SCHAFER | CULLEN
CAPITAL MANAGEMENT

Enhanced Equity Income
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

Income and Options Summary:

The Enhanced Equity Income strategy finished the first quarter on track to pay out 7.3% income for the year, annualizing 3.7% from dividend receipts and 3.6% from call options premiums. Eleven of the 34 companies held at quarter end increased dividends during the period, at an average rate of 8.8%.

In reaction to economic and geopolitical events, the continuation of the shift of investor preference by sector changed the options environment. Initial equity market corrections created a broader array of attractive call options which faded on subsequent bounces. While the Energy and Materials sectors offered good premiums throughout, Financials bids faded into inflation, rate-hike, and recessionary concerns. As the quarter ended, interest in defensives and bond proxies came into view, bolstering some Consumer Staples names, in addition to Utilities and Health Care.

Against this backdrop, EEI recorded favorable options premium characteristics, averaging a dividend-equivalent return of 18% per write from 41 covered positions. The assignment rate continued to fall through March; 86 of 327 contracts written in the representative account were assigned, yielding a 26% rate. During the quarter, calls were written at an average of 4% out-of-the-money.

Performance Analysis:

Buoyed by strong returns from its allocations to the Energy, Materials and Health Care sectors and underweight allocations to Information Technology, the Enhanced Equity Income strategy recorded a positive return during the first quarter. The strategy generally benefitted from investor preference for value names with quality earnings and free-cash-flow dividends, and from bond investors who began to turn heavily from fixed income to equity income investments.

The strategy returned 2.7% (net), outperforming its primary benchmark, the S&P 500 Buy/Write Index (BXM), which gained 0.8% and its secondary benchmark, the SPDR Barclays High Yield Bond ETF (JNK), which fell -4.7%. At quarter-end, EEI's representative account had nearly tripled the total return of JNK since inception.

Figure 1: Enhanced Equity Income Returns vs. Benchmark

March 31, 2022	QTD	YTD	1 Yr	3 Yr	5 Yr	Since Incept*
SCCM Enhanced Equity Composite (gross)	**3.0**	**3.0**	**13.5**	**11.8**	**9.4**	**10.1**
SCCM Enhanced Equity Composite (net)	**2.7**	**2.7**	**12.2**	**10.5**	**8.2**	**8.9**
S&P 500 Buy-Write Index (BXM)	0.8	0.8	14.9	8.6	7.2	7.3
SPDR Barclays High Yield Bond ETF (JNK)	-4.7	-4.7	-1.2	3.5	3.8	4.7
Russell 1000 Value Index	-0.7	-0.7	11.7	13.0	10.3	11.4

12/31/2010. 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.

Figure 2: Performance by Dividend Quintile

S&P Dividend Yield Quintiles		Q1	BofA Adj Beta	Weight in S&P 500	Forward P/E Ratio	Dividend Yield
Low Yield	0.00 To 0.00	-8.8	1.21	26.3	25	0.0
↓	0.00 To 0.97	-6.1	1.06	25.1	28	0.6
	0.97 To 1.83	-7.8	1.03	14.9	18	1.4
	1.83 To 2.78	-4.5	0.93	18.7	17	2.3
High Yield	2.78 To 8.87	8.3	0.88	15.1	13	3.7

Source: BofA Research, US Performance Monitor, 4/1/2022.

Portfolio Changes:

Purchases

We initiated a position in **Siemens (SIEGY)**, a German-based industrial conglomerate specializing in electrical engineering and electronics, supplying systems and services for power generation, transmission and distribution, building operations, factory automation, rail transportation and healthcare equipment. The company is a global market share leader in most of its end markets, with one of the largest installed base of industrial equipment worldwide. Siemens is well positioned to capitalize on long-term growth opportunities in 1) Electrification – selling products designed to generate, transmit, distribute and utilize electrical energy with high efficiency and in alternative energy, 2) Automation – maintain leading market share position in automating customer processes, and 3) Digitalization – exploiting opportunities offered by digitalization to add value to customers through software solutions and intelligent data analytics. The company's high emerging market exposure, at nearly one third of its revenues, will further drive growth as its equipment and services support the urbanization and massive infrastructure build-outs in those regions over the coming decades. As a consequence of several restructuring initiatives over the past few years, including the spin-off of its Energy and Healthcare divisions, we believe that the value of the core Siemens business will be more clearly reflected in the stock's valuation going forward, given that the remaining businesses carry less cyclical risk and tend to be deeply integrated into customer operations, customized for specific applications and are thus less likely to be swapped out for competing products. Shares of the company are valued at 14.1 times forward earnings and offer a 3.4% dividend yield.

