**Valuation 50 2024Q1 Commentary**

By *Jun Wang, CFA*

In the 1st quarter of 2024, the Valuation 50 returned 9.44% vs. 8.98% for the R1000 Value and 10.56% for the S&P500.

**2024Q1 Top Contributing Sectors**

Despite the overall underperformance, the Valuation 50 outperformed the SP500 in 9 of the 11 GIC sectors in the 1st quarter, with InfoTech being the only notable detractor. The Valuation 50 delivered impressive outperformance in Communication Services, Industrials, Financials, and REITs.

**Communication Services**: Meta Platforms (META) and Walt Disney Company (DIS) were the top performing stocks in the strategy.

Meta Platforms (META): Meta shares performed very well in Q1 after the company reported 23Q4 profit that tripled y-o-y to $14 billion, and issued its first-ever dividend, a rare step for a company still in a high growth phase. 23Q4 revenue also rose a strong 25% to $40.1 billion from a year earlier, the fastest rate of growth since mid-2021. Further, management forecast 24Q1 sales to be $34.5 to $37 billion, much higher than the $33.8 billion expected by analysts.

Meta's impressive quarterly results and guidance suggest the company is experiencing healthy engagement trends and improving monetization. The company's advertising revenue will grow significantly above the 9% industry average this year, as it captures more share of incremental advertising growth dollars. 2024 will be the year for Meta to start scaling generative AI ad tools to supplement its already best-in-class Advantage+ product suite, and the company plans to spend between $30 to $37 billion in infrastructure projects this year so it has the hardware needed to train and run AI systems.

The Walt Disney Company (DIS): Disney in early February reported 24Q1 earnings that beat expectations with narrowed streaming losses and boosted its cash dividend by 50%. Disney has made notable progress and is on track to achieve its near-term financial objectives including securing $7.5 billion annualized savings and reaching profitability in streaming segment by 24Q4. Importantly, management affirmed its double-digit longer-term margin target for the streaming business, citing plans to crack down on password sharing and creating bundles to reduce churns.

In a little over a year since Bob Iger returned to the CEO role, Disney has undertaken important steps to adapt to the evolving landscape, with actions such as the JV announcement with Warner Brother Discovery and Fox regarding a new sports app, reiterating ESPN's flagship product launch in 2025, increasing creative focus on films by shaking up its movie studio executive bench, accelerating investments in theme parks for the next 10 years, and expanding into gaming with an investment in EPIC games.

In recent weeks, Disney and the state of Florida reached a settlement to end litigation over the company's long-standing special tax district, ending a multi-year overhang. In addition, Disney prevailed in a highly contested, months long proxy battle between the company and its CEO Bob Iger against activist investor Nelson Peltz in Peltz's quest to secure board seats at Disney. Disney still has a long way to go in its journey to return to the "Disney Magic" of old, but we are encouraged by the latest progress. Management is in much greater control of challenges facing the company and has a more clearly defined vision about the future.

**Industrials**: United Rentals (URI) and Quanta Services (PWR) were the best performing stocks in the sector.

United Rentals (URI): United Rentals in late January reported 23Q4 earnings of $11.26 a share on revenue of $3.7 billion, vs. analysts expected earnings of $10.76 a share on revenue of $3.6

billion, capping a year of record revenues and profits. In addition, management issued 2024 revenue guidance ahead of Wall Street estimates and announced increased shareholder returns. 2024 revenue would be $14.7 to $15.2 billion, up from $14.3 billion in 2023 and above analysts' estimates of $14.2 billion. The company would repurchase $1.5 billion of common stock in 2024 (up from $1 billion in 2023) and raised its quarterly dividend by 10% to $1.63 a share.

URI management is very confident in delivering continued growth in 2024, citing the company's strength on large projects. Management also sees opportunities across its business as the company leverages its competitive advantages to outpace the market. Very importantly, management will continue to focus on profitable growth and strong free cash flow generation rather than growing for the sake of growing. It also lowered the targeted full-cycle leverage range to 1.5x-2.5x, from 2.0x-3.0x, again showing prudence in operating the business through cycles.

