Valuation 50 2021Q1

In the 1st quarter of 2021, the Valuation 50 returned 12.19%, vs. 6.17% for the S&P500 index, and 11.25% of the R1000 Value index. In the Valuation 50, 7 of the 11 sectors outperformed their S&P500 sector benchmarks while only Communication Services and Healthcare underperformed by more than 100 bps.

2021Q1 Top Contributing Sectors

The Valuation 50's top contributing sectors in the 1st quarter were: Consumer Discretionary, Consumer Staples, Technology, and REITs.

Consumer Discretionary**:** Outperformance in Consumer Discretionary was broad based with all five holdings outperforming their sector benchmark. Darden Restaurants (DRI) and LKQ Corp (LKQ) continued to lead the pack.

Darden Restaurants (DRI) reported much better FY20Q3 earnings and revenue than the consensus estimates - earnings were $0.98 per share on revenue of $1.73 billion, vs the expectation of earnings per share of $0.70 on revenue of $1.63 billion. In addition, Darden forecast FY20Q4 sales of $2.1 billion and EPS of $1.60 -$1.70, again easily surpassing the consensus estimates of sales of $1.94 billion and EPS of $1.25. Darden's focus on basics, and its success in leveraging its significant scale, extensive data and insights, and rigorous strategic planning, have resulted in an uninterrupted supply chain to support its operations, providing high certainty for operators, and implementing fast ramp up of digital operations during the pandemic era. In addition, management's relentless focus on simplification across all businesses has brought in significant productivity gains. Darden's companywide hourly labor productivity, for example, has improved by over 20%, with some brands improving by well over 30% such as Cheddar's. The simplification efforts are expected to result in a sustainable 150 bps margin improvement for Darden on only 90% of pre-COVID sales. Improved profitability will allow the company to open new restaurants across all brands. In short, Darden has emerged from the pandemic a truly stronger company, boasting promising potential for much better profitability and growth. Because of its confidence in its long term future, management raised the quarterly cash dividend to 88 cents a share, up from 34 cents, back to the pre-pandemic level, and announced a $500 million share repurchase program.

LKQ's 20Q4 earnings results also blew away expectations, with adjusted EPS at $0.69, vs. consensus estimates of $0.59. Revenues were $2.95 billion, above the expectation of $2.90 billion. Similar to Darden's efforts to pursue profitable revenue and margin expansion via simplification, LKQ has since 2017 shifted its focus from consolidating acquisitions to operational excellence including asset divestures. Those efforts paid big dividends in 2020, as despite revenue declines the company record higher annual earnings per share and its highest annual segment EBITDA margin for North America and the overall company since 2015. Free cash flow generated exceeded $1 billion, or nearly 8% of the company's latest market capitalization. LKQ's net leverage also dropped to 1.9 X, below 2 X for the first time since 2015. We expect LKQ' leadership position to allow the company's top line growth to return to positive territory in the current year, helped by the continuous reopening and recovery of the economies in the US and Europe. We believe LKQ's European business will reach double digit EBITDA margins soon, driving overall company profitability to a new high level.

Consumer Staples: Staples' outperformance was driven by Walgreens Boots Alliance (WBA) and Tyson Foods (TSN).

Walgreens (WBA) in early January announced its decision to sell the majority of its pharmacy wholesale unit Alliance Healthcare to AmerisourceBergen (ABC) to focus on its retail pharmacy and health initiatives. ABC will pay $6.5 billion for most of Walgreens's Alliance Healthcare unit, which sells medicines and other products to more than 115,000 pharmacies, hospitals and other facilities, mainly in Europe. Walgreens owns approximately 30% of ABC. Later in January, Walgreens also announced the appointment of Roz Brewer as CEO, who was COO of Starbucks at the time of the announcement. Prior to Starbucks, Ms Brewer was the president of the Sam's Club and worked at Kimberly Clark. Investors welcomed both sets of new as Walgreens is trying to emerge from the Covid induced traffic declines in the US and UK, and find new ways to drive growth and compete with pure online pharmacies. Walgreens' last two quarterly results were better than expected as the company delivered better execution across multiple fronts but in particular at its Boots business in the UK. From a big picture perspective, Walgreens is on track to deliver $2 billion in annual cost savings by FY22, and has invested heavily to restructure its retail offerings and accelerate its digital revolution. Very importantly, Walgreens has sharpened its focus on the partnership with VillageMd, planning to host 500 to 700 VillageMd primary care clinics in its stores across more than 30 U.S. markets within the next five years, including 40 by the end of the summer. This is an important step for Walgreens to diversify away from being a retail, pharmacy company to being a comprehensive healthcare provider. That said, we are still in the early innings and we look forward to hearing the new CEO's vision on more ways to differentiate Walgreens and continue its tech-enabled transformation.

