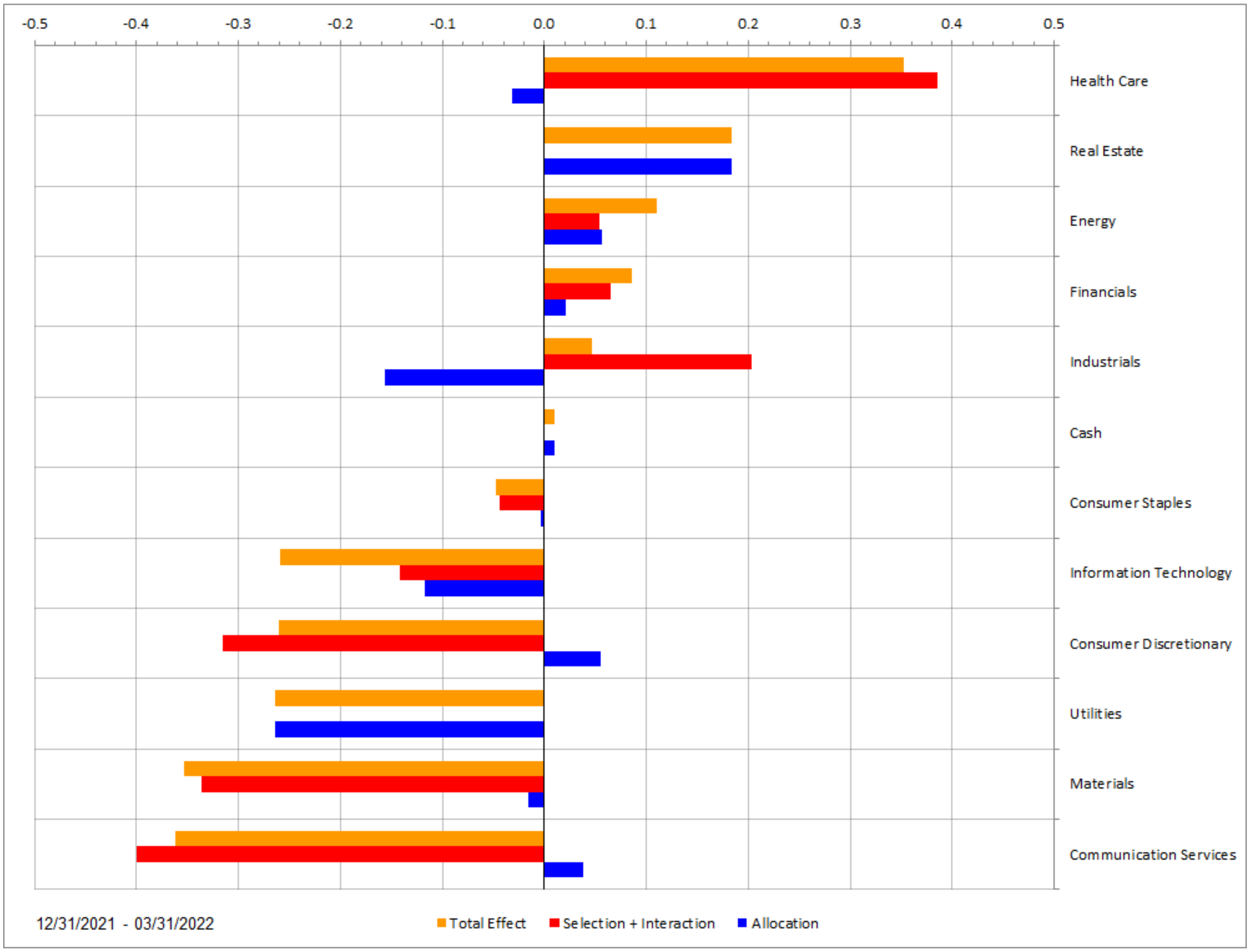
Performance for periods greater than 1 year is annualized. ***Past performance is no guarantee of future results***