Quanta Services (PWR): Quanta Services in late February reported higher than expected 23Q4 profits, led by sustained demand from the renewable energy sector for its engineering and construction services. The rise in demand is largely a result of the 2022 Inflation Reduction Act (IRA), which provides tax credits to wind, solar and renewable energy companies, as well as electric vehicle makers. On an adjusted basis, Quanta reported a profit of $2.04 per share, beating analysts' average estimate of $1.98 per share. Total revenue surged nearly 31% to $5.78 billion, beating estimates of $5.18 billion, and Quanta's renewable energy segment reported a two-fold jump in quarterly revenue to $2.03 billion. Management expects adjusted earnings for 2024 to be $8.00 to $8.50 per share, compared with analysts' estimates of $8.42 per share, and FY24 revenues of $22.25 to 22.75 billion vs. $22.02 billion expected.

Quanta completed a year of record revenues, profits and cash flow, and maintained a solid balance sheet that positions the company well to invest for the future to consistently deliver multiyear of organic growth. Its 2024 expectations reflect continued growth in revenues and double-digit growth in adjusted EBITDA, adjusted earnings per share and free cash flow. Demand is strong for the company's solutions that support customers' energy transition initiatives, and management is increasingly excited and confident about the opportunity to drive multi-year revenue and double-digit EPS growth.

**REITs**: REITs were the worst performing sector in the S&P500 in 24Q1, as rising long-term interest rates dampened property values and derailed property transactions.

On the other hand, the resilience of the economy, strong wage growth, low US unemployment rate, and strong corporate earnings continue to support a healthy leisure business. When Host reported its 23Q4 results in February, management forecast its 2024 revenue to be higher than Wall Street estimates, anticipating a continued recovery in demand for business travel, especially from small- and medium-sized enterprises. Management expects 2024 revenue between $5.59 and $5.74 billion, compared with expectations of $5.49 billion. It also expects 2024 adjusted funds from operations (FFO) to be $1.92 and $2.04 per share, compared with expectations of $1.94 per share. Separately, Host increased its quarterly cash dividend by 11% to $0.20 per share, returning to the pre-pandemic quarterly dividend level, and declared a $0.25 special dividend.

Valuation 50's InfoTech underperformed its sector peers notably in Q1.

**InfoTech**: Adobe (ADBE), Apple (AAPL), and Intel (INTC) are the main detractors for the sector.

Adobe (ADBE): Adobe's stock suffered after the company beat 24Q1 estimates but delivered a light 24Q2 revenue forecast. Adobe posted adjusted 24Q1 EPS of $4.48, above the $4.38 analysts were expecting and revenue of $5.18 billion which exceeded the $5.14 billion estimated. For 24Q2, Adobe expects adjusted EPS of $4.35 to $4.40, vs. expectation of $4.38. It said revenue will total $5.25 to $5.30 billion, slightly below the $5.31 billion estimated.

Investors were disappointed in Adobe's less than robust financial results and outlook given the company is widely regarded as an early AI beneficiary. Though revenue and profit growth momentum might be slightly soft in the near-term future, we continue to appreciate Adobe's approach to AI which focuses on product safety and customization. Adobe uses proprietary data and has the right to use that data so enterprise customers should take comfort in its IP friendly approach. In addition, Adobe is allowing customers to incorporate their own branded products, images and logos into its generative AI systems. It is still very early in the AI age, and Adobe's focus remains on driving usage

and adoption, with significant monetization likely to happen later after reaching a critical use threshold. Adobe also appears to enjoy breath of AI monetization opportunities, across many products and many business dimensions such as price, quantity, and value-added offerings. The company has created end-to-end workflows around content creation, marketing, and analytics. It will soon offer video, audio and 3D model creation tools, in addition to its photo, illustration and text creation tools. Overall, we feel confident about Adobe's growth potential, and we believe its shares are attractively priced.

