MARKET COMMENTARY

PUTTING QUALITY TO THE TEST

We believe a link exists between a business and its stock price. This is why we spend time thinking about businesses when building portfolios. If there was not a link it would be useless to spend time doing fundamental research. Considering the past five years' volatile market environment, we thought now would be a good time to see if fundamentals, especially relating to quality, translated into differences in stock price performance.

THE TEST (2018-2022)

We set the stage by studying businesses and price performance from 2018-2022. From the onset, we gathered fundamental data on large U.S. companies by market value. We looked at asset profitability, profit consistency, and level of indebtedness. For profitability, we measured return on assets to understand how productive those assets are. For consistency, we examined the steadiness of profitability through good and bad times. For indebtedness, we looked at how much of a company's total value is owed to creditors. With these three factors combined companies are then given a "quality" score based on fundamentals.

We then created "high quality" and "low quality" groups based on then-available 2018 data. The top 20% of companies with better profitability, consistency, and lower debt became the "high quality" group. The bottom 20% became the "low quality" group. With groups established, we looked at how each group differed based on key fundamental metrics. For example, higher quality companies tend to carry higher valuations than lower quality companies, as one might expect. The starting dividend yield of the "high quality" group is 1.6% compared with the 3.1% yield of "low quality." The table on page 3 shows several of the more important fundamental characteristics of each group.

PERFORMANCE DIFFERENCES

It is not the dividend yield that matters most to us. We are interested in seeing any difference in the risk/return tradeoff between the two groups. Chart A on page 3 shows this tradeoff between the "high-quality" and "low-quality" groups side by side. The chart reveals three interesting observations:

1. On average, higher-quality companies generated higher returns with less risk overall. The cluster of high-quality is located higher and more to the left than low quality. This is good and means that, on average, high-quality stocks generated higher risk adjusted returns compared with low-quality stocks in 2018-2022.

2. The higher quality companies produced more predictable results. We see this by noticing that there is a tighter ring around the returns of "high quality" returns than the "low quality" returns.

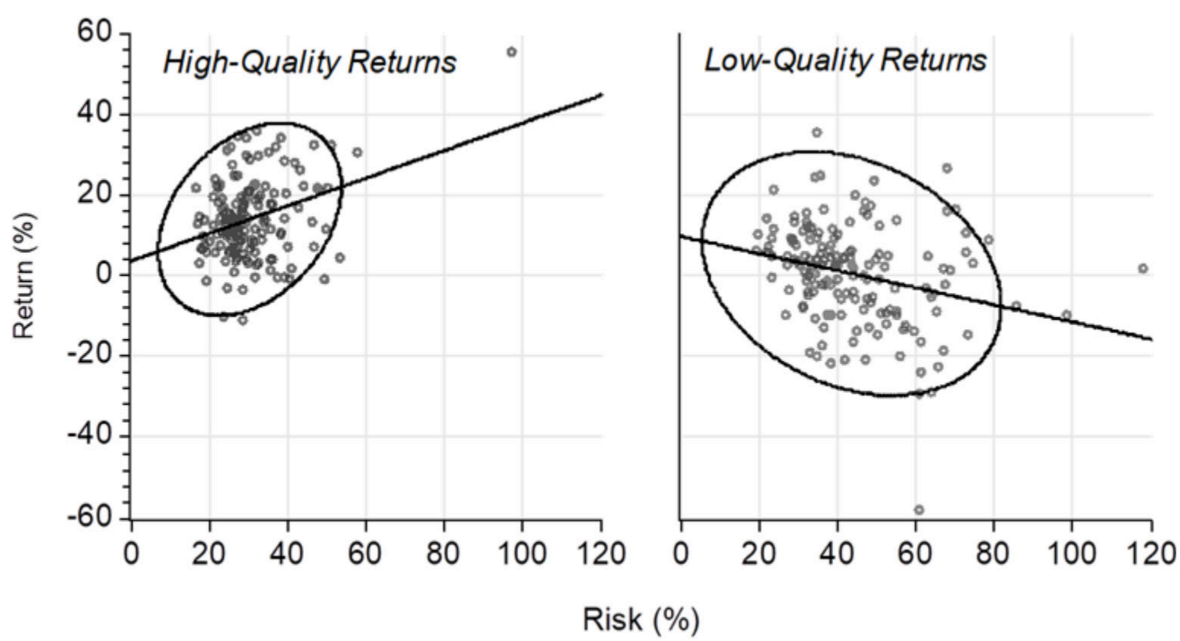
3. Returns among the high-quality stocks tended to rise with increases in risk. However, returns for low-quality stocks tended to decline with greater risk. Note that the straight lines (regression lines) slope up for high quality and down for low quality. An upward sloping line is good and means that return rises with risk, and vice versa.

