MARKET REPORT
THIRD QUARTER 2022

Key Points

- The Fed is tightening aggressively.
- Our investment opportunity set is increasing.
- Equity multiples compressed and bond yields rose.
- We discuss paying down debt and dividends in our capital allocation series.
- Equity markets are discounting machines.

Total Return as of September 30, 2022						
				Annualized		
	QTD	**YTD**	**1 Yr.**	**3 Yr.**	**5 Yr.**	**10 Yr.**
S&P 500	-4.9%	-23.9%	-15.5%	8.2%	9.2%	11.7%
NASDAQ	-3.9%	-32.0%	-26.2%	10.7%	11.3%	14.3%
Russell 3000						
Index	-4.5%	-24.6%	-17.6%	7.7%	8.6%	11.4%
Value	-5.6%	-18.0%	-11.8%	4.4%	5.1%	9.1%
Growth	-3.4%	-30.6%	-23.0%	10.2%	11.6%	13.4%
Russell Mid Cap						
Index	-3.4%	-24.3%	-19.4%	5.2%	6.5%	10.3%
Value	-4.9%	-20.4%	-13.6%	4.5%	4.8%	9.4%
Growth	-0.7%	-31.5%	-29.5%	4.3%	7.6%	10.9%
Russell 2000 (Small Cap)						
Index	-2.2%	-25.1%	-23.5%	4.3%	3.6%	8.6%
Value	-4.6%	-21.1%	-17.7%	4.7%	2.9%	7.9%
Growth	0.2%	-29.3%	-29.3%	2.9%	3.6%	8.8%

A Synopsis of the Quarter

U.S. equity markets contracted for a third consecutive quarter as the Federal Reserve (the "Fed") continued its monetary tightening campaign by increasing the Fed Funds Rate 0.75% twice during the quarter and for the third time since mid-June. These three back-to-back 0.75% rate increases mark the most aggressive sequential tightening actions since the '80s. With recent inflation levels just below 40-year highs, regaining price stability is a high priority for the Fed even if it comes at the expense of jobs in the near term.

We are generally pleased with the performance of our equity, balanced and fixed-income strategies year-to-date and are excited by the opportunities unfolding due to the recent market rout.

We recognize that declining portfolios, frantic financial prognosticators and geopolitical instability can be concerning. It is in such periods that we earn our keep by executing our value-oriented investment process and serving as a trusted sounding board offering an objective perspective.

Although some factors related to this market cycle have been unique (e.g., an extended period of ultra-low interest rates leading up to the peak) the phases are not: The period of euphoria (peak) has been followed by anxiety and fear and will likely end with capitulation (bottom) at some point. Trying to guess the market bottom is analogous to making macroeconomic forecasts and expecting them to be accurate. Unlikely. Once sellers are exhausted, the process starts over and markets generally move higher, over time, along with corporate free cash flow.

So, what do we do during periods of market turmoil? We work diligently within our circle of competence just as we do when markets are less "exciting." Our efforts are continuously geared toward improving the price-to-value relationship of our strategies, where possible, which should reduce the risk of a permanent loss of capital and improve the odds of solid compounded returns in the years ahead. This is akin to planting seeds in the spring and harvesting crops in the fall. For those of you who have visited our office, you may recall seeing the Weather Channel playing in the lobby. This is by design. We eschew the daily financial oratory, choosing to focus on businesses, their underlying fundamentals and taking care of clients. We believe this approach has served clients well over the last 29 years.

U.S. Equities

Nine of the 11 economic sectors comprising the S&P 500 declined during the quarter. Only consumer discretionary (4.4%) and energy (2.3%) posted positive returns. Communication services (-12.7%), Real Estate (-11.0%) and Materials (-7.1%) led to the downside.

Year-to-date, *earnings* growth represents an estimated 5.1% of the S&P 500's return and *multiple* growth contracted 29.9%, netting a ***price change*** return of negative 24.8% (Source: 4Q 2022 Guide to the Markets). Higher interest rates and concerns of lower future economic growth rates seemingly dampened investors' enthusiasm which led to multiple contraction.