Apple (AAPL): Apple encountered a few big challenges in the quarter, with the DOJ's antitrust lawsuit filed against the company leading the list of potential road bumps ahead. The DOJ lawsuit alleges that Apple illegally maintains its dominance over the smartphone market by boxing out competing apps and devices. Apple said it would fight the lawsuit. The DOJ's suit comes just weeks after the European Commission (EC) fined Apple $2 billion for allegedly breaking competition laws in the bloc. Also in the quarter, Apple announced the termination of its decade long automotive efforts, after investing billions. Lastly, there was report suggesting Apple's iPhone sales in China might have fallen 24% year-on-year in the first six weeks of 2024, while its chief competitor in China in premium smartphones, Huawei, saw unit sales rise 64% in the period.

With the smart phone market being choppy, investors are eagerly anticipating a fully redesigned iPhone, with generative AI being the big new opportunity. Apple's AI efforts will likely be unveiled in June at its annual developer conference, and expectations are high that a host of new AI software features will be launched to catalyze a meaningful iPhone upgrade cycle later in the year.

Intel (INTC): Intel stocks under-performed in the first quarter after it reported 23Q4 results that topped estimates but missed badly on analysts' first quarter projections. For 24Q1, management said it anticipates earnings per share of $0.13 on revenue of between $12.2 billion and $13.2 billion. Analysts were looking for $0.34 per share on revenue of $14.2 billion. Analyst estimates might have included ~$1 billion revenue from "non-core" businesses, including subsidiaries such as Mobileye, Altera the programmable chip unit which will be spun off, as well as revenue from other businesses the company has spun off or sold. Management insists the core business is healthy with no areas for market share loss and the products are getting stronger.

Intel achieved notable progress in 2023 on its multiyear long transformation, as the company drove more consistent execution and accelerated innovation, resulting in better customer momentum for its products. 2024 will remain a transitional year as Intel needs to continue to relentlessly focus on achieving process and product leadership, continue to build external foundry business and at-scale global manufacturing, and execute its mission to bring AI everywhere (enabling customers' AI solutions everywhere across the data center, cloud, network, edge and PC.)

Just last week, management laid out a long-term financial target for Intel Foundry: operating losses to peak in 2024, achieving break-even operating margins midway between now and the end of 2030, reaching 40% non-GAAP gross margins and 30% non-GAAP operating margins in 2030. Intel Foundry currently has an expected lifetime deal value with external customers of more than $15 billion and remains focused on its goal of becoming the world's second-largest foundry by 2030. Intel Products which includes Client Computing Group (CCG), Data Center and AI (DCAI), and Network and Edge (NEX), will target 60% non-GAAP gross margin and 40% non-GAAP operating margin by the end of 2030. While the transformation journey ahead will likely be winding, we are glad Intel's operation is stabilizing and management has the resolve and clarity to lead the company forward in a historical turnaround to reclaim supremacy in chip making.

### Looking Back and Forward

Recap of 24Q1: During the 1st quarter, the US equity market (R3000 as the proxy) gained 9.63%, with Growth moderately outperforming Value. The large market capitalization stocks outperformed the SMID segment, with the R1000 beating the R2000 by more than 500 bps. Among the large caps, the market cap weighted S&P500 returned 10.56% vs. 7.78% for the equal weighted S&P500.

During the quarter, equity investors have come to terms with a lowered expectation of the timing and the magnitude of interest cuts the US Fed will likely conduct in 2024, and cheered on the prospect of higher economic growth in the US which will hopefully offset lingering inflation. The emerging reality of more growth and more inflation has resulted in the bifurcated performance of the equity

and bond markets. While the broad US equity market returned nearly 10% in the first quarter, the Core U.S. Aggregate Bond index lost approximately 1% of its value, and the 10 Yr US Treasury yield rose from ~3.85% to 4.20%.

