Eubel Brady & Suttman

INVESTMENT + WEALTH MANAGEMENT

Investing in You

MARKET REPORT
SECOND QUARTER 2024

Key Points

- It was a tough quarter for many U.S. equity averages.
- We offer a refresher on value investing.
- Disparity in performance and valuations across market segments was notable.
- We continue our series on Risk vs. Uncertainty and the Decision-Making Process.

Total Return as of June 30, 2024						
			Annualized			
	QTD	**YTD**	**1 Yr**	**3 Yr**	**5 Yr**	**10 Yr**
S&P 500	4.3%	15.3%	24.6%	10.0%	15.0%	12.9%
NASDAQ	8.5%	18.6%	29.7%	7.8%	18.2%	16.1%
Russell 3000						
Index	3.2%	13.6%	23.1%	8.1%	14.1%	12.2%
Value	-2.3%	6.2%	12.9%	5.1%	8.9%	8.1%
Growth	7.8%	19.9%	32.2%	10.3%	18.6%	15.8%
Russell Mid Cap						
Index	-3.4%	5.0%	12.9%	2.4%	9.5%	9.0%
Value	-3.4%	4.5%	12.0%	3.7%	8.5%	7.6%
Growth	-3.2%	6.0%	15.1%	-0.1%	9.9%	10.5%
Russell 2000 (Small Cap)						
Index	-3.3%	1.7%	10.1%	-2.6%	6.9%	7.0%
Value	-3.6%	-0.9%	10.9%	-0.5%	7.1%	6.2%
Growth	-2.9%	4.4%	9.1%	-4.9%	6.2%	7.4%

A Review of the Quarter

U.S. stocks stumbled coming out of the quarterly starting gate, but some found their footing thereafter with a small number of large-cap growth companies dominating the field. Beyond that small lot, it was a different story with value, generally, and small- and mid-cap averages **declining** across the board (note QTD column in the table above). The S&P 500 **equal-weighted** index was also down during the quarter, declining 2.6% on a total return basis. Year-to-date, it increased 5.1%, **lagging** its cap-weighted comrade **by** 10.2%.

Fixed-income markets, in our view, continued being driven by Federal Reserve Policy expectations as market participants are waiting with bated breath for news of the first rate cut. Inflation moderated and was trending in the right direction as of quarter-end. Credit spreads (i.e., a corporate yield less a Treasury yield of equal maturity) remained **tight** during the quarter, seemingly leaving some fixed-income issues priced for perfection. As such, we **swapped** some corporate exposure for Treasuries in the EBS Income Strategy. The overall yield give up was minimal.

Value Investing, A Refresher

High spirits have infiltrated segments of the U.S. equity market, and many unseasoned investors seemingly perceive the current state of affairs to be normal, which it arguably is not. With that backdrop in mind, we offer a refresher on value investing, and more specifically, our approach.

So, what is value investing through EBS's lens? Value investing is a business-like approach to investing whereby we toil to determine the intrinsic or estimated value of a company and then incorporate a margin of safety (discount to intrinsic value). A margin of safety can serve as a buffer against unforeseen negative events or errors in judgement and helps reduce the risk of a permanent loss of capital – a key concept that is important to us and many of our clients.

Our approach to investing comes with a few strings attached, like: **a)** not participating in the latest fad, in exchange for a peaceful night's rest knowing that our time-tested investment process is being unwaveringly applied to your portfolio, **b)** acknowledging that stocks, and therefore markets, can and will likely become unhinged from fundamentals over short periods of time, but that over longer periods of time the price of stocks should track the intrinsic value of the underlying company, **c)** not allowing the availability of a daily market quote to influence our independent valuation work which considers longer time horizons, and **d)** understanding that our portfolios do not typically march in sync with the market, especially during the speculative phase of a market cycle.