The 1st quarter of 2022 marked the first negative quarter of returns since Q1 2020 as the market digested a number of headwinds and the Fed began to tighten monetary policy from the flood of liquidity initiated at the onset of the pandemic. Decades-high level inflation readings were met with a firmly hawkish Fed stance. The downturn in pockets of the most speculative corners of the market, first experienced in mid-2021, spread to other "long duration" Growth stocks as relentless inflation and higher rates became a key market concern. The initial concerns surrounding the impact of Russia's invasion in Ukraine led to further market weakness, but equities staged a strong mid-March relief rally to end the quarter. On a relative basis, it was the strongest start for Value over Growth in decades with the Russell 1000 Value (-0.7% total return) outperforming the Russell 1000 Growth (-9.0% total return) by 830 basis points in the quarter.

The shift towards Defensive equities in late 2021 continued into 2022 as mounting macro concerns drove a rotation into high dividend and low beta sectors. Energy, the highest yielding sector in the market, was the strongest performer while Utilities also outperformed in the quarter. However, nuances began to emerge as Consumer Staples, a classic Defensive sector, underperformed in March driven by the impact of spiking oil prices likely pressuring top-line growth and margins. The highest dividend yielding quintile of stocks outperformed the lowest yielding quintile by 1,710 basis points in the quarter. In conjunction, low beta outperformed high beta stocks in the quarter.

Portfolio Attribution:

Attribution Effects – Value Equity vs. Russell 1000 Value 12/31/2021-3/31/2022



Source: SCCM/Bloomberg, 3/31/2022.

Our strong stock selection made ***Healthcare*** the largest contributor to performance. Bristol-Meyers Squibb (+19.0%) announced strong fourth quarter earnings for 2021, with revenues largely in-line and EPS slightly above consensus expectations. Opdivo, the company's blockbuster immunotherapy oncology drug, saw strong sales growth and continues to see label expansion into indications of lung cancer, renal cancer, and gastric cancer. Merck (+8.0%) posted solid quarterly results, with strong sales growth for its leading immuno-oncology drug Keytruda, as well as its HPV vaccine Gardasil. Medtronic (+7.9%) outperformed as management said they are seeing a rebound in elective surgical procedures following a delay brought on by the Omicron variant of Covid. Our underweight allocation made ***Real Estate*** the next largest contributor to performance. Real Estate underperformed during the quarter, as the potential for rising interest rates weighed on the sector. Our overweight allocation and strong stock selection within ***Energy*** contributed to relative performance. Energy was by far the top performing sector, as global supply and demand dynamics remained favorable, leading to higher oil and gas prices. Prices spiked following the imposition of sanctions against Russia, which is the world's third-largest oil producer. Chevron (+40.2%) and ConocoPhillips (+39.6%) both reported strong cash flows enabling them to strengthen their balance sheets, cover capital expenditures, and pay their dividends. Our overweight allocation and stock selection within ***Financials*** contributed to relative performance. While many of the banks declined on global economic growth concerns related to inflation and the Ukraine crisis, other financial service companies, including Allstate (+18.5%), American Express (+11.1%), and Chubb (+11.1%) outperformed on the prospect of rising interest rates.

Stock selection detracted from relative performance in ***Communication Services.*** Disney (-11.5%) declined despite reporting strong quarterly results, with a notable 11.8 million net customer adds for Disney+. Comcast (-6.5%) declined on concerns over the pace of broadband net adds and account growth. Our underweight allocation and stock selection within ***Materials*** detracted from relative performance. Axalta (-25.8%) declined after the company adjusted its full-year guidance below the range it had issued in October of last year. Management noted higher than anticipated raw material inflation, primarily on the back of higher oil prices, as well as limited availability of certain materials impacted the full-year outlook. Stock selection within ***Consumer Discretionary*** detracted from relative performance. Shares of Lowe's (-21.5%) declined after posting outsized gains in 2020 and 2021. Home improvement trends have been particularly positive since the onset of Covid, with a strong housing market and stimulus funds fueling sales. While concerns have grown over how long these trends can continue, Lowe's is making continued gains in the professional contractor sales channel and increasing margins through improved operational efficiency. Finally, our underweight allocation within ***Utilities*** detracted from relative performance. Utilities outperformed, driven by a flight to safety and higher-yielding sectors of the market.

