MARKET MINUTE
WITH McGAREL

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August 2022

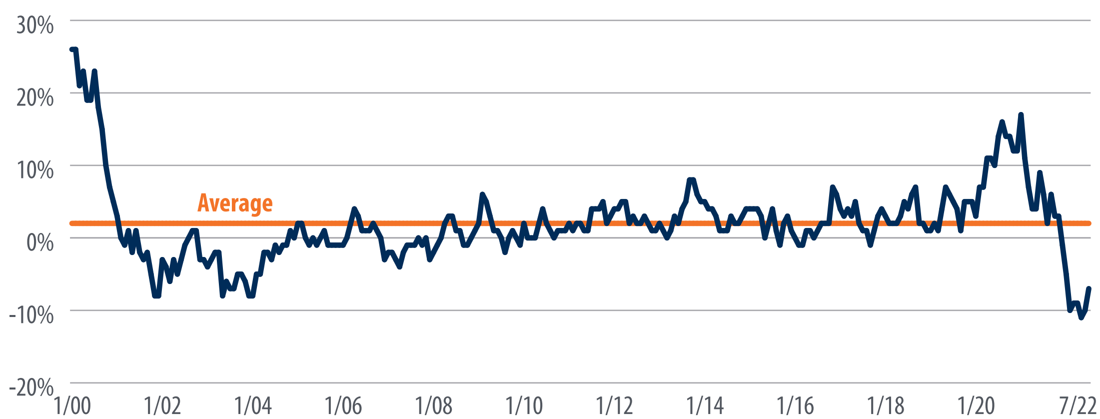
Think Quality.

If anything defined the Covid-19 investing landscape from April 2020 until the end of 2021, it's that the biggest winners were stocks or assets that defied traditional quality metrics. Instead, investors forecasted a future landscape substantially different from the past which traditionally rewarded companies on attributes such as growing cash flows, balance sheet strength, and attractive returns on capital. While the S&P 500 Index has fallen 12.6% for the year through July 31, 2022, the real damage has been done in some of those speculative assets that outperformed quality companies during the last 9 months of 2020 and in 2021. Meme Stocks, NFTs, and Crypto currencies, all declined significantly as the air came out of the areas that benefited from an environment primarily focused on outsized returns with a blatant disregard for the accompanying outsized risk that is inherent during a speculative period. In addition, those assets rely most on rosy forecasts of the future that are difficult to quantify. Bitcoin ended 2021 over $46,000 per coin and sits closer to $24,000 per coin on July 31st, down over 45%. NFTs, or non-fungible tokens, are digital images of an asset that procures unique ownership of that image. The Bitwise Blue-Chip NFT Collections Index has fallen nearly 50% this year. The Solactive Roundhill Meme Stock Index has also declined 50% this year.

The last time the market experienced a surge of speculative assets was the late 1990's during the tech bubble. While the speculation was mostly confined to publicly traded stocks, the companies that surged and then fell back to earth after the market peak in March 2000 share similar attributes to the speculative bubble this time around. Projections of massive end markets and unmitigated growth rates far into the future. A complete disregard for any fundamental based approach to valuation. Little to no concern for balance sheets and profitability. This time around, assets like NFTs and Crypto Coins don't even allow for fundamental analysis as there are no cash flows or balance sheets to bother with!

When speculative fervor ends, investors shift their mentality and seek shelter in assets that have the very fundamentals that had been given short shrift during the runup. Dividends, cash flows, and valuations become important again. In our opinion, we are at this stage today as higher interest rates and slower profit growth dictate a pivot to quality is in order for investors. The chart below, which uses return-on-equity to define the quality factor, shows that quality has become quite attractive on valuation. As investors realize the environment going forward is not likely to be conducive to speculating on assets that don't have real profits and/or traditional metrics to ascertain value, we think quality will provide one of the best ways to navigate the uncertainty in the second half of the year.

Quality Median P/E Premium/Discount to S&P 500 Index



Source: Bloomberg & Capital IQ. Monthly data is calculated from 12/31/99 to 7/29/22. The median monthly forward price-to-earnings (P/E) ratio is used for the premium or discount relative to the market. Forward price-to-earnings of a stock is the price divided by the estimated EPS for the next 4 quarters. The quality factor is comprised of the top 30% of stocks by return-on-equity from a universe of the largest 1,000 U.S. stocks with at least $1 million dollars in average daily volume over the last 3 months and 12 months of trading history. Chart is for illustrative purposes only and does not represent any actual investment. **Past performance is no guarantee of future results.**