The market for initial public offerings (IPOs) has largely dried up as deals were pulled in the face of waning business confidence and market volatility. Private equity funds hoping to exit companies via a public market transaction have generally hit pause as well. To compound their pain, with public company multiples (i.e., price-to- earnings, free cash flow, etc.) compressing in recent quarters the likelihood of some private equity fund holdings needing to be marked down in the quarters ahead has increased markedly.

Structural supply chain adjustments are contributing to the elevated levels of inflation, in our view. According to an article in the August 20-21, 2022, Wall Street Journal Weekend Edition, U.S. companies are on track to reshore an estimated 350,000 jobs in 2022. This would exceed last year's 265,000 and is roughly 58 times the 6,000 jobs reshored in 2010. Compromised supply chains abroad, America's rule of law, tax incentives and access to energy are just a few factors drawing companies back to the U.S. A heavy dose of automation will be needed for domestic companies to remain competitive on the world stage.

Higher interest rates create opportunities for companies with defined benefit plans. According to a September 29, 2022, Wall Street Journal article, "Defined-benefit plans sponsored by S&P 1500 companies were 101% funded as of August 31, up 6 percentage points from the prior year period." If discount rates (i.e., long-term corporate bond yields) keep rising, this should further improve funding levels making it easier for companies to structure transactions whereby they transfer risk to a third party like an insurance company. Generally, transferring this risk to a third party should free up future cash flow for other corporate priorities.

Fixed Income & Commodities

Corporate bonds' total returns, as measured by the ICE BofA U.S. Corporates 1-10 Yr index, declined 3.2% during the quarter and 12.0% year-to-date. U.S. Treasuries and Agencies, as measured by a similar index, declined 3.2% and 8.5%, respectively.

Treasury yields rose during the quarter with the 2-Year ("2s") increasing 119 basis points to 4.15% and the 10-Year ("10s") increasing 66 basis points to 3.69% at quarter-end. With a negative 46 basis point (a basis point is 1/100th of a percent) spread between 10s and 2s, the yield curve is inverted. An inverted yield curve often portends economic weakness ahead.

Commodities*,* as measured by the Bloomberg Commodity Index, declined 4.1% for the quarter but are up 13.6% year-to-date and 11.8% over the last year. Oil (WTI) declined 24.8% during the quarter, yet is still up 3.2% for the year and 5.9% over the last 12 months.

The war in Ukraine and China's zero-Covid policy continue whipsawing the demand and prices of various commodities. Blistering heat and drought throughout the high plains and mid-west regions of the U.S. are also taking their toll. Similar to how drug companies collaborated to solve the Covid-19 vaccine challenge, agriculture equipment manufacturers, as well as seed, chemical and fertilizer companies will need to continue working together in pursuit of more yield from less land. Altering farming practices can also play a role.

