Morgan Dempsey Capital

Performance Commentary | Large Cap Value Strategy

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Quarter Performance Commentary

Overview

Lately the stock market has all been about broken records—not only in the form of new all-time highs. A new year, a different narrative, yet the same patterns … possibly taking us into a period of excess. The market's behavior in Q1/2024 was strikingly and even eerily like Q4/2023: a "broken record" indeed.

The Morgan Dempsey Large Cap Strategy earned a total return of 6.23%, (net of fees 6.11%), in the first quarter. This made for another very strong quarter in absolute terms, as was its Q4/2023 return of 6.09%. Other trends, of course, remained intact as well. The Russell 1000 Value index, our primary benchmark, returned 8.99% in Q1 (versus 9.50% in Q4). And for the market at large, the skew toward growth and mega-cap stocks remains intact—the more extreme the size and growth (e.g. NVIDIA) the better.

While we are never pleased by relative underperformance, we wouldn't describe ourselves as particularly surprised. Our overriding priorities have been, and still are: (1) strong downside protection, (2) absolute total returns, underpinned by large, reliable, and growing dividends, and (3) consistent application of our principles and process over time. By no means are our individual stock selections perfect; there's always room for us to improve on this score. Yet we firmly believe that from cycle to cycle, these priorities—expressed through a well-diversified portfolio of inexpensive stocks—will lead to superior risk-adjusted performance. We cannot expect to be favored under all market conditions, so we choose to wait patiently to be right … rather than hurry to be wrong.

Yet let's pause for a moment and reflect on what *has* changed thus far in 2024. At the end of December, the narrative driving the rally was predicated mainly on the expectation of six or more cuts by the Federal Reserve this year. Three months in, there have been no cuts. The market-implied expectation for reductions in the remainder of the year fell to less than three. Some in the financial chattering classes have even started to write off the likelihood of any rate cuts at all, at least during 2024. Now, instead, stock prices are rising because of the U.S. economy's resilience—which had been the main threat to the policy-easing theme! But who's to complain? The stock market swapped one narrative out for another … for its near-polar opposite … and price and valuation trends barely skipped a beat.

Our day-to-day labors of love at Morgan Dempsey are focused mainly on the merits of individual businesses. But we can't help but observe that when the reasoning for changes (rate cuts vs. economic strength) the conclusion stays the same (relentless jacking-up of stock prices), perhaps the process at scale is best characterized as motivated reasoning.

We think this phenomenon is best summarized by the market's price/earnings ratio. For any one stock, P/Es may encapsulate a wide variety of business-specific factors that don't apply to

the market in general. At the level aggregated by the S&P 500, we interpret the P/E as a simple reflection of current discount rates, expected earnings growth, and confidence.

- Changes in "risk-free" interest rates and anticipated earnings growth can be observed directly (the former by way of the 10-year Treasury yield, the latter in the form of consensus estimates).

- Lower discount rates and/or faster earnings growth might both justify a higher P/E ratio, but this isn't what we've observed lately. Forward earnings estimates usually tend to roll higher simply due to the passage of time, and so they have, but there's been no step-function change in the last six months. Interest rates, on the other hand, ought to have been a net negative for the P/E. Not only did market expectations for short-term interest rate cuts fall apart during Q1, but in the same timeframe the yield on 10-year Treasuries rose to 4.20% from 3.88%.

- This leaves us with confidence, or "certainty," the emotional swing factor that accounts for so much volatility in the short term—and so very little when compounded across time. It makes sense in the context of an individual security to pay more—that is, by way of a higher P/E—if we can establish a firmer sense of conviction in the future path of earnings and income payments, and vice versa. That's why 10-year Treasuries, with 100%-guaranteed payments but 0% growth, still yield less than half the 10%-11% total return investors associate with stocks. So, certainty has its role, but it comes at a cost—more certainty today equals less return tomorrow.

Certainty is necessarily the inverse of uncertainty, which brings to mind that tired old trope, "the market hates uncertainty." Tired, but fair: When "known unknowns" are on the horizon, it's easier to be nervous—just like it's easier to be afraid of flying as the plane taxis down the runway, as opposed to merely contemplating the purchase of a ticket. That fear often translates into falling prices, and the price moves typically exceed the change in observable earnings trends and/or discount rates; the resulting drop in P/E is mainly a drop in certainty.