Tyson Food (TSN) benefited from positive sentiments towards the reopening of the food services industry, which accounted for nearly 30% of its pre-pandemic sales. In addition, chicken prices have risen in the past months. Together with the food services industry recovery, Tyson could gain better leverage at charging higher prices to help offset notable inflation in grains, freights, and labor, delivering better profits this year.

Info Technology: Technology's outperformance was mainly driven by HP Inc (HPQ), Intel Corp (INTC), and KLA Corp (KLAC). Both HPQ and Intel likely benefited from their perceived "value" classification, as Value significantly outperformed Growth tech names in the quarter. However, the companies also delivered commendable results at the corporate level.

HP (HPQ) reported strong FY21Q1 results with both revenues and earnings easily beating expectations. The company exceeded expectations for both PCs and Print, as work-from-home and remote-learning trends continued to drive strong hardware needs. It is particularly encouraging that printing supplies which account for nearly 60% of print revenues, returned to year over year growth of 4%, after two very difficult years, driven by double-digit growth in Instant Ink subscriptions, which surpassed 9 million subscribers. Expecting free cash flow generation of at least $4 billion this year, vs. its latest market cap of $40 billion, HPQ still boasts a tremendous FCF yield, and management plans to return all FCF to shareholders in the form of share repurchases (at least $4 billion) and dividends (approximately $1 billion) in FY2021.

Intel (INTC) in mid-January reported 20Q4 results that handily beat analyst expectations: adjusted earnings were $1.52 a share on sales of $20 billion, compared to expected EPS of $1.10 on sales of $17.49 billion. Outlook for FY21Q1 is also significantly better than the consensus: Guided adjusted EPS was $1.10 on sales of $18.6 billion, vs. the consensus estimates of 93 cents EPS on sales of $16.06 billion. More importantly, Intel in February replaced its CFO turned CEO Bob Swan with a technology-focused executive Pat Gelsinger, who was CEO of VMware and a 30 year Intel veteran including holding the role of chief technology officer. Since taking the helm on February 15, Mr. Gelsinger has been quick at work and provided a business update on March 23 laying out a new vision for Intel. Intel would restart Intel Foundry Services and spend $20 billion to build two manufacturing plants in Arizona. Mr. Gelsinger characterizes the new business plan as a commitment to long-term manufacturing, but with a unique strategic view for Intel to build the majority of products internally, leverage external foundries, while becoming a foundry for the industry at the same time. Mr. Gelsinger believes the new three legged approach is very differentiated, and would allow Intel to have leading products, the cost leadership, and the supply resilience and flexibility that nobody else can offer in the industry. We concur with the view that the renewed commitment to using Intel's own plants is a strategic necessity, which differentiates intel from rivals such as Advanced Micro Devices (AMD) that uses third-party foundries to make chips. In addition, the move fits into the desire of various governments around the world including the US to have a more balanced semiconductor supply chain. The U.S. government is very interested in securing domestic semiconductor manufacturing supply and regarding it as a national security issue. Separately, Mr. Gelsinger reiterated earlier statements from Intel executives that the company's issues with the 7-nanometer chips were behind the company. We believe Intel's latest decision is bold but not earth shaking as the company tried the foundry business before. Therefore the key this time, is really about commitment and execution. This time around, Intel is creating a separate subsidiary for the relaunched foundry attempt, and will be offering industry-standard tools and equipment, so its potential customers won't have to use Intel design rules or tools to make their chips. The new CEO understands the critical importance of execution in revitalizing Intel's leading position in manufacturing and has pledged to bring back a "Grovian culture," a reference to Intel's former CEO Andy Grove, and "execute, execute, execute." We remain very hopeful Intel's franchise will be resilient and flexible enough to adapt and succeed in this new era, especially with the leadership of the new CEO and a keen focus on execution.