Sales

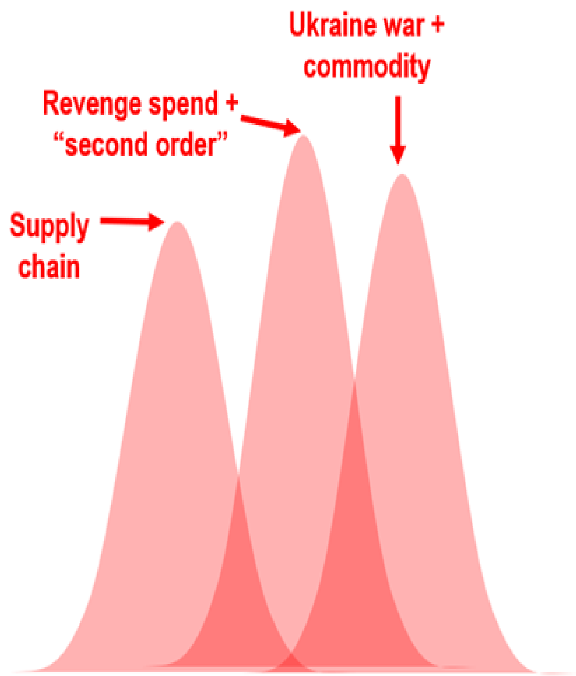
ConocoPhillips (COP) was sold out of the strategy in the quarter. Energy stocks significantly outperformed in the quarter, as global supply and demand dynamics remained favorable, leading to higher oil and gas prices. Prices spiked following the imposition of sanctions against Russia, which is the world's third-largest oil producer. ConocoPhillips has been managed well, in our view, across the recent five- to seven-year cycle in oil prices. The company has shed its higher-cost and less productive assets, favoring long-tailed basins with smoother decline rates and higher return levels. The company's acquisition of Concho Resources in late 2020 proved to be remarkably well-timed, and Concho's contiguous acreage in the Permian Basin complemented ConocoPhillips' significant presence in the oil field. ConocoPhillips' shares have roughly doubled in price over the past year, and have more than tripled since Energy stocks began rallying in November 2020.

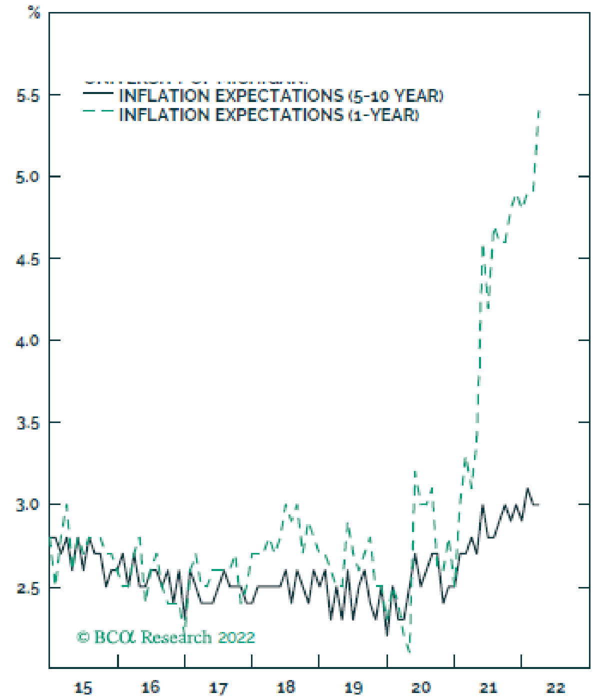
3M (MMM) was sold during the quarter. While the company has a relatively resilient set of global businesses spanning healthcare, industrial, consumer and electrical end markets that are supported by above-average innovation, several factors drove the sale of the stock. First, significantly higher commodity costs including oil-derivatives and chemicals are pressuring margins while higher pricing may not enable the company to fully recover cost inflation. The uncertain liabilities related to its PFAS (toxic chemical) and military earplugs liabilities have weighed on the stock and remain a medium-term overhang. Lastly, its healthcare and consumer end markets will likely experience declines and face headwinds as Covid-related product usage including respirators and face masks normalize over time.

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 3) 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 4). 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 3: Inflation Waves: "Episodic" Drivers **Figure 4: Inflation Expectations**

