MARKET COMMENTARY

REEXAMINING QUALITY

High-quality stocks beat low-quality stocks in every problematic market for the past twenty years, but not in 2022 (see Graph A, page 2). In each bearish phase, high quality held up better than low. However, this was not the case this year. Year-to-date, the WCA High-Quality index is down 15%, while the WCA Low-Quality index is down just 5%. While this trend is changing with recent performance once again favoring high quality (more on this below), this year's performance of high-and-low quality needs some examination.

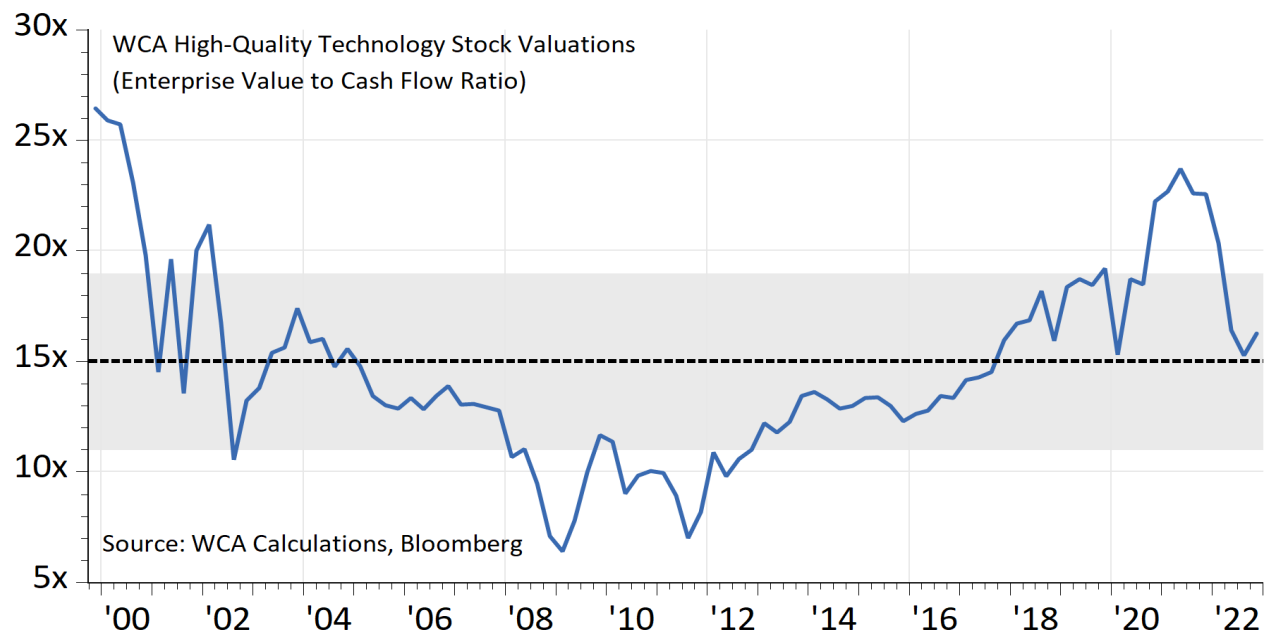
GRAPH A | HIGH VS. LOW-QUALITY PERFORMANCE IN BAD MARKETS Source: WCA, Bloomberg

Bear Market or Correction Start Date	Bear Market or Correction End Date	WCA High-Quality Index	WCA Low-Quality Index	S&P 500 Index
9/1/2000	10/4/2002	-2%	-27%	-47%
10/12/2007	3/6/2009	-44%	-70%	-45%
4/23/2010	7/2/2010	-14%	-23%	-16%
4/29/2011	8/19/2011	-18%	-29%	-18%
7/17/2015	2/12/2016	-9%	-25%	-20%
1/26/2018	3/23/2018	-8%	-9%	-10%
9/21/2018	12/21/2018	-16%	-25%	-18%
2/14/2020	3/20/2020	-32%	-47%	-32%
12/31/2021	12/16/2022 (End?)	-23%	-17%	-19%

* Dates based on declines in S&P 500 Index

WCA High-Quality and Low-Quality Index: An equally-weighted and fundamentally constructed portfolio of highest and lowest quintile companies based on largest one-thousand U.S. companies. Fundamental analysis ranks companies on three factors: asset profitability, consistency of profits, and degree of financial leverage.