KLA (KLAC) benefited from the positive sentiments towards the semiconductor industry, due to the semiconductor shortage. While chip makers enjoy the tailwind of strong demand and higher chip prices they have to deal with the headache of constrained manufacturing capacity. With chip makers rushing to increase capacity, semiconductor equipment makers such as KLA are well positioned to capitalize on increased equipment budget. INTC's recent capex boost ($20 billion capex on two plants in Arizona) and additional boost from TSMC ($100 billion on new production facilities as well as R&D over the next three years), to name a few, provide mid to longer-term boosts for semi-equipment vendors such as KLA. In addition, various governments are looking at the scanty homegrown chipmaking plants as a national security risk and are ready to provide funding to build up chipmaking capability.

REITs: In a similar fashion, Host has emerged from the most challenging year in the lodging history as a stronger company with a streamlined operation model, higher profitability potential, and robust long-term growth prospects. Assuming the inclusion of corporate level expenses for interest and G&A, HOST would breakeven at occupancy levels of 45% - 60% at Average Daily Rate (ADR) decline levels of 15% - 30% from pre-pandemic levels. With the vaccine roll out on track and green shoots emerging in leisure and business transient demand, HOST management has turned its eyes to growth, convinced the industry is at the beginning of the lodging cycle. With $2.5 billion of total available liquidity on hand entering 2021, HOST has ample capital to deploy and just bought Hyatt Regency Austin in March for $161 million with cash. This acquisition was executed at attractive pricing, with the purchase price representing a 10% capitalization rate and an 8.8X EBITDA multiple based on 2019 actual result, which reflects a 20%- 25% discount relative to pre-COVID pricing. Management expects this acquisition to raise the company's EBITDA growth profile, while positively enhancing the company's geographic diversification by adding to the attractive Austin market. This is also the first acquisition after management expanded its acquisition focus to include urban markets beyond the top 25 ones that offer higher portfolio EBITDA and revenue. We believe the future is bright for Host.

2021Q1 Top Detracting Sectors

On the detracting side, Valuation 50's Communication Services and Healthcare holdings led relative sector underperformance.

Communication Services: Verizon Communication (VZ) and The Walt Disney Company (DIS) led underperformance.

Disney (DIS) shares were flat in the quarter as the stock took a breather from an impressive run in 2020 (more than doubled from its March 2020 low), thanks to the enormous success of its streaming business, which gained more than 100 million subscribers in a little more than a year. Disney, however, should also benefit from the reopening of the economy, as its very profitable theme parks, hotels, and cruise ships businesses that suffered during Covid, will thrive from the pent- up demand for travel and leisure.

Verizon (VZ) reported lackluster 20Q4 results and its guidance for 2021 was just in line with the analyst consensus. In late February, Verizon spent $45.4 billion winning an expensive auction for a mid-band wireless spectrum it can use to build out its 5G networks to compete with T-Mobile. T-Mobile already had a substantial amount of mid-band spectrum, obtained through its purchase of Sprint. This expensive purchase will constrain Verizon's balance sheet until expanding revenue and EBITDA growth from the newly acquired spectrum enable more rapid debt reduction beginning in 2023 and beyond. While it is unfortunate the spectrum purchase is a lot more expensive than the initial expectation, it is a necessary purchase which ensures Verizon's long-term competitiveness. It also helps that Verizon is on track to remove $10 billion of annual costs from its business through year-end 2021. We will closely monitor Verizon's progress in monetizing its new spectrum assets and execute on its growth strategy.

Healthcare: The strategy's big pharma holdings underperformed the sector including Pfizer (PFE) and Merck (MRK).