Portfolio Changes:

Purchases / Additions

Applied Materials (AMAT) was purchased in the quarter. Applied Materials is a supplier of semiconductor and semiconductor-related fabrication equipment, providing manufacturing technology solutions to the global semiconductor, flat panel display, and other industries. The company is the largest supplier of semiconductor manufacturing equipment, supported by a broad product portfolio, strong technical capabilities, service and support. AMAT further benefits from solid economies of scale and a concentrated industry structure with rational competitive behavior, whereby over two thirds of wafer fabrication equipment sales are derived from five companies that have mostly specialized in different parts of the fabrication process – for AMAT, the majority of sales come from deposition, material removal and cleaning equipment. Despite the popular perception that the semiconductor equipment industry is hyper-cyclical, we believe that structural changes, including the consolidation in the semiconductor industry, the proliferation of semiconductor content across a broader set of end markets and the growing importance of localized supply chains, have paved the way for longer cycles with less severe downturns. Moreover, nearly one third of revenue is derived from maintenance and upgrade services, which is a far less cyclical and more annuitized revenue stream. Lastly, given the rising capital intensity and complexity of manufacturing at the leading edge, we believe that AMAT's scale and established customer relationships present a competitive advantage versus peers. Shares of the company are valued at 14.8 times forward earnings, nearly a 30% discount to the average multiple of the company's closest peers (Lam Research, KLA Corp, AMSL and Tokyo Electron).

Cigna (CI) was purchased in the strategy during the quarter. Cigna is a US managed care company which offers life, accident, disability, supplemental, Medicare and dental insurance products and services. Over the past 10 years, management has delivered 10%+ EPS growth, driven by new membership growth and improving its medical loss ratio (MLR) through scale, technology and cost management. The company has the opportunity to grow its Medicare Advantage (MA) program business by 10%+ by leveraging its existing federal and medical supplemental relationships. While the Covid-19 pandemic has created more volatility around medical costs, going forward the company believes it can improve margins as it reprices part of its business and benefits from a new wave of biosimilars in the prescription drug business. Management expects to use excess capital to make smaller, bolt-on acquisitions and buy back stock. The stock trades at an attractive valuation: 10x 2022 EPS with a 1.8% dividend yield.

Verizon Communications (VZ) was purchased in the quarter. The telecom company serves roughly 91 million postpaid and 4 million prepaid phone customers and connects another 25 million data devices, such as tablets, making it the largest US wireless carrier. Its fixed-line operations include local networks in the Northeast, reaching approximately 25 million homes and businesses, and nationwide enterprise services. In the wireless business the firm has a roughly 40% market share, about a third greater than either AT&T or T-Mobile, and its scale advantages allow it to generate the highest margins and returns on capital in the industry. The 2020 merger of T-Mobile and Sprint has improved the industry's competitive structure, leaving three players with less incentive to price irrationally. Verizon has undertaken a major fiber expansion project in recent years to extend its Fios offering to more locations throughout the US. Fiber expansion supports the company's wireless networks while also serving new markets such as fixed-wireless broadband and edge computing markets. Verizon has increased its dividend for 15 consecutive years, and is currently priced at 9.7x 2022 earnings with a dividend yield of 4.9%.

Sales / Reductions

Microsoft (MSFT) was sold in the strategy during the quarter. The stock was originally purchased in the strategy in April 2009. The company has built a formidable cloud business and broad-based portfolio of subscription software offerings over the years. In addition, the company's gaming hardware business is expected to be bolstered by recent gaming content acquisitions. In turn, the stock has re-rated significantly and was sold on valuation, now trading at 32x 2022 EPS with a 0.9% dividend yield.

Novartis (NVS) was sold out of the strategy in the quarter. Novartis is a Swiss pharmaceutical company, developing branded and generic drugs across key therapeutic areas, including oncology, neuroscience, immunology, respiratory and cardiology. Following the sale of its ophthalmology business, Alcon, in 2019, Novartis telegraphed its intention to divest of its generics unit, Sandoz, which has placed heightened scrutiny on the company's pipeline of innovative medicines, for which we anticipate several important readouts in the next couple of years. While the stock has performed well, we decided to reallocate capital within the Health Care sector into higher conviction, less expensive alternatives, which triggered the sale of our Novartis position and the purchase of shares in Cigna (CI).