When a stock trades below our estimate of intrinsic value and is attractive relative to other portfolio holdings, we are likely to purchase shares. Conversely, when a stock trades above our estimate of intrinsic value we will be focused on selling. Shares can sometimes trade below or above intrinsic value for extended periods of time before the gap is closed. The timing of the gap closure, in either direction, is unknown. This is the price of admission for stock investing.

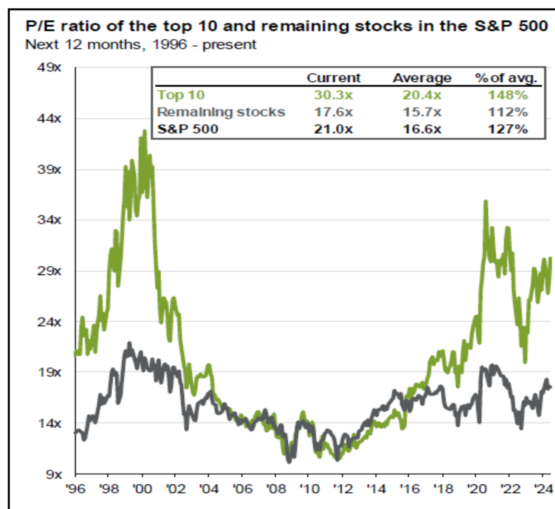
The aggregate emotion of a crowd can be and often is to the detriment of individual participants. If we made investment decisions based on wild guesses and emotions, you and we would be in serious trouble. We believe a sound investment process, rooted in fundamentals, is the best way to guard against the often-unwise pursuit of shiny objects sometimes discussed at cocktail parties and/or promoted by "influencers" on social media platforms.

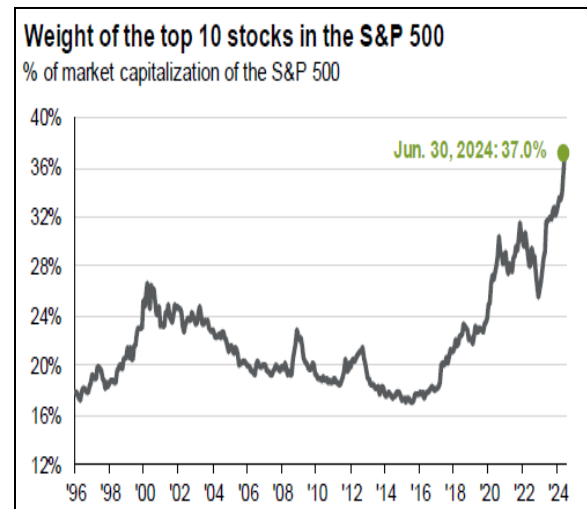
Value portfolios generally behave differently than the market. You might think of the portfolio in the context of a farming operation. Some stocks will rise faster than the market and/or the aggregate portfolio – they are "maturing nicely." Others will be dormant until the right conditions exist, and some may not germinate. However, because the operation

grows different crops and even different varieties of the same crop, the overall farming operation works well. We currently have a couple stocks in certain strategies that are dormant. If we determine that they may never germinate, we will plow them under and replant. It is unrealistic to expect every seed to germinate, which is why farmers plant multiple seeds proximate to one another to prevent “skips” in the row. We will, however, always strive for 100%.

U.S. Equities

The disparity in performance and valuations across market segments is notable, likely unsustainable and worth discussing. We provide context below (all charts sourced from 3Q 2024 Guide to the Markets):





The forward P/E of the S&P 500 remained elevated (21.0x) at quarter-end, putting it just over one standard deviation above its 30-year average (16.6x). Reviewing the **above chart on the left**, you will note that the P/E of the **top 10 stocks (30.3x)** relative to their average (20.4x) and the S&P 500 is high. The remaining stocks, sans the top 10, are closer to the long-term average.