For Pfizer (PFE), there was some disappointment in its Covid Vaccine profitability, as $4 billion additional expected sales from its Covid vaccine in 2021 will likely add only 10 cents per share in incremental earnings, according to management's latest forecast. Overall, we believe Pfizer should be able to deliver on its long-term revenue CAGR target of mid-high single digit growth, and the agility it has displayed in developing and manufacturing its highly successful Covid vaccine using the new messenger RNA technology proves Pfizer's ability to execute. In March, Pfizer announced plans to test a coronavirus treatment pill in healthy adults and to push deeper into mRNA vaccines.

Merck's (MRK) 20Q4 results missed expectations slightly though its 2021 guidance was above the consensus estimate. Keytruda delivered another standout quarter and now accounts for nearly 40% of Merck revenues. With Keytruda's extraordinary success, there comes growing concern about what is Merck's next act, given Keytruda now represents a concentration risk and faces competitor headwinds in the mid-term. Separately in early February, Merck announced its intention to spin off its women's health and off-patent drugs into a new standalone business to be named Organon, in the first half of 2021. Organon generated $6.5 billion in global revenues in 2020, or 13.5% of Merck total revenues, with about 75% of its sales generated from outside the U.S. Merck expects the spin off to save the company $1.5 billion a year by 2024 while the "Remain Corp" will focus on oncology, vaccines, hospital and veterinary drugs. This spin off follows similar moves by Pfizer which spun off its generic and off patent drugs business last year, but received a largely lackluster reception from investors, who seem more interested in M&A and growth opportunities.

Thermo Fisher Scientific (TMO) also underperformed due to continued unfavorable sentiments towards Covid beneficiaries – the company is one of the biggest covid test providers. That said, TMO is actively involved in covid vaccine/antibody bioprocessing and manufacturing, and its 2021 guidance calls for ~$7 billion in covid related revenue, as well as +7% base business growth, which would translate into a two-year base business annualized growth of 3-4%, a respectable performance for its non-covid products given the ongoing pandemic impact worldwide.

Looking Back, Looking Forward

In Q1, The Valuation 50 returned 12.19%, outperforming the SP500 by 602 bps, and the R1000 Value by 94 bps.

There is no easy way to properly describe the market movement of the past 14 months, which has undergone three extraordinary phases. The 1st phase was a quick, drastic, and indiscriminate sell off of equities across the board. The 2nd phase was a sharp move towards high profitability, high growth firms. The current and 3rd act ushered in a move towards low multiple "value" stocks. While most of the investment community had been sounding the alarm that "value" was significantly undervalued relative to growth for years, we disagreed. However, by September of 2020, from an intrinsic value perspective, "value" finally did become statistically undervalued relative to growth. (Valuation Analysis – Time to Reconsider Large Cap Value & Growth Allocations)

Given the intrinsic valuation disparity that existed between "value" and "growth" companies in the large cap space, we are not surprised at the transition to value stocks since last fall. Since the beginning of November, the Russell 1000 Value has outperformed the R1000 Growth by nearly 15%, offsetting part of Value's underperformance in the first 11 months of 2020. Value's outperformance was driven by the traditional cyclicals - the Energy and the Financials, due to Value's heavy exposure to the two sectors. Both sectors extended their extraordinary outperformance in 20Q1, thanks to continuously rising oil prices and steepening yield curve. In fact, the surge in commodity prices has been very broad, beyond the crude oil. Almost all commodity prices are higher in 2021Q1 versus a year ago and pre-pandemic 2019Q4, including energy (coal and natural gas); agricultural products (coffee, tea, coconut oil, fish meal, rice, soybeans, sugar); raw materials (logs, cotton and rubber); fertilizers; and industrial metals (copper, aluminum, iron ore, lead, nickel, tin and zinc), literally everything. Partly because of surging commodity prices, investors have expressed growing concerns over inflation, pushing the 10 Year US Treasury yield to ~1.7%, up from 0.92% at the end of 2020.

