High Dividend Value
Q4 2022 Commentary

Market Review:

Following declines in each of the first three quarters of 2022, US equities rebounded in the 4th quarter with the S&P 500 returning 7.6% and the Russell 1000 Value up 12.4%. Equity markets were up sharply in October and November, driven in part by talk of another potential Fed pivot, as some investors anticipate the central bank to slow or pause interest rate increases in 2023. However, the rally faded in December, as concerns grew about a slowing economy and a potential recession.

For the full year, US stocks posted their biggest declines since 2008, as the S&P 500 dropped 18.1% while the Russell 1000 Value was down 7.6%. Likely the most significant development impacting financial markets in 2022 was the sharp pivot by the Federal Reserve, and central banks worldwide, away from the ultra-low interest policies that have been in place since the 2008-2009 financial crisis. Although central bankers were gradually lifting rates in the 2017-2018 timeframe, persistently low inflation allowed them to quickly pivot back to their low interest rate regimes, particularly after the onset of Covid-19 in 2020. In 2022, with inflation running in the high-single digits, central banks were left with little choice but to aggressively raise rates. Starting at a near-zero level at the beginning of the year, the Fed Funds rate was 4.25%-4.50% by the end of the year, the highest level since 2007. The dramatic shift in interest rate policy had the most severe impact on high-multiple, long-duration Growth stocks, as reflected in the performance of the Russell 1000 Growth index, which was down 29.1% for the year. Energy (+65.7%) was by far the best performing sector, following 2021 when the sector was up 54.7%. Communication Services (-39.9%) was the worst performing sector in 2022, driven down by media and entertainment stocks.

For the 4th quarter, Energy was the best-performing sector, up 22.8%. OPEC+ upended global markets by cutting daily oil production by two million barrels, roughly twice consensus expectations. Leading Energy companies also reported another strong quarter of earnings, with higher cash flows and returns to shareholders. Industrials (+19.2%) was the 2nd best performing sector, as transportation and capital goods stocks rallied partly on economic optimism and the anticipation of a Fed pivot. Materials (+11.8%) was the next best performer, as commodities prices rallied, including copper, gold and other metals. Consumer Discretionary (-10.2%) was the worst performing sector, brought down in the quarter by outsized weights in Tesla and Amazon, both of which sharply declined. Communication Services (-1.4%) was the next worst performer, as leading media and entertainment stocks declined on disappointing earnings.

The Consumer Price Index (CPI) increased 7.1% in November, below consensus expectations and down from 7.7% in October and 8.2% in September.[1] The Fed raised interest rates 0.5% in December but forecast a higher-than-expected peak rate in 2023 of 5.1%. Acknowledging the lag between monetary policy actions and their full impact on the economy, Powell said it makes sense for the Fed to slow the pace of increases and monitor inflation and other economic data. In the mid-term elections, Democrats fared better than widely anticipated, as they retained a Senate majority and only narrowly lost the House of Representatives. The split Congress should result in gridlock, a scenario that has historically favored stock market performance.

[1] https://www.bls.gov/news.release/cpi.nr0.htm

Performance Analysis:

The High Dividend Value Equity strategy composite returned 15.2% (net of fees) for the fourth quarter of 2022 versus 12.4% for the Russell 1000 Value and 7.6% for the S&P 500. For the full year 2022, the strategy returned -3.1% (net of fees) versus -7.6% for the Russell 1000 Value and -18.1% for the S&P 500.

Figure 1: High Dividend Value Equity Returns vs. Benchmark

December 31, 2022	QTD	YTD	1 Yr	3 Yr	5 Yr	10 Yr	Since Incept*
High Dividend Value Equity (gross)	15.2	-2.7	-2.7	6.7	7.3	10.1	10.1
High Dividend Value Equity (net)	15.2	-3.1	-3.1	6.3	6.9	9.7	9.5
Russell 1000 Value Index	12.4	-7.6	-7.6	6.0	6.7	10.3	9.2
S&P 500 Index	7.6	-18.1	-18.1	7.7	9.4	12.6	9.6

12/31/1993. Performance for periods greater than 1 year is annualized.* ***Past performance is no guarantee of future results*