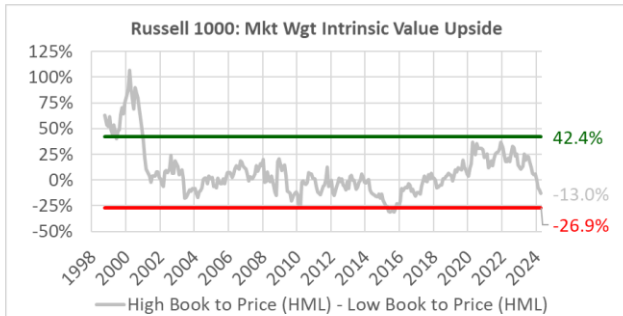
While the Fed appeared unhurried to cut rates early in the quarter, citing a "good economy", they made overtures at the latest Fed meeting in March to convince investors that three interest cuts remained on the table for 2024 despite their upgraded US economic outlook. Maybe the Fed believes there is no need to rock the market by materially changing expectations of rate cuts so early in the year. Maybe the Fed believes in the conventional wisdom that restrictive Fed Fund rates cannot possibly coexist with robust economic growth for an extended period. Fed fund rates are theoretically very restrictive at the current 5.25 - 5.50% level, given annual US inflation was only slightly greater than 3% for the 12 months ending February, and likely will head lower in the next 12 months. This implies real Fed Fund rates of 2.25 - 2.5%, which in theory, are very restrictive. According to some estimates, the real neutral rate was 0.4 - 0.8% pre-pandemic, and might have risen to 0.5 - 1.0%. Indeed - it is hard to argue the implied current real fund rates are not significantly higher than any reasonable new real neutral estimates.

It has been a mystery why the historically high interest rates have had a very limited impact on dampening economic growth. Maybe the cumulative effect of higher rates will eventually catch up and the Fed does need to cut preventively before it is too late. Consumers' extra savings from Covid will be depleted sooner or later, some argue. However, a big portion of the population enjoys rising wealth, as homeowners saw home values soar and households with investment accounts benefited from strong stock market returns. In addition, bigger companies in the country had strong balance sheets entering the rate hike cycle and still don't need to borrow excessively to expand. Those two cohorts might continue to isolate a big part of the US economy from being materially affected by higher and longer interest rates.

Looking forward: The economic backdrop in the past three months has become even more favorable for equity investing, evidenced by the Fed's confidence in projecting higher economic growth for 2024 and 2025. FactSet, however, reports a slight decrease in earnings and revenue growth for the S&P500 for CY2024. Analysts expect the index to report double-digit earnings growth in CY 2024 of 11%, down from 11.5% three months ago but still well above the trailing 10-year average annual earnings growth rate of 8.4% from 2013 – 2022. Analysts also expect the S&P 500 to post single-digit revenue growth in CY 2024 of 5%, down from 5.6%, in line with the trailing 10-year average annual revenue growth rate of 5.0% from 2013 – 2022. However, CY2025 growth expectations are higher. SP500 CY2025 earnings growth are now expected to grow 13.4%, up from 12.7%, while revenue growth will be 6%, up from prior expectation of 5.6%.

We have discussed in our previous quarterly reviews that Applied Finance's real Market Derived Discount Rate (MDDR) since 2020 has been approximately 5%, with only small increases during the latest Fed hike campaign. We had a historically high Equity Risk Premium (ERP) heading into the Fed Hikes, meaning we had an abnormally high equity risk premium embedded into share prices relative to US debt. Rising interest rates have served as the mechanism to bring the ERP back more in line with historical norms, which is where we are today. The latest real MDDR is still at ~5%, assuming nominal 10 Yr yield of ~4.2 % and ~ 2.3% inflation expectations, which suggests an implied real ERP of ~ 405 bps. Whether the Fed starts its first rate cut in June or later in the year, we don't expect material changes to the MDDR. We believe higher long-term interest rates will likely be accompanied by a moderate ERP, and equity investors can take comfort from a "normal" real MDDR level, with an economic environment that is widely believed to be "good". On the other hand, two wars are ongoing in two very dangerous regions with significant US involvement. As we race to November, the upcoming US presidential election will surely become more intense. Investors should buckle up for a likely bumpier ride in the months ahead.

In our 23Q4 quarterly review, we wrote about the stunning, shrinking Intrinsic Value Gap® between "value" and "growth" - a mere 0.4% exiting 2023, meaning "value" stocks offered no meaningful Intrinsic Value upside relative to "growth". Exiting 2021, the relative upside for "value" vs. "growth" was 31.5%, setting the table for 2022 being a strong "value" year, which brought that gap down to 12.4% as 2022 ended. Fast forward to today, the relative "value" vs. "growth" gap has further declined to -13%, meaning "value" stocks are overpriced relative to "growth". This is not entirely surprising given heavy Growth constituents such as Nvidia, Amazon, Eli Lilly's intrinsic value estimates have increased in past months due to better-than-expected growth and profitability projections for the companies' operations.