Consider 2022, a year not remembered fondly in most corners—to the extent that, just now, 2022 is remembered at all. Supply chains were still snarled, inflation soared to multi-decade highs, and the Federal Reserve finally moved off the ZIRP ("zero interest rate policy") to which investors become accustomed for most of the preceding 14 years. This led to a bear market for the S&P, but it was falling P/Es that accounted for the bulk of the losses—more so than the decline in estimated earnings. Dividends, of course, made only positive contributions to returns. That's always true, whether handsomely large as from the Morgan Dempsey strategy, or pitiably small in the case of the Russell 1000 Growth index.

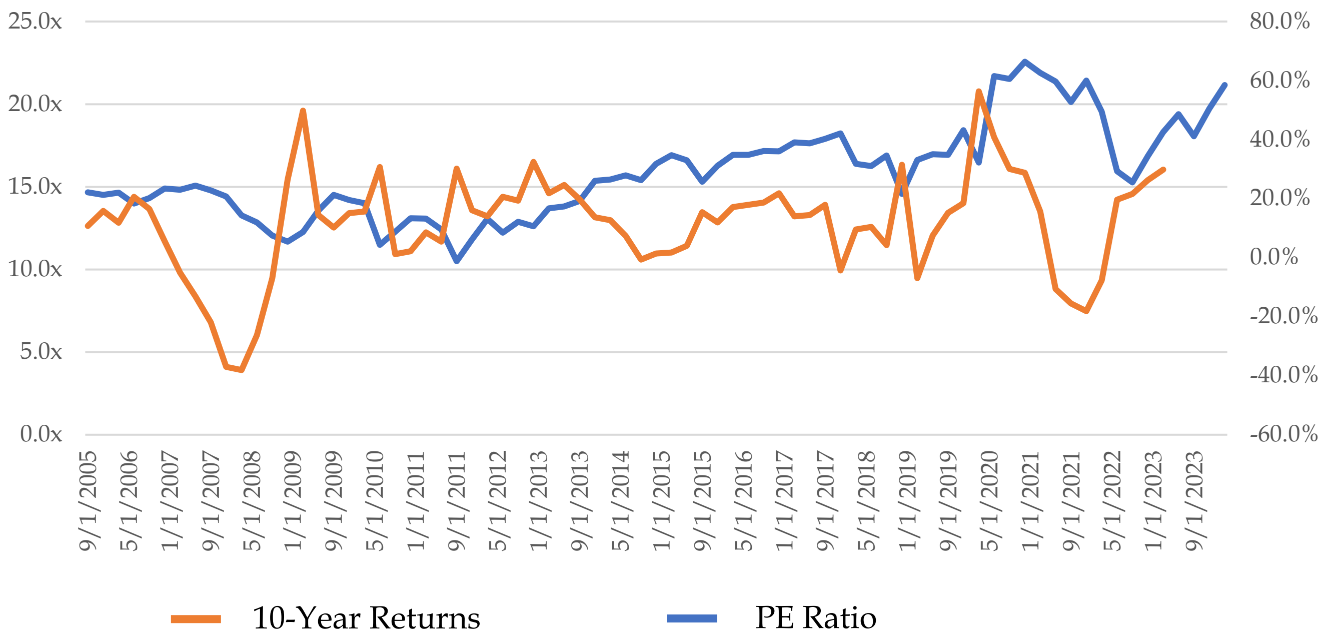
On the flip side, the recovery in stock prices during 2023 and into Q1/2024 was largely predicated on P/E expansion, which contributed 9.4 percentage points to the S&P 500's Q4/2023 total return of 11.7%, and another 7.4 percentage points in Q1 out of a 10.6% total return.

Forgive us for being a wet blanket, but investors should be cautious when the primary driver of return is sentiment and not demonstrated earnings growth. The recent PE expansion is

evidence of a significant of positive market sentiment which has historically been a less than dependent "friend."