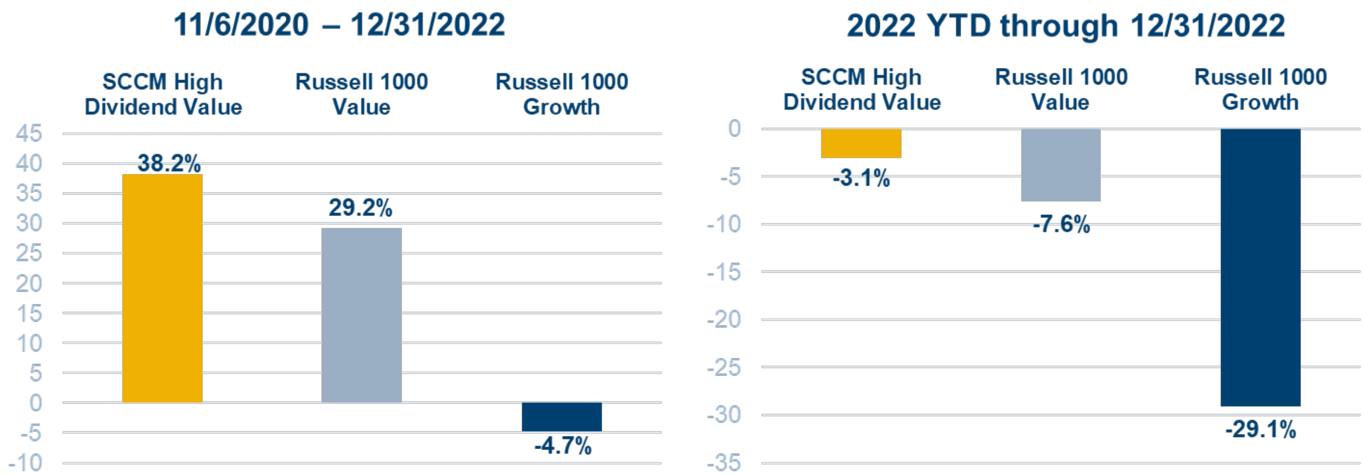
The strong fourth quarter market rally, initially driven by signs of peaking inflation, strengthened after core CPI in October declined from the prior month's decades-high reading. The subsequent release in November confirmed a downside break from the escalating inflation trends experienced over the past year. Equity markets quickly began to discount an earlier pause in the Federal Reserve's tightening cycle. However, despite the welcomed drop in inflation, equity markets drifted lower in December with the historically positive seasonal tailwinds failing to materialize. The Fed remained resolute in its primary objective to bring inflation lower and reiterated the need to observe a sustained decline before adjusting monetary policy to a less restrictive stance. Importantly, the Fed's quantitative tightening program, the reduction of its balance sheet through asset sales, remains an overhang on the market as it pressures money supply. Meanwhile, global economic growth is further decelerating and numerous leading indicators point to an imminent decline in earnings and an increasing chance of recession.

Value led the market higher in the fourth quarter and outperformed Growth for the full year. Growth stocks faced headwinds from higher interest rates, more restrictive financial conditions and a greater preference for current, sustainable earnings. The more speculative and richly valued an asset, the greater the underperformance as higher rates have highlighted the importance of cash generation, financial discipline and balance sheet strength. Pockets of blow-ups among former market darlings such as cryptocurrencies, the continued weakness of Covid beneficiaries in market rallies and the underperformance of former bulletproof FANG stocks suggests a secular change in market leadership. The Russell 1000 Value outperformed the Russell 1000 Growth by 10.2 ppt in the quarter and 21.6 ppt for the full year 2022, the largest annual spread between the two indices in 20 years.

High dividend stocks benefitted from a preference for quality, low-beta and defensive earnings and cash flow. The sharp rise in interest rates pressured long-duration growth stocks and highlighted the relative attractiveness of current income and inflation hedges.

The High Dividend Value Equity strategy has outperformed the Russell 1000 Value and Russell 1000 Growth indices since the initial turn to Value in November 2020 (Figure 2). As we look ahead to market opportunities and risks, we evaluate the deteriorating economic environment but see reasons for optimism in the Market Outlook section of the commentary.

<u>Figure 2: Performance Since Pfizer Vaccine Announcement and YTD 2022</u>



Relative Performance	11/6/20 – 12/31/22	FY 2022
Value vs Growth	+33.9%	+21.6%

Source: CCM Research, 12/31/2022.
Past performance does not guarantee future results. You cannot invest directly in an index.

The overall valuation and dividend yield of the High Dividend strategy are attractive on an absolute and relative basis. At quarter-end:

- **Low Price/Earnings Valuation Discipline**: The strategy's P/E is 13.9x 2023 earnings versus 16.9x for the Russell 1000 Value and 18.2x for the S&P 500 (Q4). The 10-year average valuation spread between the strategy and the Russell 1000 Value and the S&P 500 is 220 and 360 basis points respectively; the current valuation spread is 300 and 430 basis points respectively.

- **High Absolute Dividend Yield**: The strategy's dividend yield is 3.5% versus 2.3% for the Russell 1000 Value and 1.8% for the S&P 500 (Q4).