GRAPH B | VALUATIONS RETURN TO EARTH FOR HIGH-QUALITY TECH Source: WCA Calculations, Bloomberg



Before doing so, we remind readers that quality is important but just one aspect of good portfolio construction. We also care greatly about the price paid; otherwise, we just introduce risk by another route. And valuations were an obvious problem by the end of 2021. To understand why, please see these articles written in late 2021, where we described the issue in detail:

- **Five Reasons for Caution** (December 6, 2021)
- **Beta Revisited** (November 29, 2021)
- **What Matters Most** (November 23, 2021)

A year on, we now conclude that high valuations, mostly among technology names, are less of an issue. In addition, high quality is again outperforming, relative valuations are better, and attention is starting to shift to concerns about global growth.

HOW WE GOT HERE: THE '20-21 FLIGHT TO QUALITY

The shutdown and onset of the pandemic in 2020 ushered in a different way of life. Unprecedented stimulus collided with global supply shocks as society reorganized around remote work. To survive, the world turned to communication technology, distributed networks, and remote work. Earnings for the technology sector exploded, growing by more than 50% in 2021. Valuations for technology companies within our WCA High-Quality index soared to levels not seen since the tech bubble of 2000. At the peak in 2021, the total value of these firms, including debt, was 24 times cash flow — 60% above the 20-year average of 15 times (see Graph B, page 2).

With vaccinations rolled out and policy stimulus drying up, technology struggled in 2022. The technology-heavy Nasdaq Composite Index is down 31% for the year. Our WCA High-Quality index's average high-quality tech stock is down 18% this year, in line with the market's 19% decline. We describe these firms as "high quality" because they tend to have consistent and highly profitable assets with little or no debt. These characteristics make for more flexible, durable, and predictable businesses. All else being equal, the same elements can nurture sustainable growth and may point to a competitive "moat."

ALL ABOUT TECHNOLOGY?

The preceding might lead us to think quality investing is all about technology, but we would be wrong to think that. In fact, our WCA High-Quality index, an equally-weighted index of consistent, profitable, low-debt businesses, is consistently dominated by a mix of industrials, technology, healthcare, and consumer companies (see Graph C, page 4).

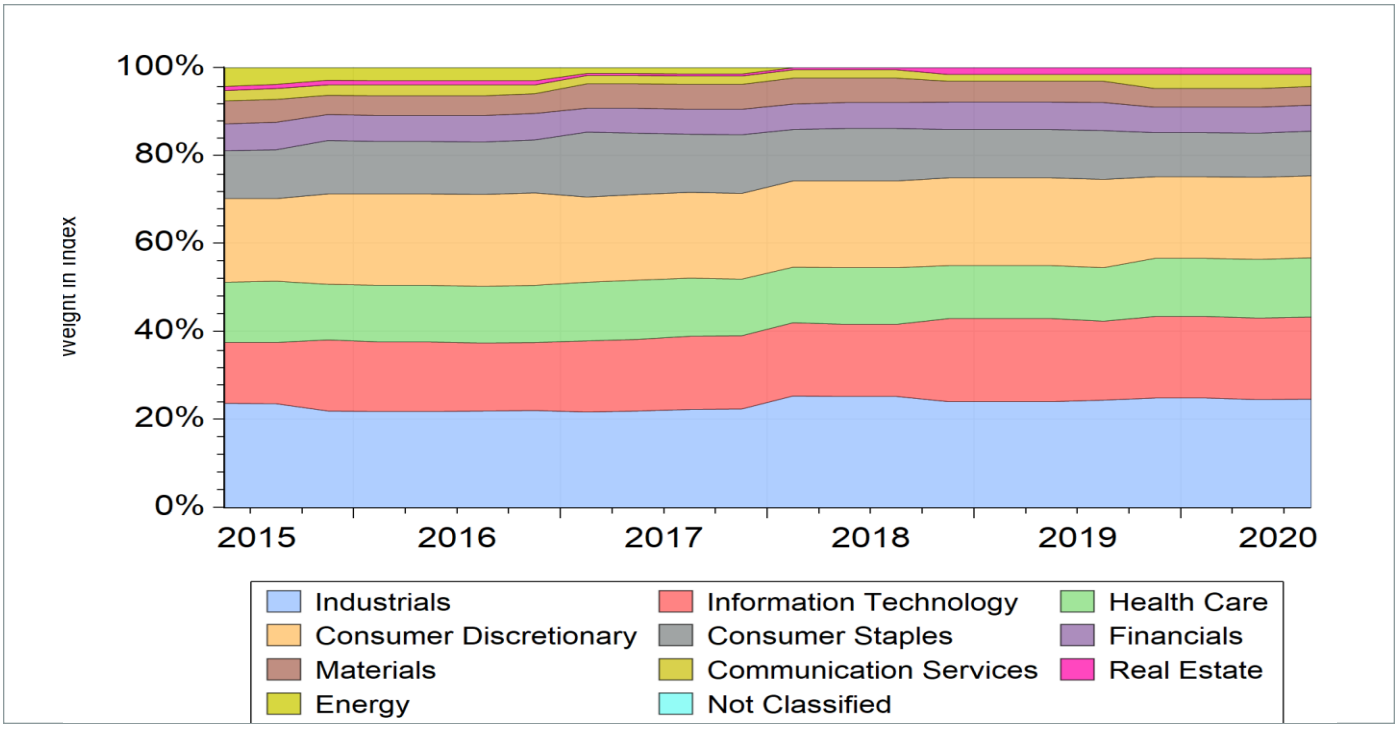
A recession or worsening financial market conditions would likely harm lower-quality, commodity-driven, or highly leveraged companies more. Sectors like these, notably energy and financials, depend more on commodity prices and financial engineering to generate returns. Conversely, higher-quality companies rely less on commodity prices and financial leverage, so they should show more flexibility and resilience in a recession.

