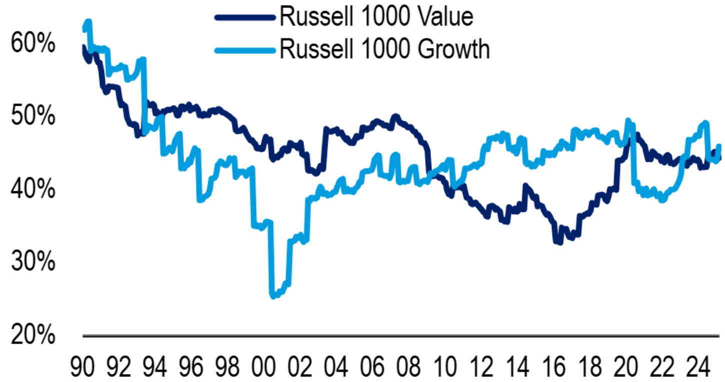
Resilient Quality

The Lead | April 2025

Value Stocks Are Now Tied With Growth, Measured by S&P Quality Ratings

% of B+ or Better stocks in Russell 1000 Growth and Russell 1000 Value
(equal-weighted, as of 2/2025)



Sources: BofA Global; FactSet.

We are once again in NCAA basketball tournament season. On the men's side, there are 352 schools that competed to make the tournament, with four teams remaining as of the end of March. We noticed the absence of "Cinderella teams" this year, referring to lower-seeded teams that make it further into the tournament than expected. The emergence of certain "power conferences" with strong brands, large fan bases, and corresponding resources have dominated the field. We believe these teams have done a good job recruiting the right players to run the gauntlet of the regular season and tournament conference schedule.

We seek to identify stocks that have similar characteristics of strength, resiliency, and resources to succeed over the long haul. We found that quality stocks paying consistent and rising dividends fit the bill. How does one define quality? One way is through S&P Quality ranks which measure return on equity (ROE) and balance sheet strength. Historically, growth stocks were considered higher quality, but that has recently changed as the chart above depicts. To our surprise, the economic sectors associated with value stocks, such as industrials and financials, have seen their quality measurements improve. We attribute the improvements primarily to the strengthened balance sheets and capital ratios for banks in the assessment below.

Over 70% of Industrial and Financial Stocks are of High Quality, Measured by Quality Ratings

% of B+ or Better stocks in the S&P 500 (equal-weighted 2/2025)

	% of high quality stocks in sector	LT average
Industrials	71.8%	64.0%
Financials	71.2%	65.8%
Utilities	67.7%	58.4%
Discretionary	66.0%	63.2%
Staples	65.8%	81.7%
S&P 500	60.0%	56.9%
Health Care	55.7%	62.5%
Tech	55.1%	39.6%
Real Estate	51.6%	46.3%
Comm. Svcs.	47.4%	46.0%
Materials	46.4%	44.3%
Energy	13.6%	29.6%

Source: BofA Global.

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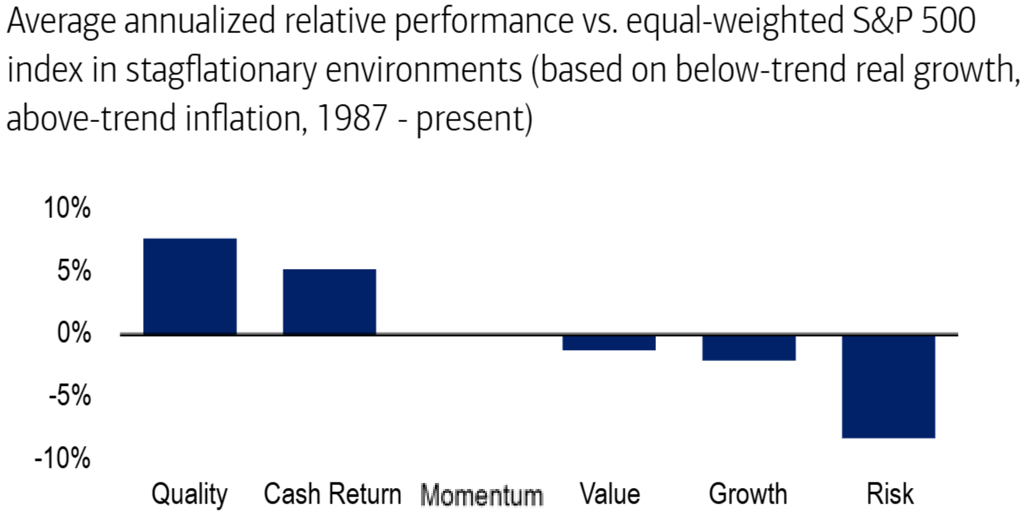
Quality, Dividends, and Share Repurchase Have Shined in Prior Periods of Stagflation



Sources: BofA Global; FactSet.

Slowing economic growth and persistent inflation have resulted in the highest amount of Google searches for “stagflation” ever, according to Google Trends. What are the characteristics of stocks that tend to perform well in a stagflation environment? In the chart above it appears quality and cash return, which include dividends and share repurchase, perform well. The combination of high returns on capital and strong balance sheets appear to enable these companies to be masters of their own destiny in challenging times. Just as each team has built their team with talented players with the goal of winning the final game, we seek to build a strategy of owning a select number of high-quality companies with rising dividends that may enable our clients to succeed.