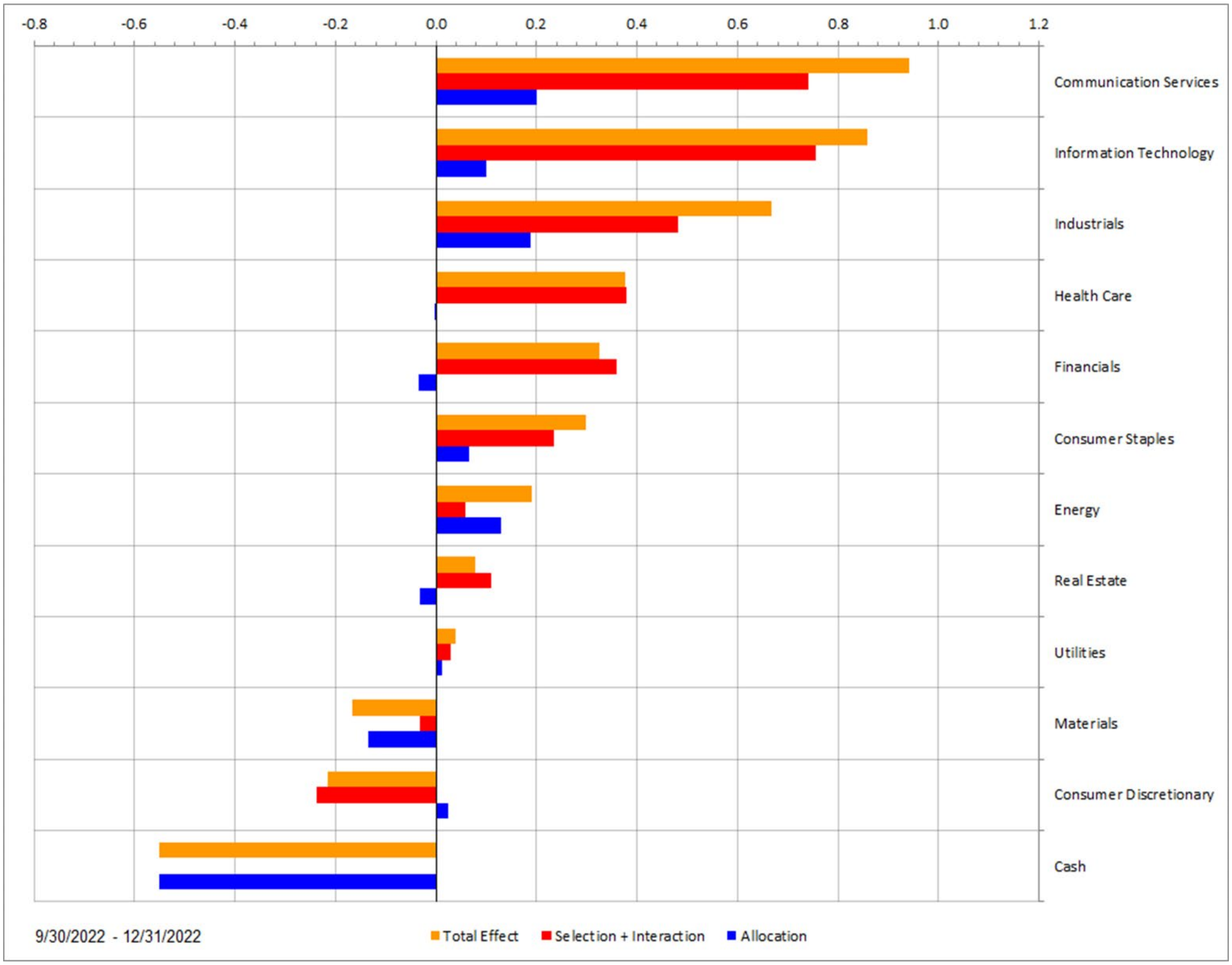
- **Strong Dividend Growth**: In the fourth quarter of 2022, 3 out of 42 portfolio companies raised their dividend payments with an average increase of 7.1%:

  - Exxon Mobil (XOM) raised its dividend payment by +3.4%
  - Merck & Co. (MRK) raised its dividend payment by +5.8%
  - Broadcom (AVGO) raised its dividend payment by +12.2%

  <u>For the full year 2022, 34 out of 42 (81%) portfolio companies raised their dividend with an average increase of 9.5%.</u>

Portfolio Attribution:

Attribution Effects – High Dividend Value vs. Russell 1000 Value 9/30/2022 -12/31/2022



Source: SCCM/Bloomberg, 12/31/2022.

The following attribution analysis of the High Dividend Value Equity portfolio is compared to the Russell 1000 Value benchmark.

