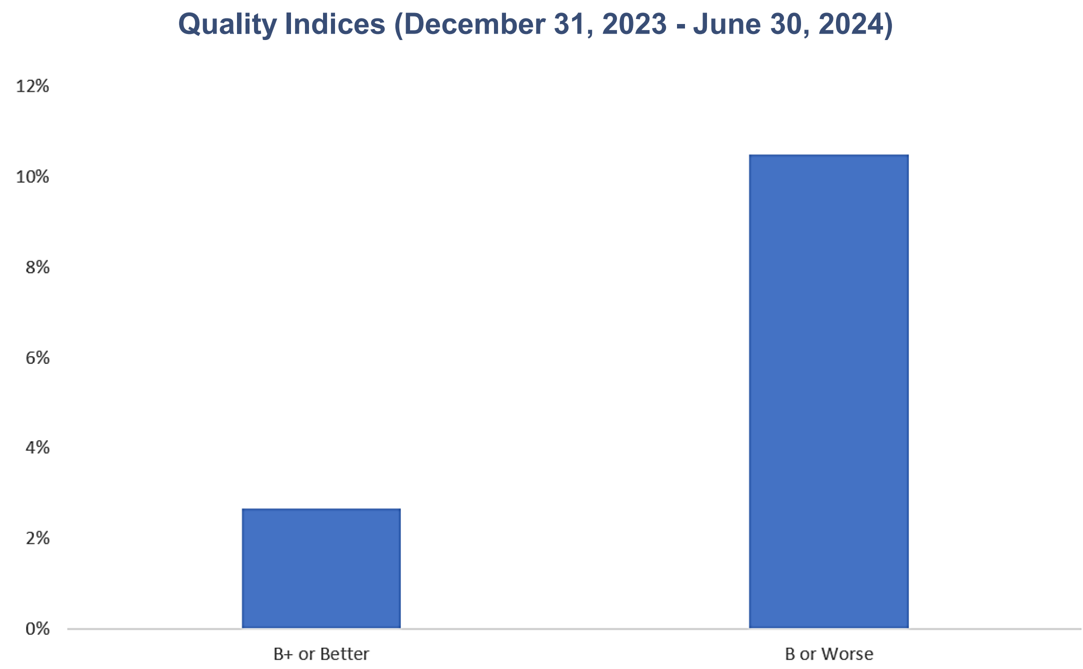
Value in Stability

The Lead | August 2024

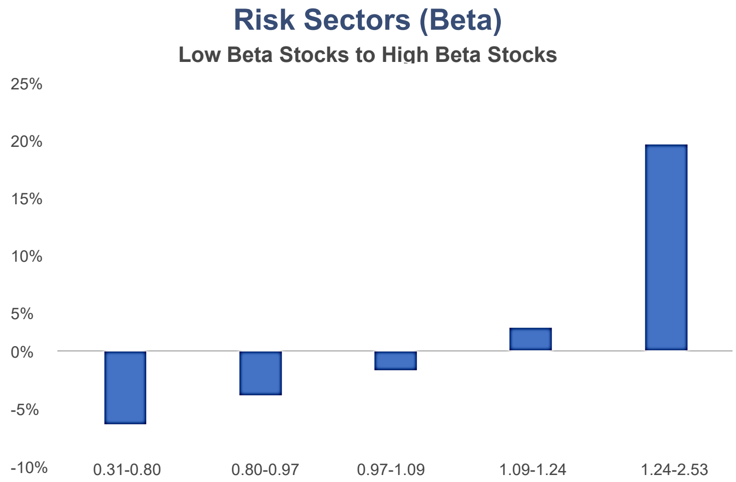


Source: BofA Global Research.

In Paris, the U.S. men's gymnastics team won their first Olympic medal in sixteen years, combining their performances across six different pieces of equipment. Working through multiple stages, the team merged their scores into one final result. In the same way, we manage client portfolios in the pursuit of producing results that position clients on the podium. We believe the best way to perform is to employ techniques and processes that have demonstrated value through different stages and could succeed in the end. To do so, we believe that clients should understand how our processes work and how they perform in the short and long term, depending on the investing environment.

Low quality and risk performed well in the first half of 2024, as measured by the two charts on this page. The top chart shows the year-to-date return of stocks based on their return on equity, earnings quality, and debt levels. The second chart shows how the riskiest, or highest beta stocks, have outperformed year-to-date.