Just because there are fewer "known unknowns" in view doesn't mean the dark matter of "unknown unknowns" has changed at all. Granted, over a one-year time horizon, the correlation between initial P/Es and subsequent returns is all but nonexistent. Valuation is not itself a catalyst, and a lousy tool for short-term timing. The exhibit below charts the forward P/E of the S&P 500 against its one-year forward total return—and if the pattern seems hard to discern, it's because there isn't any. (The R-squared, for those interested, lands at 0.0009.)

S&P 500 Forward PE Ratio vs 1-Year Return



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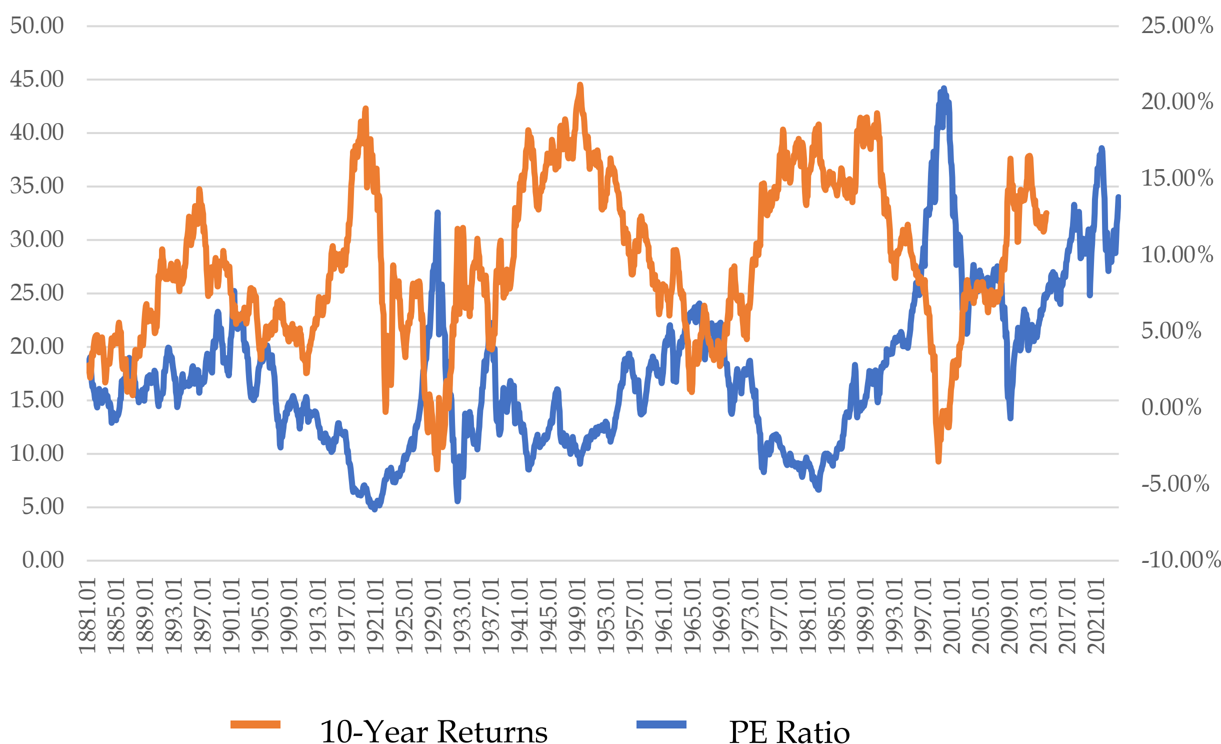
But stretch out to ten years, using Yale professor Robert Shiller's cyclically adjusted P/E ratio framework (CAPE), and the correlation becomes obvious. Ten years sounds like forever, keep in mind that ten years is still only a fraction of the lifetime investing experience for most people. Simply put: The more you pay, the less you get.

Adjusted CAPE PE Ratio vs 10-Year Returns



You might notice the total-return data in Exhibit 2 stops in 2014, since from that point to the present there are no longer 10-year periods to match. Perhaps—just perhaps—if it turns out we are in some new era for investment returns, maybe the next decade will serve up data contradicting our thesis. But history recommends a harsh assessment of "this time is different" conceptions, and while we'd like to stop short of using the "B-word" (bubble) that others are already calling into the conversation, we don't need to predict a short-term crash to justify our present conservatism. It's far easier simply to observe that over longer stretches of time, during which time emotional factors average out, you'd rather pay less and get more than pay more … and get less.