Our underweight allocation and strong stock selection made ***Communication Services*** the largest contributor to relative performance for the quarter. Communication Services was the 2nd worst performing sector as leading media and entertainment stocks underperformed on disappointing earnings. However, AT&T (+22.2%) rebounded on strong results in its wireless division as postpaid subscriber additions and average revenue per user both exceeded expectations. The company continues to expand its 5G network capacity as well as its fiber footprint across the country. Shares of Comcast (+20.3%) also outperformed after the company reported strong broadband subscriber gains, growth in its NBCUniversal Studios division as well as a recovery at its theme parks. Our underweight allocation and stock selection in ***Information Technology*** also contributed to relative performance. The sector underperformed as high multiple Growth stocks continued to lag. Broadcom (+27.0%) outperformed on strong networking demand, driven by cloud and enterprise data center spending. Cisco (+20.2%) also benefitted from strong demand for enterprise software and networking equipment, while supply chain issues that have challenged the company throughout the pandemic have normalized. Our overweight allocation and stock selection within

Industrials aided relative performance. Siemens (+40.5%) significantly outperformed after issuing bullish forward guidance, with strong visibility into its order backlog, particularly in short-cycle businesses. Revenue and cash flow increased in all four of Siemens' industrial businesses, with the strongest growth in factory automation and smart infrastructure. Johnson Controls (+30.8%) also rebounded in the quarter as a recovering supply chain resulted in improved backlog conversion and price realization. The company's record backlog was up 13% year-over-year with continued demand for its commercial HVAC products and services. Raytheon Technologies (+24.0%) outperformed, driven by a recovery in its aerospace businesses as well as several notable international orders for its Patriot missile defense and Tomahawk missile systems. Stock selection within ***Healthcare*** also aided performance. Merck (+29.7%) capped off an exceptional year with continued sales growth for its oncology treatment, Keytruda, and its Gardasil HPV vaccine franchise. Novartis (+19.4%) gained with continued momentum in its core branded products, including Entresto and Cosentyx, as well as recently launched drugs including Scemblix for myeloid leukemia and Pluvicto for the treatment of prostate cancer.

Only two sectors detracted from relative performance in the quarter. Stock selection within ***Consumer Discretionary*** detracted from performance. Target (+1.0%) lagged due to weakening sales trends as the 3rd quarter progressed, with a notable drop in the final few weeks of October. However, comparable sales for the overall quarter were strong, as the number of transactions and transaction amount both improved. Management announced an enterprise efficiency initiative expected to yield up to $3 billion in cost savings over the next three years. Lowe's (+6.7%) lagged on concerns of a slowing housing market. However, the company reported strong comparable sales growth, driven by strength in both their DIY and pro sales channels. Furthermore, Lowe's ecommerce sales continue to accelerate, growing 12% from last year. Our underweight allocation and stock selection within ***Materials*** detracted from relative performance. Materials was the third best performing sector in the quarter, driven by rallying commodities prices. Although Dow (+16.3%) was up significantly in the quarter, it ended up trailing the sector's performance and therefore was a slight relative detractor. Dow continues to benefit from its US-based operations, which have significant cost advantages particularly over European competitors that are plagued by sharply higher natural gas costs.

Portfolio Changes:

Purchases / Additions

The positions in Dow (DOW), Duke Energy (DUK), Kimberly-Clark (KMB), Truist Financial (TFC), and VICI Properties (VICI) were added to in the quarter.