The last point above is significant because risk is assumed to be rewarded with higher return, but that is not what happened with low quality companies. Increased risk among low quality names was not generally rewarded with higher return. The fact that higher quality tended to generate greater returns as risk rose a distinct positive, demonstrating a solid risk/return tradeoff during a period of extreme volatility.

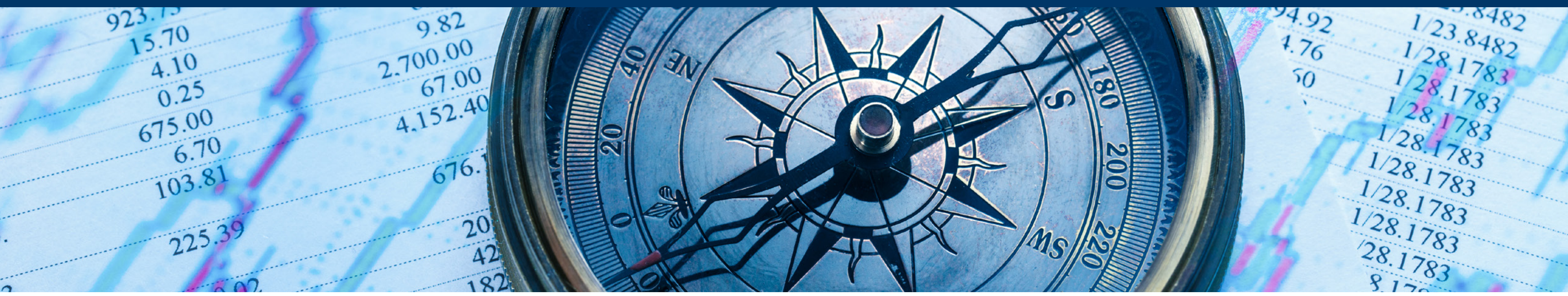
TABLE A | FUNDAMENTAL CHARACTERISTICS BY GROUP Source: WCA, Bloomberg

Measure	WCA High Quality	WCA Low Quality	S&P 500	S&P Value
Dividend Yield	1.6%	3.1%	2.1%	2.7%
Debt % Total Firm Value	10%	64%	20%	31%
Total Firm Value / Cash Flow	14.8x	7.7x	12.8x	10.6x
Asset Profitability	14.4%	2.5%	11.2%	6.8%

CHART A | PERFORMANCE OF HIGH vs. LOW QUALITY (2018-2022) Source: WCA, Bloomberg



CONCLUSION



We see an imperfect but real relationship between fundamentals and stock price performance. Markets seem rational, after all, and tend to discern differences between companies based on quality. Higher-quality companies tend to trade at a premium compared with lower-quality, as expected. Most importantly, high quality behaved consistent with what might be predicted under portfolio theory, namely that risk and reward would exhibit a positive relationship.

The results of this small study shows why quality should be an essential organizing idea when building portfolios. The 2018-2022 environment saw restrictive and expansionary policy, economic expansion and contraction, and high and low inflation. Thus, this period helps evaluate how fundamentals, quality, and performance interact under stress. In our judgement, quality passed the test as markets were able to discern between high and low quality companies as evidenced by stock price performance.

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.

Index Descriptions: 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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