*Applied Finance Research data

The Valuation 50 will continue to focus on Applied Finance's Intrinsic Value factor and that the strategy will remain agnostic to the conventional but misnamed "value"/ "growth" convention - adhering to our Intrinsic Value and Stewardship analysis framework, which we believe results in a Safer Market from which to build portfolios.

While corporate earnings growth for America's largest companies are projected to accelerate in 2024, individual companies will have their unique fortunes depending on their sector/industry association, their interaction with the macro economy, and critically, their management team's ability to be a capable steward of capital. For the Valuation 50 strategy, we are glad to see Meta emerge successfully from its efficiency campaign and regain its growth momentum. It is also reassuring to see Intel, Disney, and Target making notable progress from their operational troughs, with management resolute in executing on tough decisions regarding cost savings and investing for the future. We have yet to hear what Walgreens' new management will say about righting the ship and leading the company out of the quagmire. We are cautiously optimistic Walgreens now has the right executive suite in place, and we look forward to the unveiling of its new strategy in a few months' time. As always, the Valuation 50 will continue to maintain broad sector exposure and industry diversifications and focus on owning companies with attractive intrinsic value and management team, to outperform each holding's respective sector peers.

**Valuation 50 Changes in 2024Q1**

- On January 3, 2004, we replaced Pfizer (PFE) Inc with Incyte Corp. (INCY) in the healthcare sector.

**Valuation 50 2024Q1 Performance and Attribution Summary**

| Sector Attribution 2024Q1 | | | | |
|---|---|---|---|---|
| | Portfolio Return | | S&P 500 | |
| **GICS Sector** | **Weight** | **Return** | **Return** | **Delta** |
| Comm. Srvcs. | 9.25% | 23.52% | 12.39% | 11.14% |
| Cnsmr. Disc. | 11.23% | 5.46% | 2.84% | 2.62% |
| Cnsmr. Stpls. | 6.64% | 8.11% | 6.01% | 2.10% |
| Energy | 3.76% | 16.54% | 12.61% | 3.93% |
| Financials | 13.32% | 16.49% | 12.02% | 4.47% |
| Health Care | 12.29% | 9.58% | 8.32% | 1.26% |
| Industrials | 8.66% | 17.17% | 10.50% | 6.67% |
| Technology | 27.95% | 0.46% | 8.20% | -7.75% |
| Materials | 2.29% | 8.23% | 8.59% | -0.36% |
| Real Est. | 2.40% | 7.25% | -1.32% | 8.57% |
| Utilities | 2.21% | 6.44% | 3.66% | 2.77% |
| **Totals** | **100.0%** | **9.44%** | 10.56% | **-1.12%** |

| Top/Bottom 10 Performers - 2024Q1 | | | | Top 10 Mkt Cap Ret | |
|---|---|---|---|---|---|
| Top 10 | | Bottom 10 | | Ticker | Return |
| META | 37.3% | WBA | -16.0% | AAPL | -10.8% |
| DIS | 35.5% | ADBE | -15.4% | GOOGL | 8.0% |
| VLO | 32.3% | INCY | -13.0% | META | 37.3% |
| URI | 26.1% | INTC | -11.8% | JPM | 18.5% |
| TGT | 25.3% | APTV | -11.2% | MA | 13.1% |
| CMI | 23.8% | AAPL | -10.8% | MRK | 21.8% |
| MRK | 21.8% | CSCO | -0.4% | BAC | 13.4% |
| TRV | 21.4% | MCHP | 0.0% | CVX | 6.9% |
| KLAC | 20.4% | UNP | 0.6% | DIS | 35.5% |
| PWR | 20.4% | HPQ | 1.3% | ADBE | -15.4% |