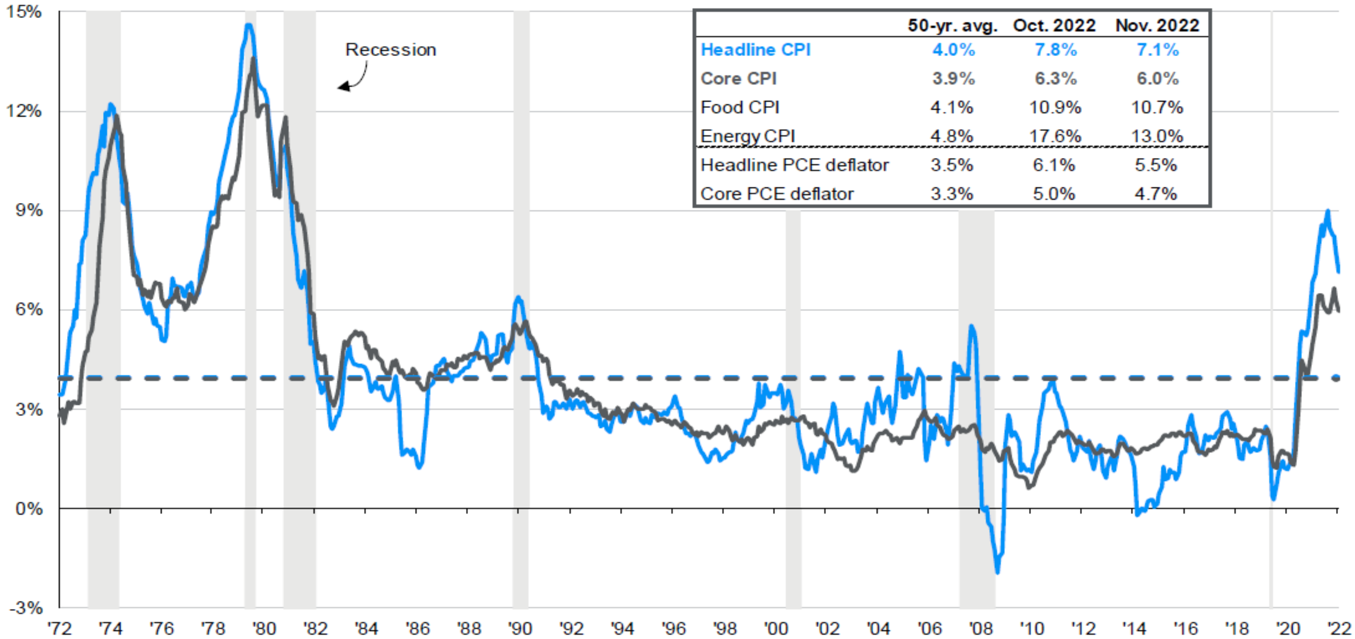
Sales / Trims

The positions in Chevron (CVX), ConocoPhillips (COP) and Genuine Parts (GPC) were trimmed in the quarter.

Market Outlook:

Global inflation appears to have peaked and is decisively falling as one of the most widely watched economic releases, US monthly CPI, showed year-over-year headline inflation declining from a decades-high reading of 9.0% in June to 7.1% in November (Figure 3). The less volatile core CPI measure peaked in September at 6.6% and has since declined to 6.0% in November. The combination of decelerating economic growth, more stable commodity prices and a moderation in wage and shelter inflation point to headline and core inflation moving closer to the Fed's target. This has brought considerable relief to financial markets as Fed futures predict lower peak rates and interest rate cuts considerably earlier than the Fed's current communicated plans.

Figure 3: US CPI Y/Y Change



Source: JPMorgan, Guide to the Markets, 12/31/2022.
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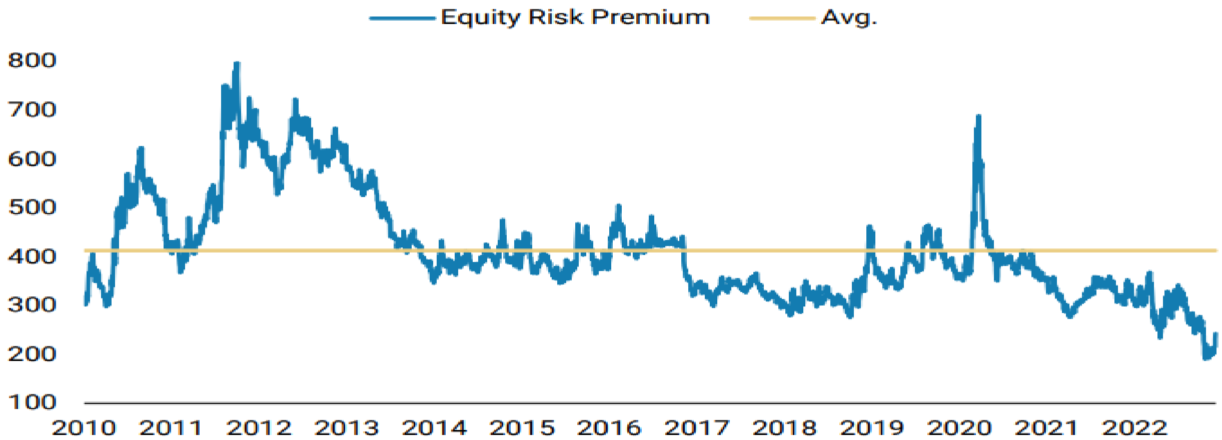
Meanwhile, the effects of the fastest and most aggressive global central bank tightening cycle in decades is impacting global growth and corporate earnings. The effects of monetary tightening typically work with a lag but are already evident in broadening economic weakness, drawing increasing concerns of an eventual recession. Economic and financial market data indicate an increasing likelihood of a recession:

- Currently, 84% of Treasury yield curves are inverted. The US 10Y-2Y Treasury Spread is the most negative in 40 years; an inverted yield curve has historically preceded recessions.
- A variety of leading economic indicators are flashing red: 75% of the world has a manufacturing PMI in contractionary territory (including the US), the USES Business Cycle Indicator (combination of hard and soft economic data) turning severely negative, and housing gauges weakening.
- Money supply (M2) year-over-year growth fell to zero in November 2022, the lowest level since 1995.
- Positively, the unemployment rate, a lagging indicator, remains near cycle lows; however, the consumer personal savings rate has reached a 15-year low, indicating a weaker spending environment ahead.