Market Outlook:

After an exceptionally strong three-year return for US equities through 2021, macroeconomic headwinds and geopolitical shocks fueled greater market volatility and a weak start for both bonds and equities in the first quarter of 2022. Decades-high broad-based inflation levels driven initially by supply chain constraints and subsequently economic re-opening spending (Figure 2) are forcing the Fed to normalize monetary policy through a series of planned interest rate hikes and the eventual implementation of its balance sheet run-off. The Russian invasion of Ukraine has created a tragic humanitarian crisis across the region and is further propelling inflation. Despite the current inflation and rate angst, longer-term inflation expectations remain within recent historical levels between 2-3% (Figure 3). The market believes inflation will normalize naturally over time -or- the Fed can successfully engineer a soft landing. Inflation readings and expectations will be key factors in how aggressive the Fed intends to follow-through with its intended policy actions; if inflation does not subside in the near-term, a faster tightening cycle restricting financial conditions and lowering liquidity will be downside risks to markets. Another factor likely to influence market performance is the US Presidential cycle - 2022 is a midterm election year, historically the weakest in the four-year cycle and exhibiting above-average volatility as policy uncertainty is elevated.

Figure 2: Inflation Waves: "Episodic" Drivers

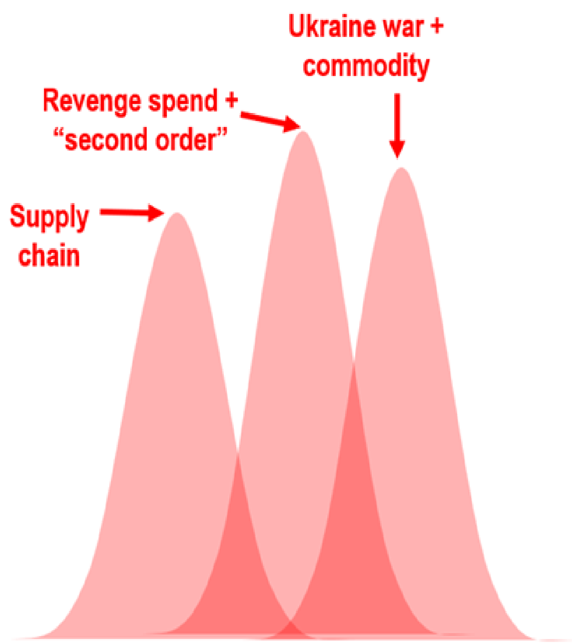
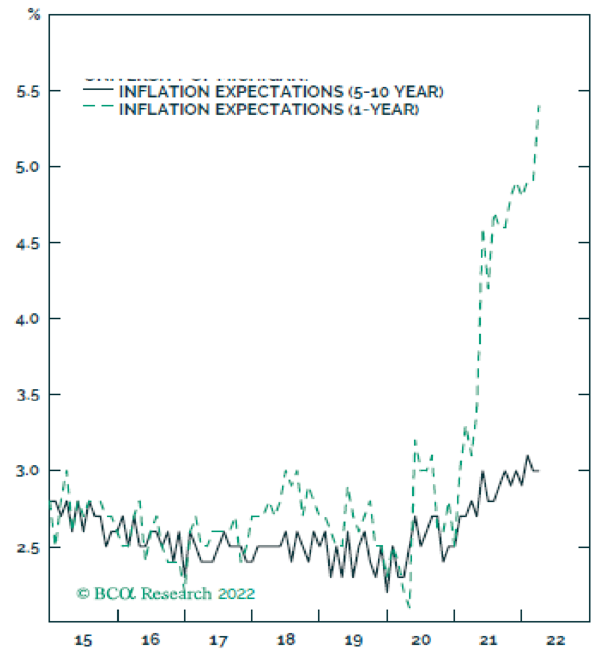