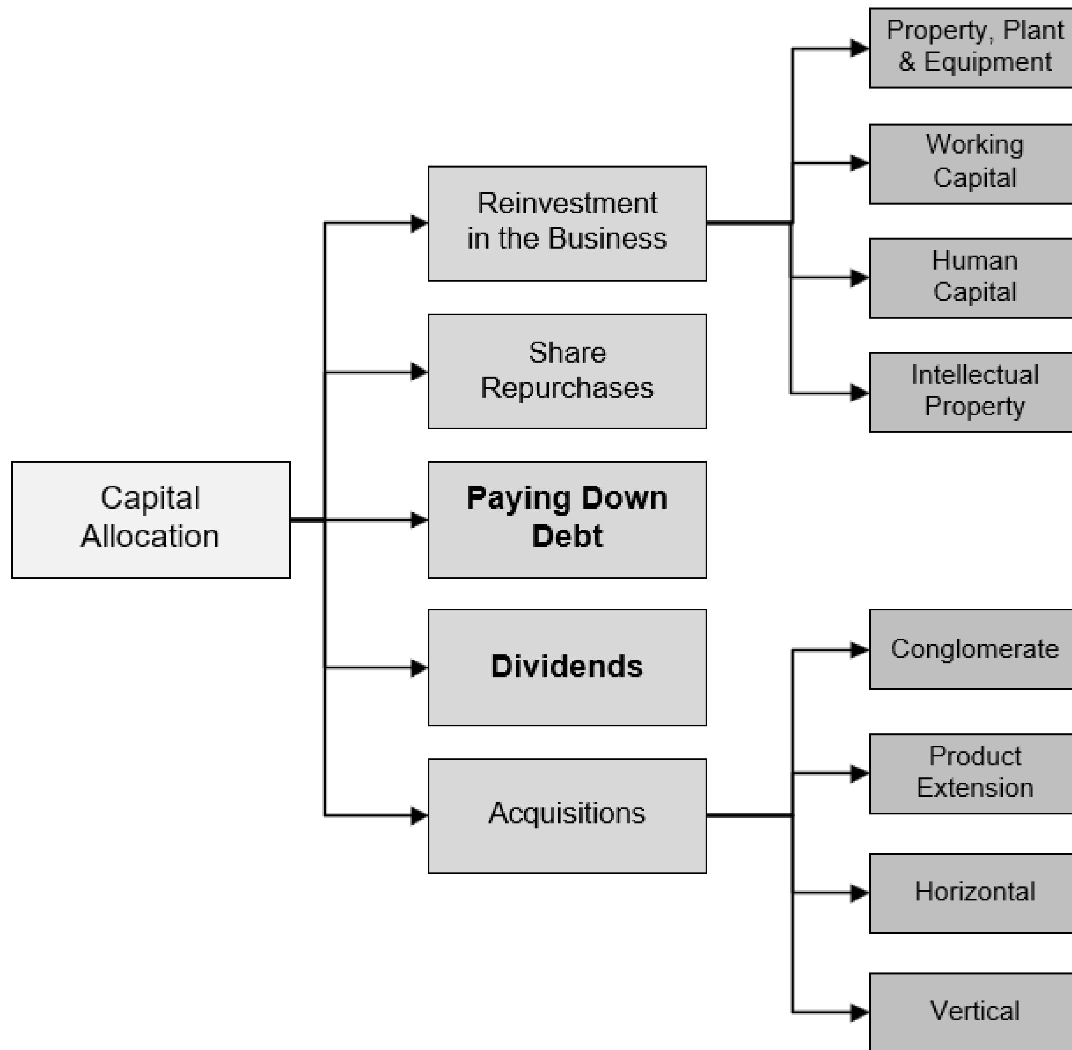
Capital Allocation Series

Capital allocation is the process of determining the most efficient investment strategy for a company's financial resources with the goal of maximizing shareholder value. This is the single most important function of a company's management team, in our view.

Too often, management allocates funds in a manner that destroys shareholder value. If resources are allocated to projects that produce returns lower than a company's weighted average cost of capital or WACC (i.e., an acceptable minimum rate of return on capital projects), the value of the company will eventually erode. On the other hand, when capital is effectively allocated year after year to projects that produce returns above the company's WACC, the magic of compounding takes place and shareholders are rewarded in the long run through additional corporate value creation. To illustrate, take a company that has $100 million of equity capital on its balance sheet and earns 15% on its capital for five years: By the end of year five, the company will have over $200 million ($100 x 1.15 x 1.15 x 1.15 x 1.15 x 1.15) of equity. Management's diligence and capital allocation decisions over that period caused the equity **to double**.

We prefer companies that first and foremost have durable competitive advantages (moats), but also leadership teams that understand the importance of successful capital allocation programs and the compounding effect they can have on value.

Along those lines, management teams have numerous "levers" to pull when allocating capital and pursuing their goal of maximizing shareholder value. We will cover each of these levers throughout this series: reinvestment in the business, share repurchases, paying down debt, dividends and finally acquisitions. Last quarter we discussed share repurchases. This quarter we dive into **paying down debt** and **dividends**.