It's almost as if Warren Buffett was really on to something when he said, "The future is never clear; you pay a very high price in the stock market for a cheery consensus."

If we are correct in observing the market now is possessed by an excess of certainty, we will further observe that the excesses are not equally distributed—not by a long shot.

Our well-below-market P/E ratio and well-above-market dividend yield are statistical expressions of our defensive posture. We look out across a landscape now populated by "unknown unknowns" in the shadows and cannot find much reason to be cheery even if we could correctly guess how or when the next risk event will take shape. Nor, truth be told, are we resolutely bearish—at least on factors other than valuation. Valuation matters tremendously across time. As we are in this business for the very long haul, we shall invest our clients' funds accordingly. We expect our philosophy, and indeed the figures shown above, to serve our investors very well over the remainder of this cycle—however long it may last, and however odd it may be. We pay less, and in the long run, expect to earn more.

Portfolio Update

Relative to the Russell 1000 Value index, there were no notable themes in our Large Cap Value composite during Q1. The winners, as well as the losers, have basically nothing in common … except that we owned them both. ("The common denominator in all your dysfunctional relationships is … you," or so we've read on the Internet.) From a high level, our Q1 return looks mainly like a reflection of the portfolio's low beta—not a factor we'd want to upend on a wholesale basis, but rather to enhance through alpha—intelligent selection of individual stocks.

During the first quarter, we made three changes to our Large Cap Value portfolio:

Position Added: WEC Energy Group (WEC)
Initial Weighting: 1.50%
Forward Dividend Yield: 4.07% | **Forward P/E Ratio:** 16.37
(*Weighting, yield, and P/E data as of 3/28/2024.)*

We suppose there's no way to know who made more money out of 19th-century gold rushes in absolute terms—the hardy miners, or their suppliers of pans, shovels, and … bacon, we suppose? We will venture that the merchants did better on a risk-adjusted basis—they didn't have to find gold, only to have other people believing they could.

Our latest purchase, WEC Energy Group, is a low-risk merchant play on two modern-day gold rushes: decarbonization (principally electric cars) and "artificial intelligence." We don't know if these are solutions to humanity's problems, or even if the problems themselves are problems. With rising electricity demand comes the opportunity for rising investment and earnings growth. WEC is a stock we expect to "bring home the bacon", with its 4.07% dividend yield at a 20+ year high, yet its dividend- and EPS-growth trends are intact at roughly 7% a year.

Of course, it would be facile at best—misleading at worst—to see all electric utilities through this lens. Not all utilities will benefit equally, or even at all, from rising demand. Much depends

on the competitive nature of their regional markets in the case of merchant generators or purveyors of renewable sources; even more depends on the nature of regulation for regulated utilities like WEC. But Wisconsin, home to the bulk of WEC's assets as well as its future capital expenditure opportunities, is a premium regulatory jurisdiction. Despite the obviously negative political attributes of allowing electric-bill rate hikes, Wisconsin's regulators have shown themselves to be very fair in adjudicating the tradeoffs between consumers' costs and the reliability and even availability of energy itself. WEC has repaid state regulators' faith with heavy investment over the past two decades, which in turn has made the state a magnet for data centers—which of necessity require highly reliable as well as affordable supplies of electrons.

It isn't as if the power demand dynamics of AI and decarbonization are exactly a secret, but old habits die hard. WEC, and most regulated utilities, are still being treated as the "bond proxies" they'd been since electricity demand growth began to wane in the 1970s. (Prior to that, utilities were often thought of as growth stocks—no kidding!) And while interest-rate sensitivity, both to earnings as well as the stock's valuation, are among our concerns for WEC, we think the growth and value-creation opportunity is too attractive to pass up.

WEC has not traded at these valuations for over 10 years.