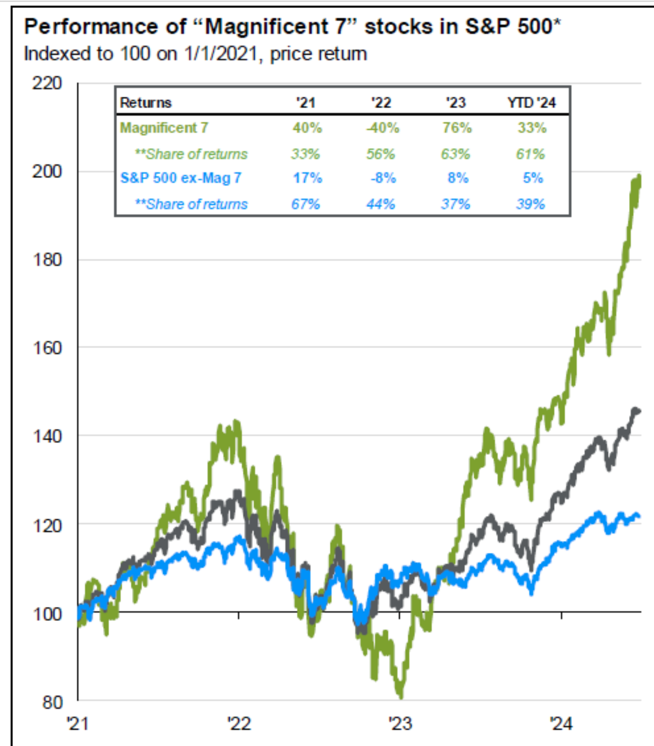
Moving to the **chart above on the right**, the **weight of the top 10 stocks** in the S&P 500 hit a **high, since ’96, of 37.0%** at quarter-end. The index was driven by a small number of stocks during the quarter that, on average, are rising faster than their earnings – resulting in multiple expansion (getting more expensive). The future compounded return of market averages, over an extended time horizon, is typically correlated to the starting P/E. The higher the P/E of the market average at a point in time, the lower the compounded return over the subsequent 5-10 years and vice versa. Unsuspecting investors in many passive large-cap strategies are taking on concentration risk that is seemingly expensive to boot.

The **chart on the right** takes the Top 10 and **narrows** the list to the so called "Magnificent 7." Returns by calendar year are listed in the **top row**, in green. Note '22's weakness when the market retrenched. In the **second row**, in green, note the **share of return** that this group of seven contributed to the overall return of the S&P 500. Sometimes it is helpful to think about things **in reverse**: In 2023 and year-to-date through quarter-end, **the other 493 (+/-) stocks** in the S&P 500 **contributed less than 40%** of the total return.

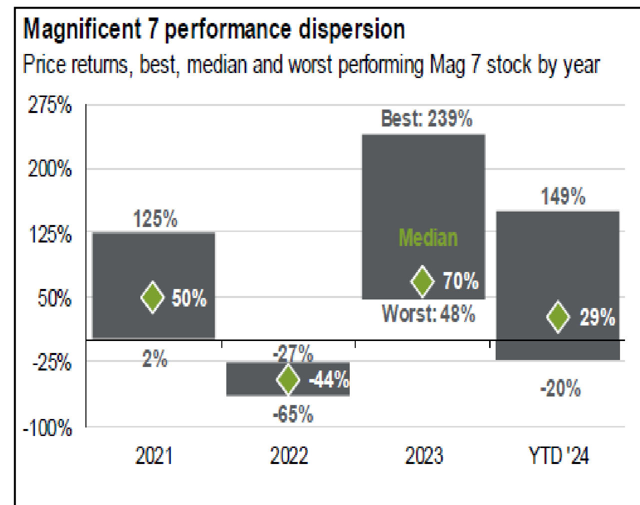
The S&P 500 return, **excluding** the "Magnificent 7," is illustrated in **the third row** in blue and paints a very different picture.

In addition to that small number of companies creating **concentration risk** within the S&P 500 and being expensive, on average, there is significant stock performance dispersion among them.

The **bottom chart on the right** illustrates the best, median and worst performing "Magnificent 7" stock by year (price change only). Note the wide range in absolute terms and relative to the median. A wild ride.