A result of COVID lockdowns and the tremendous monetary and fiscal stimulus unleashed by governments around the world, is consumers in the world's largest economies amassed $2.9 trillion in savings during COVID-related lockdowns, including nearly $1.6 trillion in the US alone. While those enormous savings are yet to be spent, the Biden administration passed another $1.9 trillion rescue bill in February, which for sure will turbocharge the economy in the near term. The Fed now expects the US economy to grow 6.5% in 2021, up from December's 4.2% expectation, and some economists expect 2021 US GDP to grow as much as 9%. Is higher inflation in order? For sure. Higher inflation concurrent with above average economic growth should be ok, however. The question is will inflation get out of hand, with economic growth stalling in the mid-term future, reviving stagflation?

The Fed has been trying to assure us higher inflation is expected in 2021, but that it will be transitory. The Transitory Inflation camp argues that technology advancements and productivity gains will continue to play the role of a secular deflator, to help offset labor cost increases if there are any. Given that the unemployment rate is still nearly 2.5% higher than the pre-pandemic level in the US, the labor market still has slack rather than being an inflationary concern. Then there is housing. Home prices have been on an upward trajectory but home ownership is regarded as an investment and the home as the asset. It is house rental prices that are counted in determining inflation. House rental rates have been falling and will take a while to recover. Lastly, the cost of capital. The belief is with the Fed committed to keeping the Fed fund rates at near 0 until 2023, the cost of capital can't be a systematic inflator in the foreseeable future, people argue.

These are obviously very complicated issues, and the Fed is not the only one having a say. The 5-year breakeven inflation rate, which implies what the market thinks the inflation rate will be on average over the next five years, reached ~2.5% in March, its highest level since July 2008. Maybe this time the US economy will reach the Fed's inflation target of 2% in a sustainable way? But will the economic growth also stay at a healthy 3% to justify 2% inflation?

A significant number of economists argue the last rescue bill of $1.9 trillion passed in February, might be wasteful as it will have a limited multiplier impact on the economy, since it is unleashed at a time when the economy is already expected to fire on all cylinders. Despite the limited bang for the buck, US federal debt will surpass 130% of GDP in 2023 and increase further thereafter. Higher interest rates will simply make high debt levels materially worse at the federal level. Then, there is a relatively high possibility that the US will undergo the largest tax increase in history as soon as later this year.

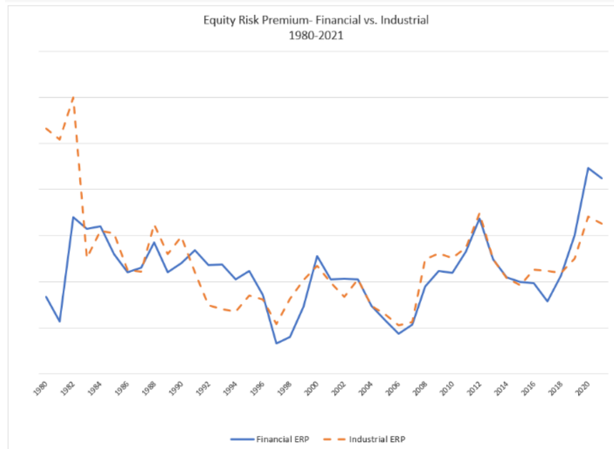
The Biden administration just announced its tax reform proposal, which calls for the US corporate tax rate to grow from the current 21% to 28%. US personal income taxes on individuals and households that earn over $400,000 annually will also be raised to 39.6%. Capital gains tax for individuals who make over $1 million annually will go up as well. Tax rate hikes will almost undoubtedly result in economic growth deceleration, job reduction or at least less job creation. The last time the US underwent a large tax hike was in 1993 when President Clinton signed omnibus legislation that raised the gasoline tax and increased the top marginal income tax rate by one-third. From 1993 to 1997, the US economy grew at 3.3% per year, below potential and real wages declined at 0.06% a year. The backlash cost Democrats control of Congress and swept in the first Republican majority of the House in 40 years. The economy began to expand faster in 1997 after Congress passed a tax cut, which reduced the capital gains rate from 28% to 20%. From 1997 to 2000, the US economy grew at an annualized rate of 4.4%, and real wages grew 1.7% per year. While tax policies in the Clinton years were not the only reason behind the economic growth discrepancy in his 1st and 2nd term, they certainly played an important role.