LOW QUALITY / HIGH YIELD

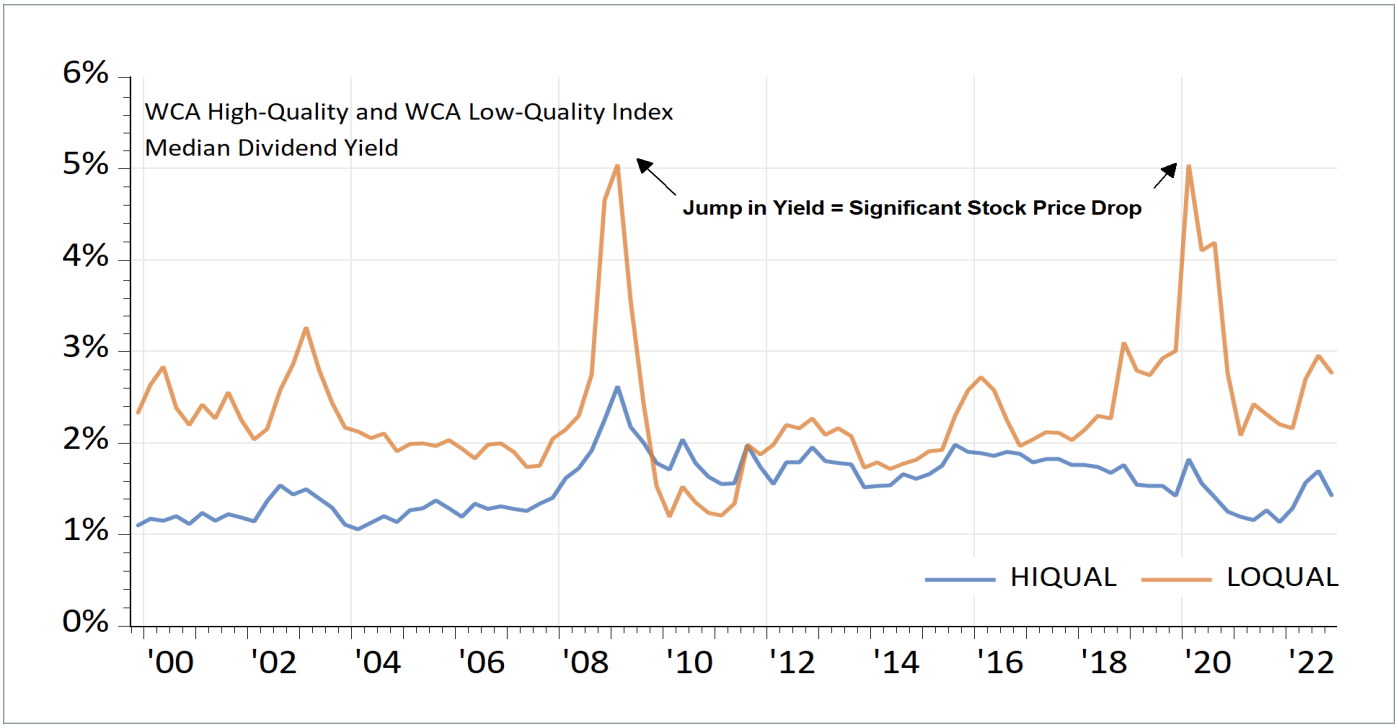
As the world contemplates recession, we are reminded of another significant relationship. Time and time again, we see that high dividend-yielding companies also tend to be low-quality. Moreover, these low-quality companies tend to get hurt the most when business conditions unexpectedly deteriorate.