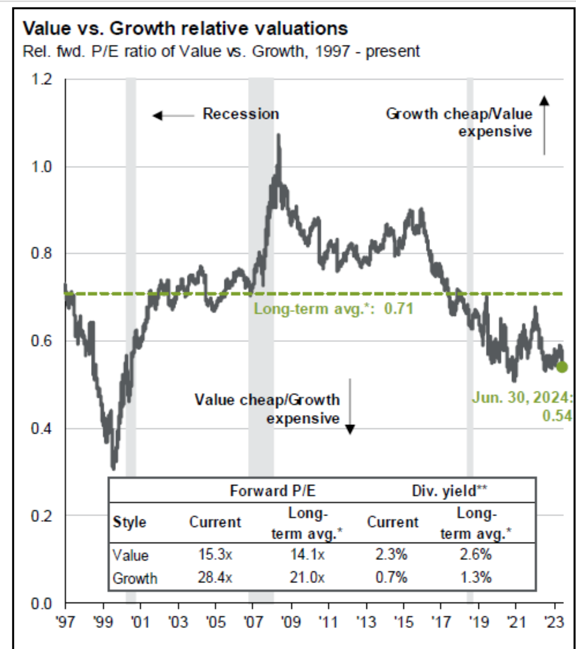


Returns	'21	'22	'23	YTD '24
Magnificent 7	40%	-40%	76%	33%
**Share of returns	33%	56%	63%	61%
S&P 500 ex-Mag 7	17%	-8%	8%	5%
**Share of returns	67%	44%	37%	39%



Given the ultra-high multiples that some of these companies trade at, any slowdown in growth may be met with a declining stock price or a stagnant stock price until the company grows into the valuation currently ascribed to it. Either scenario could easily play out if investor confidence is shaken.

Continuing with our theme of providing some market context, note the **relative cheapness** of "value" as compared to "growth" in the accompanying **chart to the right**. Since 1997, there have been only two other periods – '99-'00 and '19-'20 – during which markets were at such relative extremes. The '99-'00 period was the height of the "dot.com" large-cap growth peak.



	Forward P/E		Div. yield**	
Style	Current	Long-term avg.*	Current	Long-term avg.*
Value	15.3x	14.1x	2.3%	2.6%
Growth	28.4x	21.0x	0.7%	1.3%

Given the current statistical advantage, value is seemingly better positioned than normal. We like the odds of each discipline reverting to the mean over the next 5-7 years.

Fixed Income & Commodities

Corporate bonds' total returns, as measured by the ICE BofA U.S. Corporates 1-10 Yr. index, increased 0.8% during the quarter bringing the year-to-date total to 1.3%. U.S. Treasuries and Agencies, as measured by a similar index, increased 0.7% for the quarter bringing the year-to-date total to 0.3%.

As previously mentioned, we shifted a portion of the EBS Income Strategy from corporate issues into Treasuries given tight credit spreads. This should position us well to capitalize on corporate opportunities if credit spreads widen in the future. Within our EBS Income & Appreciation Strategy, convertible exposure was 51.6% at quarter-end. Convertibles meeting our criteria were more limited during the quarter, but the hunt continues.

Treasury yields rose during the quarter with the **2-Year** ("2s") increasing 10 basis points to 4.72% and the **10-Year** ("10s") increasing 8 basis points to 4.30% at quarter-end. With a **negative 42 basis point** (a basis point is $1/100^{th}$ of a percent) spread between 10s and 2s, the yield curve **remains inverted** (short-term yields above long-term yields). The inversion continued to set new records for length of time.

Commodities, as measured by the Bloomberg Commodity Index, increased 2.9% for the quarter and were up 5.1% year-to-date. Oil (WTI) decreased 2.0% for the quarter, but is up 13.8% for the year. OPEC production cuts continued to be balanced by non-OPEC countries, especially the U.S.