While the vaccine-driven economic reopening, alongside the $6 trillion deficit financed spending, will turbocharge the US economy in the coming 1-2 years, side effects may result in high inflation, asset bubbles, and even fiscal crises. It is indeed concerning a historically high tax increase might be implemented at a time when the economy is entering some new kind of unchartered waters. It is pure math that higher corporate taxes will increase the cost hurdle of starting and operating businesses. Raising personal income taxes and capital gain taxes will reduce companies' ability to raise funds for new investments due to higher required rates of return by investors.

It must be noted the Biden administration is marketing the tax hike proposal as the means to fund an ambitious infrastructure package that will cost $2.1 trillion in its first phase. We support infrastructure spending and believe true, smart infrastructure investment is critical to sustain America's competitiveness in the global economy. The details of the infrastructure bill, however, seem to reveal a rather limited percentage of the spending actually fits the commonly accepted infrastructure project definition. If that is indeed the case, this "infrastructure" package likely can't justify a meaningful tax hike, let alone the biggest tax increase in American history.

Can a richly valued US large cap equity market cope with the prospect of higher inflation, higher borrowing cost, and higher taxes? From a discount rate perspective, Applied Finance's median Market Derived Discount Rates (MDDR) for industrial firms in the past 13 years (from 2008 to 2020) is nearly 60 bps lower than the median from 1980 to 2020. Interesting enough, incorporating the 10 Yr US Treasury yield into our MDDR calculation, the median Equity Risk Premium (ERP) per our estimates, is nearly 60 bps higher since the financial crisis than the median in the past 4 decades. Some say low treasury yields are actually the reason behind a high ERP, as low yield suggests a potentially volatile macro-economic environment with low growth implications. Therefore, should the ERP decline with higher yields? Maybe it will if higher yields reflect a vibrant economy that grows at faster real rates? Maybe it won't if higher yields reflect higher inflation without better economic growth? From a cashflow perspective, higher tax rates will result in lower earnings and cashflows, everything else constant. Companies in different industries and with different market positioning will have different abilities to pass higher taxes to employees and customers to potentially keep earnings and cash flows intact. However, we don't expect that the overall economy can deliver the same or higher growth rate in a higher tax rate environment.

In our last quarterly review, we discussed Financial firms' ERP being ~8.9% in nominal terms, their highest point since 1980. Everything else equal, Financials appeared to be more attractively priced than the industrial firms. Three months later, Financials still command an ERP of ~8.5%, Together with a steeping yield curve and growing economy, Financials probably enjoy better protection against inflation thanks to their growing earnings power and hefty implied ERP, relative to their Industrial counterparts.



*Applied Finance Research Data

We believe the Valuation 50's holdings have navigated the Covid 19 induced economic volatility fairly well, and they are well positioned to perform strongly during the reopening, economic growth phase of the foreseeable future. We stressed in our 20Q4 newsletter that over longer time horizons, since the mid-90s, Large and Growth factors have not consistently generated alpha. This observation was quickly proven true YTD, as Large and Growth significantly lagged Small and Value. While those traditionally defined style factors are helpful in explaining short term performance, we believe in the long term, it is valuation that delivers alpha. The Valuation 50 is a Valuation Driven strategy seeking outperformance by investing in companies with attractive valuation and sustainable operational advantages. The Valuation 50 is unbound by conventional style labels and has outperformed the SP500 by almost 140 bps a year since its inception in June 2004. In the year ahead, we expect to gain greater clarity on companies' future prospects and we plan to perform valuation stress tests to understand the intrinsic value resilience of companies in our portfolio given a higher interest/tax rate environment. We will continue to focus on companies' fundamentals and their valuation attractiveness.

Valuation 50 Changes in 2021Q1

- No changes. We are still holding on to Alexion Pharmaceuticals (ALXN) which has agreed to be acquired by AstraZeneca (AZN) in December. We intend to replace ALXN before the acquisition's expected completion in 21Q3.

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