Just look at the graph of dividend yields (see Graph D, page 4). See that lower-quality companies usually come with higher dividend yields. But also notice how those yields soar in times of stress. This means that the prices of these stocks suffered more rapid and significant declines than those of higher-quality stocks under pressure. The adage, "you get what you pay for" comes to mind when buying dividend yield. High-yield stocks, like high-yield bonds, tend to go hand-in-hand with higher risk.

GRAPH C | A SECTOR VIEW: WCA HIGH-QUALITY INDEX Source: WCA



GRAPH D | YIELD BEHAVIOR: HIGH-QUALITY VS. LOW-QUALITY Source: WCA



TURNING POINT?

Changing leadership and better valuations for high-quality technology stocks suggest a turning point at hand. Since June, when the Treasury yield curve inverted (signaling higher recession odds), the WCA High-Quality index declined just 1%, while the WCA Low-Quality Index fell over 7%. We conclude that now is the time to reconsider high-quality in all its forms, including technology.

Ultimately, understanding the role of quality is critical for understanding risk. While high starting valuations did pose a challenge for many high-quality stocks in 2022 (i.e., high-quality technology), we now see this as a fading issue. We should be bold in pursuing high quality where valuations make sense. We will continue seeking the highest total return possible from companies we view most likely to generate the least amount of risk. ***Quality at the right price was, is, and always will be how we pursue this goal.***

WCA Fundamental Conditions Barometer Description: We regularly assess changes in fundamental conditions to help guide near-term asset allocation decisions. The analysis incorporates approximately 30 forward-looking indicators in categories ranging from Credit and Capital Markets to U.S. Economic Conditions and Foreign Conditions. From each category of data, we create three diffusion-style sub-indices that measure the trends in the underlying data. Sustained improvement that is spread across a wide variety of observations will produce index readings above 50 (potentially favoring stocks), while readings below 50 would indicate potential deterioration (potentially favoring bonds). The WCA Fundamental Conditions Index combines the three underlying categories into a single summary measure. This measure can be thought of as a "barometer" for changes in fundamental conditions.

WCA Quality Indices are based on Washington Crossing Advisors' quantitative analysis of firms along three dimensions: asset profitability, consistency, and leverage. Higher quality companies are defined as those which fall in the top quintile of largest-cap U.S. companies and tend to have higher average profitability, greater than normal consistency, and low leverage. Lower quality companies are defined as those which fall in the lowest quintile based on the same criteria. Indices are reconstituted annually, continuously rebalanced, and presented on a total return basis, as calculated by Bloomberg. Indices are unmanaged and do not represent performance of any actual portfolio or portfolio strategy offered by Washington Crossing Advisors, LLC.

Standard & Poor's 500 Index (S&P 500) is a capitalization-weighted index that is generally considered representative of the U.S. large capitalization market. S&P 500 Growth Index and S&P 500 Value Indices are designed to provide a comprehensive measure of global equity growth and value performance.

S&P High Beta Total Return Index is designed to measure the performance of the constituents of the S&P 500 that are most sensitive to changes in market returns.

S&P Low Beta Total Return Index is designed to measure the performance of the constituents of the S&P 500 that are least sensitive to changes in market returns.

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All investments involve risk, including loss of principal, and there is no guarantee that investment objectives will be met. It is important to review your investment objectives, risk tolerance and liquidity needs before choosing an investment style or manager. Equity investments are subject generally to market, market sector, market liquidity, issuer, and investment style risks, among other factors to varying degrees. Fixed Income investments are subject to market, market liquidity, issuer, investment style, interest rate, credit quality, and call risks, among other factors to varying degrees.

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