Position Eliminated: U.S. Bancorp (USB)

We think it's best to characterize our opinion of banks in a long-term context. There have been long stretches in the history of the Morgan Dempsey Large-Cap Strategy that our exposure to this group was nil—even though it has consistently accounted for a meaningful (sometimes double-digit) share of all U.S. stocks meeting our basic investment criteria.

The problem with banks, as we see it, is that they have attracted all the *downside* associated with being a very heavily regulated industry—not unlike utilities—but have none of the *resilience* associated with, say, the cost-recovery mechanism to which utilities are entitled by law. Though in recent years we've given a few banks a chance, and we continue to hold our position in Citigroup, U.S. Bank was the last of the "ordinary regional banks" that we've let go.

U.S. Bank isn't a bad bank, by any means, and as we've maintained all along it has an enviable noninterest revenue stream that reduces risk and enhances returns. Yet it is still very much a bank, taking deposits (costs up) and making loans (which may or may not be repaid). We have lately paid a great deal of attention to what seems like a looming crisis in CRE lending—commercial real estate. Very few, if any observers might have predicted what would happen to office spaces in the event of a pandemic. But at this length, we now understand that (1) offices are rather less occupied than they were pre-pandemic, (2) businesses are always eager to reduce costs, and (3) if work-from-home types are willing to supply office space for free, it's going to be hard for their employers to say no. And this phenomenon, of course, lands on top of a much higher interest rate environment which makes it more difficult for CRE borrowers to refinance that nearly $1 trillion in loans that are coming due in 2024.

And so it is that we've lost whatever taste for the banking industry that we'd only recently developed. It's not for nothing that U.S. Bank was our second-to-last holding in the industry, and we almost feel bad throwing shade on U.S. Bank at this stage. Still, we think it's only fair to insist on some baseline level of fundamental performance, which even U.S. Bank is not providing—given its rapidly declining rate of dividend growth, falling consensus earnings estimates, and a yield that—even at 4.38%--cannot be expected to carry the day by itself.

U.S. Bank is a good bank, but it's still just a bank, and not distinctive enough from its industry to be worth holding given our sour view of the industry at large. But we regard Citigroup, our last remaining position in the group, as a very different animal—it's been mismanaged, bloated, and banged-around for so long, that we believe its medium- and long-term fate will be governed by the restructuring efforts of its refreshed management team. And Citi, unlike U.S. Bank, has a unique set of global capabilities and assets that are not readily duplicated. It's not just that it's too big to fail; it's also too essential *not* to succeed, given even mediocre management. Citigroup isn't a bet on banks in general—that's not a bet we'd care to take any longer. U.S. Bank, whatever its other company-specific merits, is too much like its peers to chart its own course.

As a side note, we do not want to imply that we are somehow excluding new banks from our investable opportunity set. Far from it: Anyone that makes the grade can make the portfolio. They are not on a permanent "pay-no-mind" list; if one or more can help the Large Cap Value strategy achieve its aims, we'll be back. But U.S. Bank wasn't likely to be that stock, in our opinion, and for now we are not concerned about being dramatically "underweight" in banks. The risk/reward equation is just not there.

Position Increased: Lockheed Martin (LMT)
Weighting: 3.0%
Forward Dividend Yield: 2.77% | **Forward P/E Ratio:** 17.6
(Weighting, yield, and P/E data as of 3/28/2024.)

Sometimes it's the biggest trends that are the easiest to miss. We haven't missed the point that humanity well on its way back into a multi-polar world—and those poles don't agree on much. Due to this fragmentation, we expect defense spending to remain on the rise--regardless of which political party happens to cycle into power in any one election. And there aren't many better resources for the U.S. government to turn to than Lockheed Martin. It's currently grappling with cost pressures and production delays on the F-35, but we have little doubt these headwinds will eventually be resolved, even if it's the taxpayer footing a bigger bill. Ultimately, the Department of Defense only has a handful of contractors capable of delivering really big things, which makes the capabilities of a Lockheed Martin something of a private-sector tax, accruing to the benefit of its private-sector shareholders. We very much admire this company's record of returning value to shareholders via dividends as well as dividend growth, and at its

valuation in 17.6 times earnings find it worthy of a modestly increased commitment—one that brings it to what we consider a full-size position.

Contact Dave Isaacson with any questions or request for additional information.

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