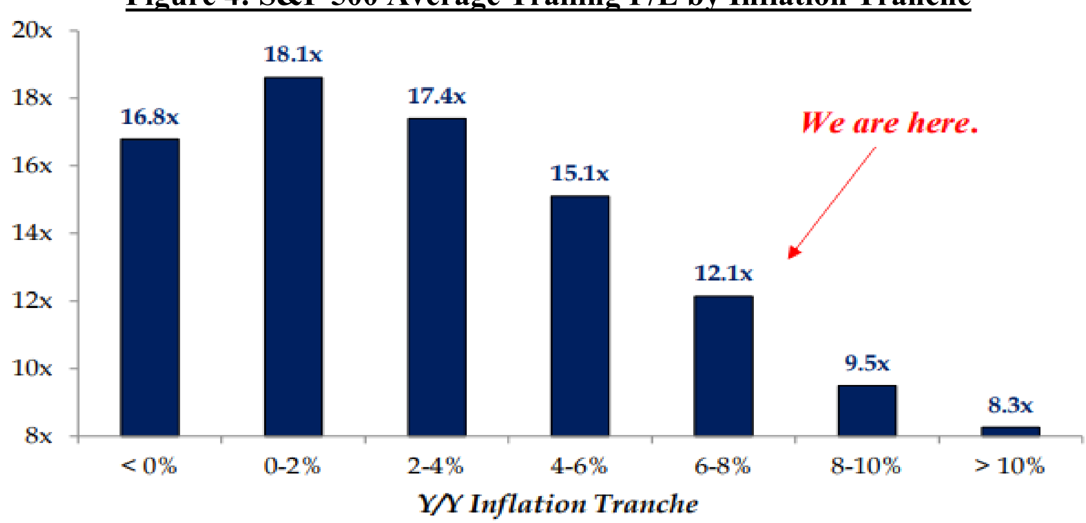
Figure 3: Inflation Expectations



Source: *Figure 3*: Fundstrat Strategy, 03/29/2022. *Figure 4*: BCA Research Sector Chart Pack Commentary, 4/4/2022.

Despite these numerous headwinds, equity markets appear to have digested the negative news flow and bounced back strongly from recent lows. The intra-quarter 13% drawdown in the S&P 500 from its peak into correction territory was worse at the individual stock level. The average US stock reached bear market or recession-levels by mid-March - the average stock drawdown from its 52-week high was -21% for the S&P 500, -40% for the Russell 2000 and -47% for the Nasdaq Composite. These periods of broad-based price consolidation can act to productively shake out market excesses and correct elevated valuation multiples. While valuations on US equities have declined, aided by strong earnings growth, the current S&P 500 forward P/E stands at 21.8x 2022 earnings, an elevated level especially given the rise in inflation (Figure 4).

Figure 4: S&P 500 Average Trailing P/E by Inflation Tranche



Source: Strategas, Quarterly Review in Charts, 04/04/2022.

The normalization of US monetary policy and the Fed's resolution to combat inflation is a momentous change that is beginning to disrupt trends that have been in place since 2009 and the start of the Quantitative Easing (QE) era. Importantly, Q1 reflected several large shifts:

- It was the first time since 2009 that bond yields have gone up during a market correction and failed to act as a hedge for stocks in market sell-offs. Notably, during the inflation years (1965-1982), stocks and bonds regularly declined together.
- Tech stocks (QQQ) did not act defensively as in the past.
- "FANG" was not treated as an asset class. There were wide performance divergences in large-cap technology stocks.
- Oil hit its highest level since 2014 and stocks are underperforming commodities.

Source: Strategas, Technical and Macro Research, 2/7/2022.

These indicate a transition where new long-term opportunities emerge as the market shifts focus away from past "winners" into areas that have lagged for the past decade. Given the incredibly strong equity returns generated this past decade combined with near record absolute valuation levels, forward market returns are expected to be muted, and 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. The current valuation of our portfolio remains attractive - the strategy trades at 14.4x 2022 earnings versus 20.6x for the Russell 1000 Value and 21.8x for the S&P 500 (Q1).

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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