The US equity bear market, a full year in length, has been driven by a significant decline in valuation multiples as a result of higher inflation / interest rates and fears of an economic slowdown. The Price/Earnings multiple on the market fell from 21.4x (January 2022) to 16.7x (December 2022), a 22% decline. However, the spike in interest rates led to a drop in the Equity Risk Premium – the excess compensation needed to take on more risk – to below its long-term historical average (Figure 4), indicating a lower equity market return profile. The current equity risk premium is materially below levels typically observed at bear market lows suggesting the market has yet to price in a meaningful earnings downturn.

Figure 4: S&P 500 Equity Risk Premium



Source: Morgan Stanley, Weekly Warmup, 12/19/2022.
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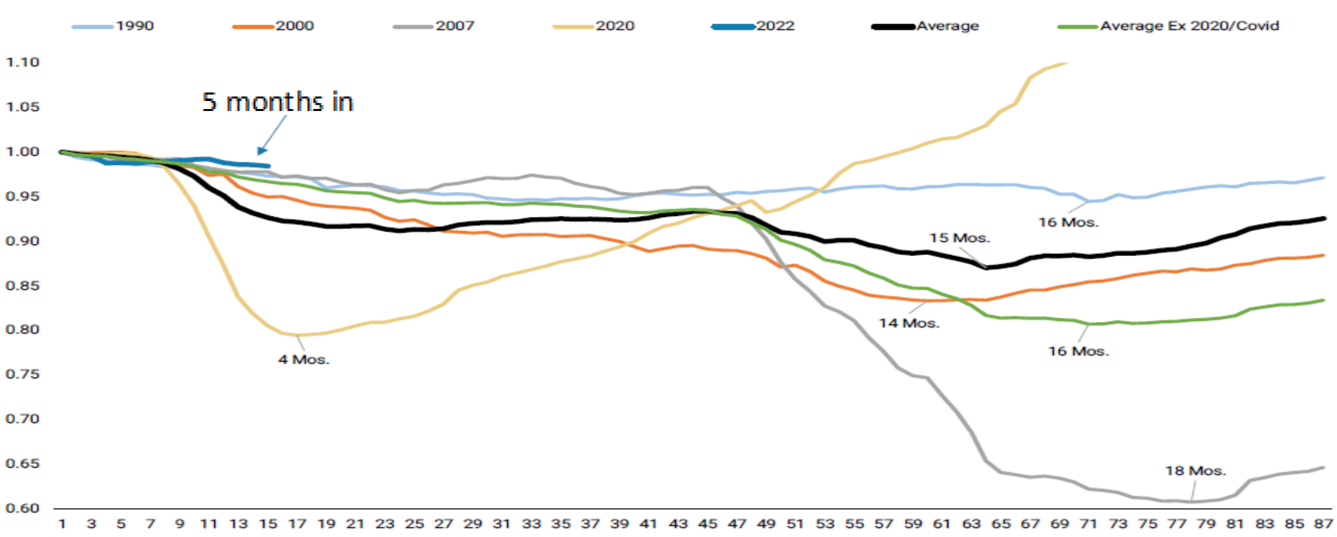
The second leg of bear markets is driven by a decline in corporate earnings. Currently, consensus earnings expectations for the S&P 500 are for a 4% increase in EPS in 2023, a level which is likely to be revised lower in the coming months. In recessions, the S&P 500 EPS declines by an average 15% (magnitude) for on average 15 months (duration) (Figure 5). In this cycle, earnings have declined for 5 months; therefore, we are likely in the early innings of an earnings downturn. Importantly, S&P 500 Dividends per Share have proven to be particularly resilient in recessions with S&P 500 DPS largely flat in most recessions. Dividends become the key contributor to total returns in down markets.