As always, thank you for your interest and trust managing your investments.

Charles J. Wittmann, CFA®, Executive Director, joined Sterling Capital Management in 2014 and has investment experience since 1995. Chip is Co-Portfolio Manager of the Equity Income strategy. Prior to joining Sterling, he worked for Thompson Siegel & Walmsley as a portfolio manager and (generalist) analyst. Prior to TS&W, he was a founding portfolio manager and analyst with Shockoe Capital, an equity long/short hedge fund. Chip received his B.A. in Economics from Davidson College and his M.B.A. from Duke University's Fuqua School of Business. He holds the Chartered Financial Analyst® designation and served as President of CFA Society Virginia from 2012-2013.

Important Information

Disclosures

Past performance is not indicative of future results. Any type of investing involves risk and there are no guarantees that these methods will be successful. Economic charts are provided for illustrative purposes only. The information provided herein is subject to market conditions and is therefore expected to fluctuate.

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The volatility of an index varies greatly. All indices are unmanaged and investments cannot be made directly in an index.

The Russell 1000® Growth Index measures the performance of the large-cap growth segment of the U.S. equity universe. It includes those Russell 1000® companies with higher price-to-book ratios and higher forecasted growth values. The Russell 1000® Growth Index is constructed to provide a comprehensive and unbiased barometer for the large-cap growth segment. The index is completely reconstituted annually to ensure new and growing equities are included and that the represented companies continue to reflect growth characteristics.

The Russell 1000® Value Index measures the performance of the large-cap value segment of the U.S. equity universe. It includes those Russell 1000® companies with lower price-to-book ratios and lower expected growth values. The Russell 1000® Value Index is constructed to provide a comprehensive and unbiased barometer for the large-cap value segment. The index is completely reconstituted annually to ensure new and growing equities are included and that the represented companies continue to reflect value characteristics.

The S&P 500® Index is a readily available, carefully constructed, market-value-weighted benchmark of common stock performance. Currently, the S&P 500 Composite includes 500 of the largest stocks (in terms of stock market value) in the United States and covers approximately 80% of available market capitalization.

Dividend-focused strategies may underperform strategies that do not limit their investment to dividend-paying stocks. Stocks held strategy may reduce or stop paying dividends, affecting the strategy's ability to generate income.

Dividend Growing, No-Change-in-Dividend, and Dividend Cutting: Each dividend-paying stock is further classified into one of the three categories based on changes to their dividend policy over the previous 12 months. Dividend Growers and Initiators include stocks that increased their dividend anytime in the last 12 months. Once an increase occurs, it remains classified as a grower for 12 months or until another change in dividend policy. No-Change stocks are those that maintained their existing indicated annual dividend for the last 12 months (i.e., companies that have a static, non-zero dividend). Dividend Cutters and Eliminators are companies that have lowered or eliminated their dividend anytime in the last 12 months. Once a decrease occurs, it remains classified as a cutter for 12 months or until another change in dividend policy. (Source: Ned Davis Research).

Technical Terms: **Dividend Risk:** Dividend yield is one component of performance and should not be the only consideration for investment. Dividends are not guaranteed and will fluctuate. This report should not be regarded by the recipients as a substitute for the exercise of their own judgment. It is important to review your investment objectives, risk tolerance and liquidity needs before choosing an investment style or manager. **Dividend Yield**: a financial ratio that measures the annual value of dividends received relative to the market value per share of a security. In other words, the dividend yield formula calculates the percentage of a company's market price of a share that is paid to shareholders in the form of dividends. **Return on equity (ROE)** is a measure of a company's financial performance. It is calculated by dividing net income by shareholders' equity. Because shareholders' equity is equal to a company's assets minus its debt, ROE is a way of showing a company's return on net assets. **S&P quality ranks**, used in S&P Quality Indices, assess a company's financial health and stability by evaluating three fundamental measures: return on equity, accruals ratio, and financial leverage ratio. **Stagflation** is an economic condition characterized by simultaneous high inflation, high unemployment, and slow economic growth, posing a challenge for policymakers as traditional solutions can worsen the situation. (Technical definitions are sourced from Corporate Finance Institute and Investopedia.)

The **Chartered Financial Analyst® (CFA)** charter is a graduate-level investment credential awarded by CFA Institute — the largest global association of investment professionals. To earn the CFA charter, candidates must: 1) pass three sequential, six-hour examinations; 2) have at least four years of qualified professional investment experience; 3) join CFA Institute as members; and 4) commit to abide by, and annually reaffirm, their adherence to the CFA Institute Code of Ethics and Standards of Professional Conduct.

Since we began publishing The Lead in 2015, our primary purpose has been to communicate our investment philosophy and process as an investment advisor in the context of changing markets. In creating portfolios that differ from our benchmarks by focusing on characteristics that have a long term history of attractive relative returns according to Ned Davis Research, the portfolios are different from the benchmarks and as a result there can be periods where results differ including below benchmark performance. Since strategies are oriented toward the long term characteristics, if those characteristics are out of favor over a period of time, the given strategy's performance could be challenged in terms of relative performance. While Sterling believes active professional investment management that employs a consistent process with a long term orientation and aligned with client interests offers benefits, management fees to support the active approach can be higher than certain alternatives. When hiring an investment manager we believe it is important to monitor the investment risks taken including sector concentrations, portfolio turnover, and the impacts of dividend policy changes.

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