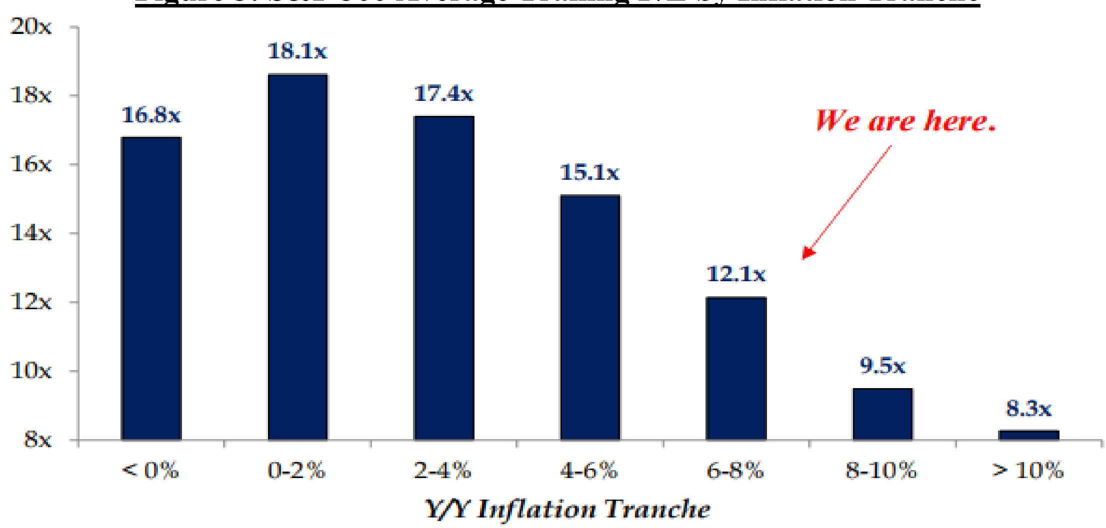




Source: *Figure 3*: Fundstrat Strategy, 03/29/2022. *Figure 4*: BCA Research Sector Chart Pack Commentary, 4/4/2022.

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 5).

Figure 5: 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:

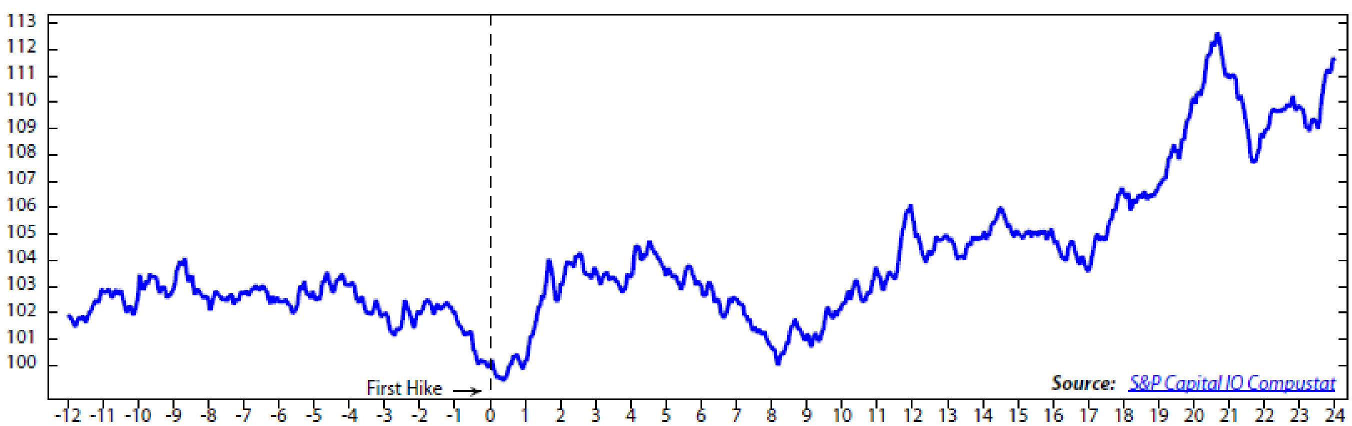
- It was the first time since 2009 that bond yields have gone up during a market correction and failed to act as a hedge for stocks in market sell-offs. Notably, during the inflation years (1965-1982), stocks and bonds regularly declined together.
- Tech stocks (QQQ) did not act defensively as in the 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.

When the market transitions away from speculation and beta, it has favored Value, Quality and High-dividend stocks. Historically, in Fed rate hike cycles, High dividend equities deliver strong relative performance. In the past fifty years, dividend payers have outperformed non-payers after the first rate hike and 1-year later in 75% of the cycles by a median 6.6%. The low-beta nature of high dividend payers is rewarded as the market gravitates towards quality and income. 2-years into a tightening cycle (Figure 6), the highest dividend-yielding quartile of stocks have outperformed the lowest dividend-yielding quartile of stocks in 75% of cycles by an average of 12%. Importantly, the current valuations of high dividend payers are extremely appealing in an expensive market.

Figure 6: Performance of High Dividend Yielders / Low Dividend Yielders in Tightening Cycles



Source: Ned Davis Research, "Dividend stocks during tightening cycles", 2/15/2022.

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 dividends will likely be a more important contributor to total returns.

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

Respectfully,

Schafer Cullen Capital Management, Inc.

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