Figure 5: Forward EPS Declines Around Prior Earnings Recessions



Source: Morgan Stanley, Weekly Warmup, 10/17/2022.
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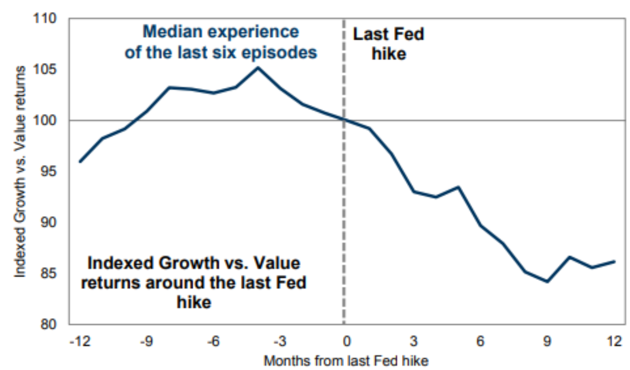
Despite all these concerns, there is reason for optimism. Equity bear markets typically bottom before fundamentals improve – past bear markets have typically troughed approximately two quarters before EPS bottoms. On the one hand, markets could be supported by weaker growth and the several rate cuts being discounted into Fed futures as a result of higher recession probabilities and a shift in focus back to growth in a pre-election year. On the other hand, a soft landing could counterintuitively be a more bearish outcome as it would serve to maintain a more restrictive monetary policy.

Looking ahead, the Fed expects to pause its rate hike cycle as inflation declines to more acceptable levels. Historically, after the peak in Consumer Price Index (CPI) (Figure 6) and after a Fed pause (Figure 7), Growth has surprisingly underperformed Value over the subsequent year.

Figure 6: Growth vs. Value Returns Following Peaks in Core CPI

CPI peak	Growth vs. Value returns in 1/3/6/12m from core CPI peak: 1m	3m	6m	12m	Core CPI peak (YoY)
Jun-80	(2)%	2 %	4 %	4 %	14 %
Sep-81	4	(0)	(7)	(7)	12
Aug-84	(4)	(7)	(9)	(9)	5
Feb-91	(2)	(2)	(3)	(3)	6
Dec-01	(5)	(11)	(15)	(15)	3
Sep-06	(0)	(2)	(3)	(3)	3
Apr-12	1	2	(3)	(3)	2
Aug-16	(1)	(7)	(7)	(7)	2
Median	**(1)%**	**(2)%**	**(5)%**	**(5)%**	**4 %**

Figure 7: Growth vs. Value Performance Around Last Fed hike



Source: Goldman Sachs Research, US Thematic Views, 9/6/2022.

The recent market leadership of Value stocks has a number of long-term secular tailwinds for sustained outperformance. First, while near-term inflation may subside, the underpinnings of several inflationary trends will continue to build, benefitting Value stocks:

- Globalization, a driver of deflation over decades, is no longer providing downward pressure on pricing for manufactured goods as import prices from China are no longer falling at the same magnitude as in the deflationary era. In addition, reshoring and corporations' drive to increase manufacturing base diversification is inflationary in nature.
- Demographic trends, highlighted by the global support ratio (number of workers to number of consumers) declining, are turning increasingly inflationary as output will potentially decline relative to spending over the coming years.
- The unmitigated rise of global sovereign debt over the past several years coupled with rising rates may increase investor preference towards hard assets.

Next, money supply growth is a key factor in financial conditions and liquidity as well as investor risk appetite. The Fed's quantitative tightening actions are leading to a decline in money supply (M2) which is reversing the impact of quantitative easing; since 2009, the Fed's balance sheet expansion has a near perfect correlation with the rise of large cap technology stocks. In addition, investors willing to pay up for Growth stocks on the view that they provide better relative growth in downturns would be surprised to find that three of the top ten industries with the highest correlation with composite PMI levels (cyclicality) are in the Technology and Communication Services sectors (Source: Morgan Stanley Research). Furthermore, the opportunity for Value to outperform Growth given the abnormal length and magnitude of Growth's recent decade of outperformance rests on the improving valuation of Value stocks or mean reversion of Technology stock performance (Figure 8). The weight of the largest four stocks in the S&P 500 peaked at

22% of the index in 2021 and is currently 18%, still far above the long-term historical average weight (Figure 9). Despite the bearish headlines in 2022, flows into Domestic ETF and mutual funds were over $100B for the full year (Strategas, 4Q'2022 Quarterly Review in Charts, 1/3/2023).