Risk vs. Uncertainty and the Decision-Making Process

This is the fourth piece in the Risk vs. Uncertainty and the Decision-Making Process series. Thus far we have covered:

- 2023 Q3 - Decision and outcome quality – the concept of Resulting or outcome bias. Determining whether a decision was good or bad based solely on outcome.

- 2023 Q4 – The differences between Risk and Uncertainty. Both involve unknown outcomes, but Risk's potential outcomes are known (known, unknowns). Uncertainty means all possible outcomes are not known or predictable (unknown, unknowns).

- 2024 Q1 – Types of Risks and the relationship between Risk and Return. The relationship is commonly misconstrued as more risk equals more return, when in fact more risk means a wider range of possible returns (including permanent losses of capital).

This quarter, we discuss Uncertainty's prevalence in everyday life, human beings' psychological relationship with uncertainty, and finally a focus on what does not change in an uncertain world.

Remember, **Uncertainty** pertains to unknown outcomes with unknown probabilities. We encounter Uncertainty every day, whether it be in our personal or professional lives. Circumstances in **retrospect** are plausible, but we would have no realistic expectation of **foreseeing** them. **For example**, it is possible that you are out for a walk and stumble upon a winning lottery ticket someone mistakenly discarded. Sure, crazier things have happened, but you'd have no reason to expect that scenario to occur when you began your walk.

Human beings are rarely comfortable with Uncertainty. Predictable and knowable outcomes are usually preferred. So, what happens when seemingly random things occur? Prior assumptions are **often ignored** and a story is made up to justify the events. In a world filled with Uncertainty, we are prone to hindsight bias or "knew it all along bias."

Hindsight bias is the **tendency to perceive** past events as more predictable than they really were. It helps justify events as inevitable and can also lead to overconfidence in predicting future events. For this reason, forecasting has been proven **unreliable**. No one can consistently and accurately predict future events. This is why we put little stock in economic, stock market, interest rate and company forecasts. They are data points for us to weigh, but we know there are many variables that could shift, impacting assumptions and altering outcomes. We focus on business quality, competitive advantages and a margin of safety, all of which should render short-term forecasts moot over time.

Uncertainty and change go hand in hand. The world is constantly evolving, and we should not expect it to stop. Prognosticators focus on where things are going, what's the next big technology (AI, internet, electric vehicles, etc.) or trend (remote work, fashion changes,

etc.). This makes sense, humans want to know what the future holds and how to adapt. **We should ask**, what do we expect to stay the same? Jeff Bezos once commented, "I never get the question, what is not going to change in the next 10 years?" Change (or lack thereof) **is weighed** in our investment process. We recognize Uncertainty as an important variable, but what can we reasonably predict will still be true in the future? No matter what the future holds, we can reasonably predict that food, shelter, transportation, technology and healthcare will still be needed down the road. In a way, these constants provide some margin of safety over the long-term.

In summary, Uncertainty is a fact of life. We must recognize some things are unknowable and unpredictable. Hindsight bias occurs when past events appear predictable. Forecasting is a tool that has a bad long-term track record. As such, a margin of safety can account for Uncertainty in forecasts and helps to minimize the risk of a permanent loss of capital. Finally, when factoring in Uncertainty, it is also important to recognize what variables likely will **not** change over time. **Next quarter**, we will discuss the concept of "Noise" and how it can cloud peoples' mindset.

Looking Ahead

With equity markets pricey and fixed-income credit spreads tight, a negative catalyst could lead to increased volatility. Volatility can create opportunities for long-term investors. We would welcome the chance to purchase deeply discounted shares from motivated sellers, thereby improving the price-to-value relationship within many of our equity strategies. On the fixed-income front, if a sufficient widening of credit spreads occurs, we should have an opportunity to reposition some of our Treasury holdings into higher yielding corporates.

The relative difference between growth and value valuations is likely unsustainable and a move toward the mean would be logical at some point. The very narrow market leadership – only a few large-cap companies driving returns – is also unlikely to be sustainable over time.

Enjoy the balance of your summer!

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.