What could cause low quality, high beta stocks to perform so well in the short term? As a result of more tepid inflation data supporting a potential reduction in the federal funds rate, we believe the market began anticipating that lower rates may aid companies that need stress relief from the higher interest payments placed on their businesses.



Source: BofA Global Research.

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. Charts are for illustrative purposes only.

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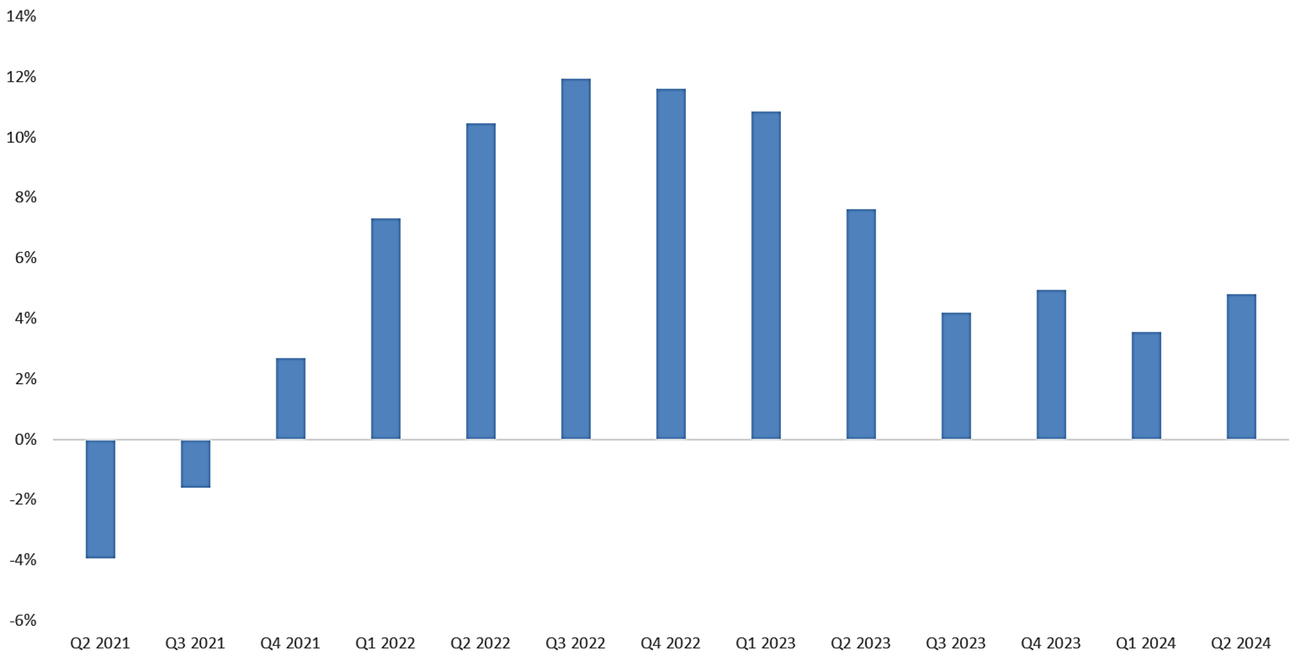
S&P 500 Dividend Growth Rate (Year-Over-Year)



Source: Bloomberg L.P.

Evidence of this stress can be seen in the chart above, which shows how companies in the S&P 500® Index began reducing the growth rate of dividends they pay their shareholders as cash flows become more difficult to generate.

We'd note that those same high-quality stocks that have underperformed their lower-quality counterparts year-to-date have outperformed the S&P 500 over the past three, five, and ten years, according to S&P Global (S&P 500® Quality Index as of June 30, 2024). We believe quality companies that increase rather than decrease their dividends and signal their financial strength through short- and long-term environments may be a formula for client success.

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 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.

The S&P 500® Quality Index is designed to track high quality stocks in the S&P 500 by quality score, which is calculated based on return on equity, accruals ratio and financial leverage ratio.

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: **Beta** is a measure of a stock's volatility in relation to the overall market. By definition, the market, such as the S&P 500 Index, has a beta of 1.0, and individual stocks are ranked according to how much they deviate from the market. A stock that swings more than the market over time has a beta above 1.0. If a stock moves less than the market, the stock's beta is less than 1.0. **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. (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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