Figure 8: 10-Year Annualized Monthly Returns from Technology Stocks

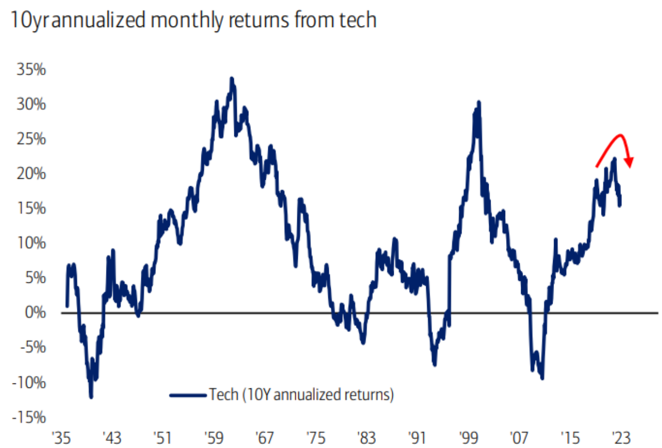
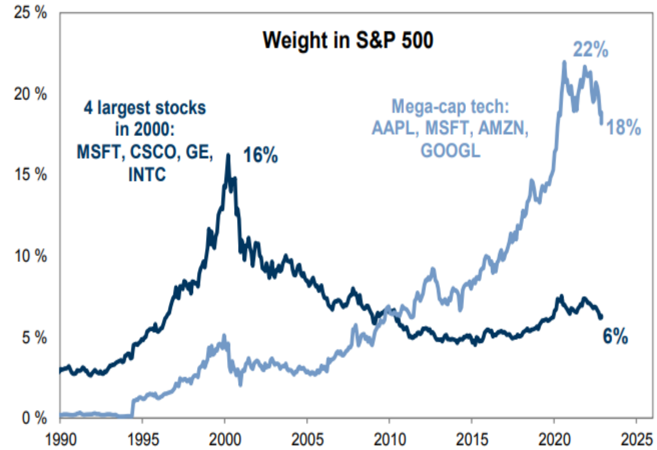


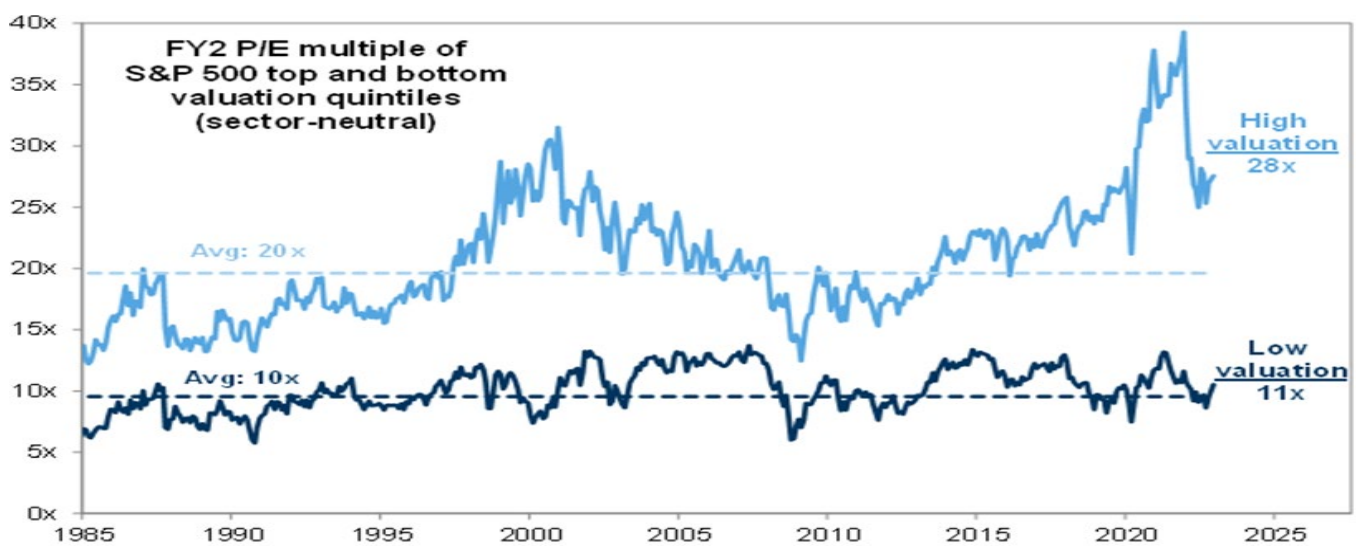
Figure 9: Weight of Largest 4 Stocks in the S&P 500



Source: BofA/ML, The Flow Show, 10/27/2022; Goldman Sachs Research, 2023 US Equity Outlook, 11/21/2022.
Past performance does not guarantee future results. You cannot invest directly in an index.

Value stocks still represent an attractive investment from a valuation perspective. Despite the recent relative outperformance of Value stocks, the valuation spread between Growth and Value stocks in the S&P 500 is still historically wide (Figure 10).

Figure 10: Valuation Between Growth and Value Stocks



Source: Goldman Sachs Research, 12/31/2022.
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