**Portfolio Characteristics: Weighted Average - 3/28/2024**

| **AFG Company Grade** | |
|---|---|
| **AFG Company Grade** | 3.02 |
| **% AFG Company Grade = D/F** | 13.3% |
| **Valuation:** | |
| Percent to Target - Current | 22.1% |
| Percent to Target - Current SR | 68.6 |
| Percent to Target - Plus3 | 46.4% |
| Percent to Target - Plus3 SR | 65.2 |
| Market Value / Net Invested Cap. | 2.86 |
| P/E Last Fiscal Year | 33.6 |
| P/E Current Fiscal Year | 21.0 |
| P/E Next Fiscal Year | 18.5 |
| Price/Book | 5.57 |
| P/Sales | 3.84 |
| EV/EBITDA Last Fiscal Year | 15.49 |
| **Size Analysis:** | |
| Weighted Average Market Cap: | 271409 |
| Median Market Cap | 76070 |
| Largest Market Cap | 2651120 |
| Smallest Market Cap | 12778 |

| **Performance Metrics:** | |
|---|---|
| EM+1 Change | -0.28 |
| EM+1 Change SR | 42.7 |
| EM (LFY) | 3.90 |
| EM+1 | 3.61 |
| EM+1: 1 Month Momentum | 0.05% |
| EM+2: 1 Month Momentum | -0.01% |
| RONA LFY | 12.0% |
| ROE LFY | 30.5% |
| **Earnings Metrics:** | |
| EPS - 5 Year Historical Growth | 8.5% |
| EPS - LFY Growth | 3.1% |
| EPS +1 Growth | 7.4% |
| EPS +2 Growth | 10.0% |
| EPS 3-5 Year Growth | 10.4% |
| **Miscellaneous** | |
| Default Model Accuracy | 74 |
| Beta | 0.98 |
| Z-Score | 4.31 |

| **Value Driver Metrics:** | |
|---|---|
| Sales Growth +1 (Analysts) | 2.4% |
| Sales Growth LFY | 5.7% |
| Sales Growth 3 Year Median | 13.0% |
| Sales Growth 5 Year Median | 7.7% |
| EBITDA Margin LFY | 23.3% |
| EBITDA Margin 3 Year Median | 23.9% |
| EBITDA Margin 5 Year Median | 23.8% |
| Implied Sales Growth - LFY | 5.8% |
| Implied Sales Growth - 3 Year Median | 3.8% |
| Implied Sales Growth - 5 Year Median | 4.5% |
| % of Sales - Foreign | 35.0% |
| ***Value Drivers do not include Financials/Utilities** | |
| **Quality Metrics:** | |
| % Management Quality Score = -1 | 15.5% |
| Earnings Quality | 6.3 |
| Earnings Quality SR | 50.2 |
| Dividend Yield | 1.81% |
| Financial Leverage | 23.6% |

*VALUATION 50 DISCLAIMER*

*The Valuation 50 Portfolio is a long strategy comprised of approximately 50 U.S. traded large cap equity securities believed to offer superior total returns over long-term investment horizons. The equity securities have attractive valuations and are selected to provide broad economic sector exposure. The Valuation 50 is a hypothetical model portfolio and does not reflect actual client investments.*

*The above presentation is based on holdings in the Valuation 50 strategy which started 6/10/2004. Holdings in the Valuation 50 strategy and security prices are subject to change throughout the year.*

*Gross Performance of the Valuation 50 strategy is based on a hypothetical fully-invested portfolio and excludes all fees and expenses. Net Performance of the Valuation 50 strategy is calculated by deducting an annual investment management fee from Gross Performance. Most individual accounts will have some cash level. Performance is calculated on a pre-tax basis and does not include any reduction for applicable non-U.S. withholding taxes, if any. Past performance is no guarantee of future results. Individual security weights may vary by account.*

*References to stocks held in the Valuation 50 are for informational purposes only and do not constitute an offer to buy or sell any security.*

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*The Russell 1000 Index is a market capitalization-weighted index of 1000 of the largest U.S. equities. The Russell 1000 Value index measures the performance of the Russell 1000's value segment, which includes firms with lower price-to-book ratios and lower expected growth values.*

*The S&P 500 Index is a market capitalization-weighted index of 500 of the largest U.S equities and is often used as the standard for measuring large-cap U.S. stock market performance.*

*An investor cannot directly invest in an index and the performance of the index may be materially different from the actual performance obtained by a specific investor.*