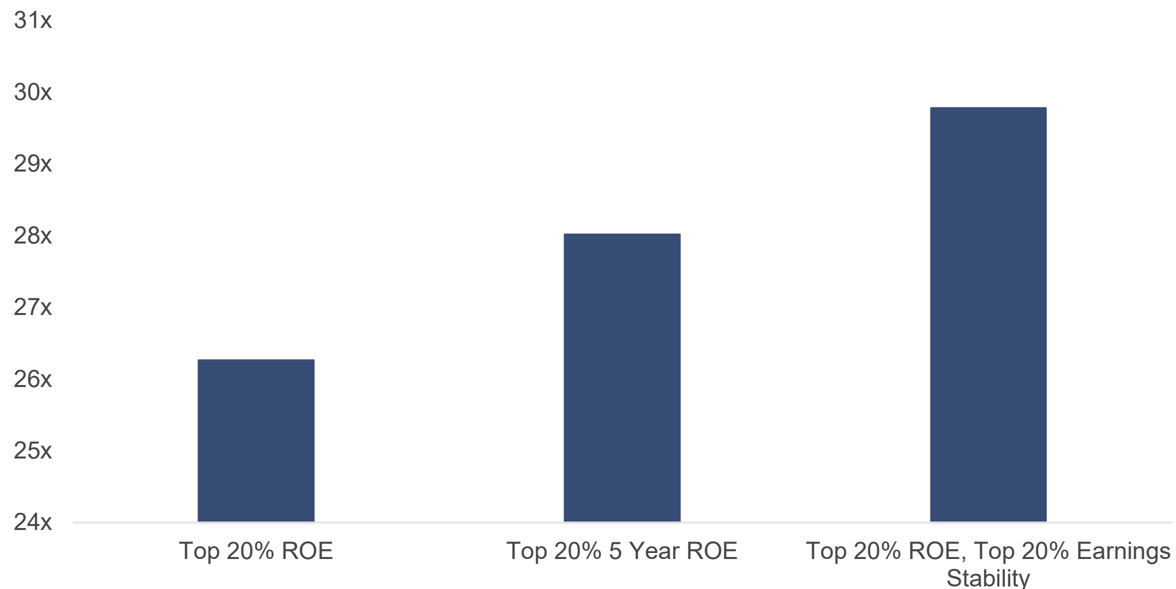
Margin of Upside

The Lead | October 2024



Source: Sterling Capital Management Analytics. Data is as of 09.26.2024.

Investors may use heuristics, or mental short cuts, to make valuation decisions rather than seeking to understand the true value of a business. One of the most common mental shortcuts is regression to the mean, or the idea that outcomes far from average will revert to average over time. The foundation for this understanding was established centuries ago with Adam Smith in *The Wealth of Nations* (1776) with the concept of the invisible hand. Alfred Marshall, an English economist, theorized if a good earns a high margin, competition will enter the market and offer it at a lower price, driving it lower to equilibrium. In valuing companies, the result is the assumption in the chart on the second page that companies earning a return on capital above the average may see their returns revert downward over time to the cost of their capital as those goods or services are sold in fewer amounts or at lower margins.

If this is true, how can our longest-term holding in the Sterling Capital Equity Income strategy have a higher ROE in 2024 than it did in 2007, and how could its return be continually above that of the market average over the same time period? Additionally, how can the market award it a higher P/E valuation multiple now versus then? Such examples challenge the regression to the mean belief as fait accompli (accomplished and presumably irreversible) rather than a statistical tendency. The good news is that investors employing regression to the mean as settled law may provide opportunity to other participants in the market that are willing to look into the deeper reality, searching for distinct investment models.

In our view, certain principles outlined centuries earlier are still valid for companies operating in a smokestack and bulk processing economy. In our search for advantaged-value companies, we have found companies that craft knowledge into their products and can generate increasing returns through market share gains and dominance, economies of scale, and international expansion.

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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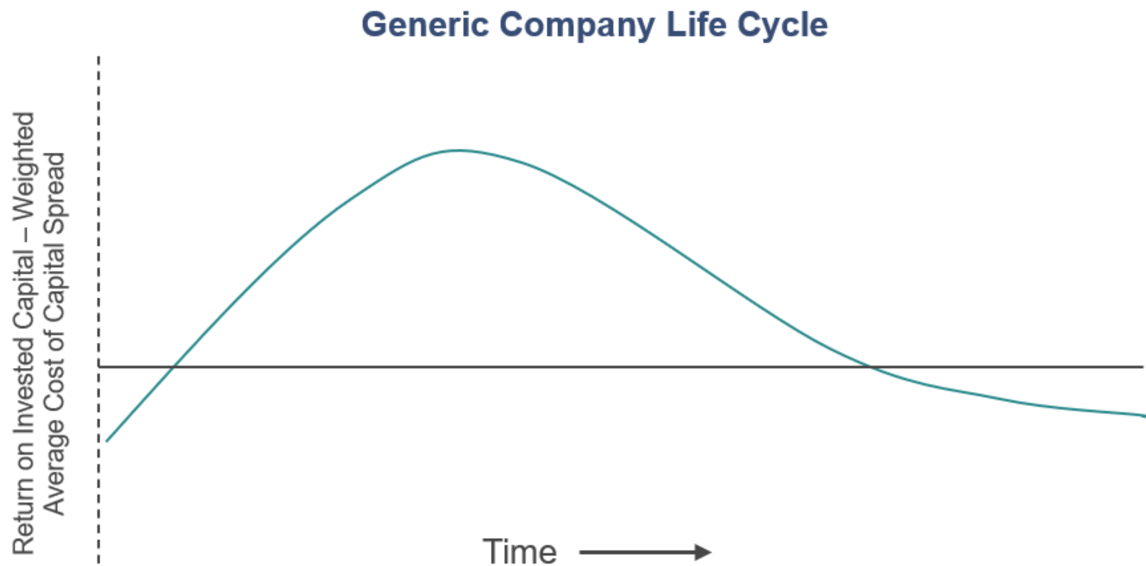


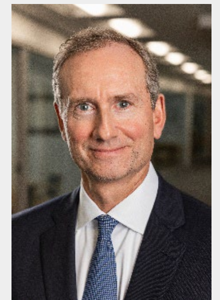
Source: Sterling Capital Management Analytics.

We believe their advantage enables them to earn higher returns for longer than expected. Technology and pharmaceutical companies that develop and sell their products over time are prime examples of the types of companies we seek out. Why? The chart of the first page that shows that the market tends to award higher valuations for higher return companies. We took the top quintile (20%) of the highest ROE companies in the market and have shown the average P/E valuation investors are willing to award these high-quality companies. Across the board, the valuation premium is 20% or more to the market.

We would note how the market provides higher valuation multiples for greater sustainability of those returns and predictability of earnings. Finally, we would note that our Equity Income strategy earns the same median ROE as the top quartile of returns found in the chart, yet its holdings trade at a discount to the market. Perhaps therein lies the opportunity.

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.



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Important Information

Disclosures

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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: **Price to earnings ratio**, or P/E, is a way to value a company by comparing the price of a stock to its earnings. The P/E equals the price of a share of stock, divided by the company's earnings-per-share. It tells you how much you are paying for each dollar of earnings. **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. **A smokestack industry** is a traditional heavy manufacturing industry that produces large items or inputs into other industries. Examples include cars, shipbuilding, steel and other metals, chemicals, and heavy machinery. (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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