Paying Down Debt

After reinvesting in the business and assessing share repurchases, paying down debt is the next logical capital allocation consideration. Reducing debt strengthens a company's balance sheet and reduces interest expense. When an economic storm blows in, overleveraged companies often collapse under the weight of their debt and interest expense. On the other hand, businesses with solid balance sheets are generally able to ride it out until the skies clear. Finally, many companies have variable rate debt, meaning interest expense fluctuates along with interest rates (assuming a static debt balance). In a period of rising interest rates (like the current environment), paying down variable rate debt can help reduce financial uncertainty.

However, it is important to recognize the benefits of debt by looking at a company's WACC. A company's WACC is a blend of its cost of equity and debt. Equity holders demand a higher return for their capital as they are lower in the capital stack; for this illustration we assume 15%. The cost of debt can be variable or fixed and is dependent on credit quality; let's assume 5% (the after-tax rate will be less due to the tax savings derived from deducting the interest expense thus lowering taxes owed).

Scenarios:

- Company A is 100% equity financed and a 15% cost of equity is assumed; therefore, company A's WACC is 15% (100% x 15%).

- Company B is 50% equity and 50% debt financed, resulting in a WACC of 10% (50% x 15% + 50% x 5%). By using debt financing, company B has a lower hurdle to earn an economic profit (i.e. returns above its WACC), but has increased its financial risk (relative to company A).

We generally view companies with little or no debt more favorably as they have a lower risk profile. However, it is also important to consider the benefits of debt financing like a lower WACC and potentially higher returns for shareholders. Of course, the prudent level of debt a company might employ is dependent upon the predictability of its revenue streams and margins.

Dividends

A cash dividend is a distribution by a corporation to its shareholders. Collecting dividends is great, but we prefer management exhaust opportunities to reinvest in the business before returning capital in the form of dividends. Paying dividends today can rob investors in the long run, as they miss out on the compounding on the cash distributed (and pull income tax liabilities forward). The table below illustrates the difference in after-tax cumulative returns over five years when comparing the reinvestment of profits (compounded) versus paying dividends (non-compounded) at 15% per annum.

		Initial Investment	Year 1	Year 2	Year 3	Year 4	Year 5	After-Tax, Net Cash Flow	After-Tax Cumulative Return
Capital Reinvested									
Capital Value		**$ 100**	$ 115	$ 132	$ 152	$ 175	$ 201		
Compounded Return	15%								
Cost Basis							$ (100)		
Capital Gain							$ 101		
Capital Gains Tax @	20%						$ (20.2)		
After-Tax Cash Flow								**$ 81**	**81%**
Dividends Paid Out									
Capital Value		**$ 100**	$ 100	$ 100	$ 100	$ 100	$ 100		
Non-Compounded Return	15%		$ 15	$ 15	$ 15	$ 15	$ 15		
Qualified Dividend Tax @	20%		$ (3)	$ (3)	$ (3)	$ (3)	$ (3)		
After-Tax Cash Flow			$ 12	$ 12	$ 12	$ 12	$ 12	**$ 60**	**60%**
Difference									**21%**

*Tax rate assumed on qualified dividends and long-term capital gains; non-qualified dividends are taxed at ordinary income tax rates.

Again, there is nothing wrong with collecting dividends as investors have "a bird in the hand" and can spend or reinvest those funds as they wish. However, all things being equal, we would prefer management exhaust their opportunities to reinvest in the business, assess the appropriateness of repurchasing shares and pay down debt to achieve the company's targeted capital structure before paying dividends as a means of rewarding shareholders.

We will wrap up our capital allocation series next quarter with acquisitions.

Looking Ahead

Equity markets are large discounting machines and often reflect "news" before it is printed. With monetary conditions tightening and the Fed's telegraphed willingness to sacrifice jobs in pursuit of price stability (i.e. inflation levels closer to its 2%, average, goal), economic headlines could be gloomy heading into year-end. The year-to-date compression in equity multiples suggests, however, a degree of bad news has already been priced into stocks.

It is in periods of market turmoil that good investments can transfer from financially weak hands to financially strong hands at bargain prices, setting the stage for above-average compounding over the subsequent 5-7 year period.

Past performance is not indicative of future results. Market and economic data have been provided by third party sources. This data, while believed to be reliable, has not been independently verified by EBS.