WASHINGTON CROSSING ADVISORS 11 DEC 2023

MARKET COMMENTARY

QUALITYLAND

At Washington Crossing Advisors (WCA), we go to great lengths describing the high quality businesses selected in our Rising Dividend and Victory equity portfolios. We believe in buying quality companies at reasonable prices that have low debt, predictable cash flows, and are highly profitable and reinvesting back into their business.

This follows an intuitive, common sense approach to investing, particularly when considering risk-adjusted return in a strategy. That said, quality investing often becomes convoluted and misunderstood by investors — mainly due to antiquated frameworks put into practice decades ago that have unintentionally become foundational to investing and financial planning.

In the early 1990s, famed economists Eugene Fama and Kenneth French developed their Three-Factor Model* to explain investment returns in excess of market performance. One such factor was the outperformance of companies with the equivalent of low price-to-book ratios vs high price-to-book ratios. Fama and French described companies with low ratios as value stocks — that is, companies with low market prices relative to their intrinsic (book) values.

On the other side of this continuum, growth stocks represented those companies that had high price-to-book ratios. The appeal and willingness to pay more for growth stocks lies in the belief that those companies will grow significant cash flows over a longer time horizon than cheap value stocks. Chart A on page 3 depicts the very familiar Value-Growth Continuum utilized by virtually every financial professional when making investing decisions.

Whether in academic or professional settings, sometimes it makes sense to step back and "sanity check" ones work. When doing so, in the case above, we believe investors are presented with a simple logical fallacy. Along a continuum or spectrum, we are presented with things that are complete opposites of each other — hot and cold, tall and short, fast and slow, etc. However, in the continuum example above, the opposite of value is not growth and vice versa. At the most basic level, the value and growth style spectrum, with trillions of investment dollars predicated on it, does not make sense.

WHERE'S THE RISK?

There are other reasons to be skeptical about investing according to Value and Growth style. Risk, for example, is commonly misrepresented or completely unaccounted for using this framework. On page 3, Chart B breaks down Risk (Beta) for stocks across Value-Growth by specific price-to-book ratios. Not surprisingly, expensive growth stocks present the most risk. Investors must understand the risk they assume when buying a growth stock and taking a bet on future performance. Most importantly, note the increase in risk that comes with deep value stocks. A well-intentioned investor may mistakenly believe that they are buying a less risky asset because it is a cheap value stock. Indeed, risk pervades on both sides of the Value-Growth Continuum.

VALUE AND YIELD

In addition to assessing risk, investors and financial professionals oftentimes look for yield when constructing portfolios for retirement and other liquidity needs. In Chart C on page 4, we can see how Value stocks with the lowest price-to-book ratios often offer the highest yields. Before claiming victory and assembling a Value portfolio of high yielding stocks, one mustn't forget about the aforementioned risk!

The concept of a Value Trap is most prevalent in these situations, when risky companies, often saddled with heavy debt burdens and unstable businesses, try to lure investors by offering high yields.

**Corporate Finance Institute, Fama-French Three-Factor Model*

CHART A | THE VALUE-GROWTH "CONTINUUM" Source: WCA

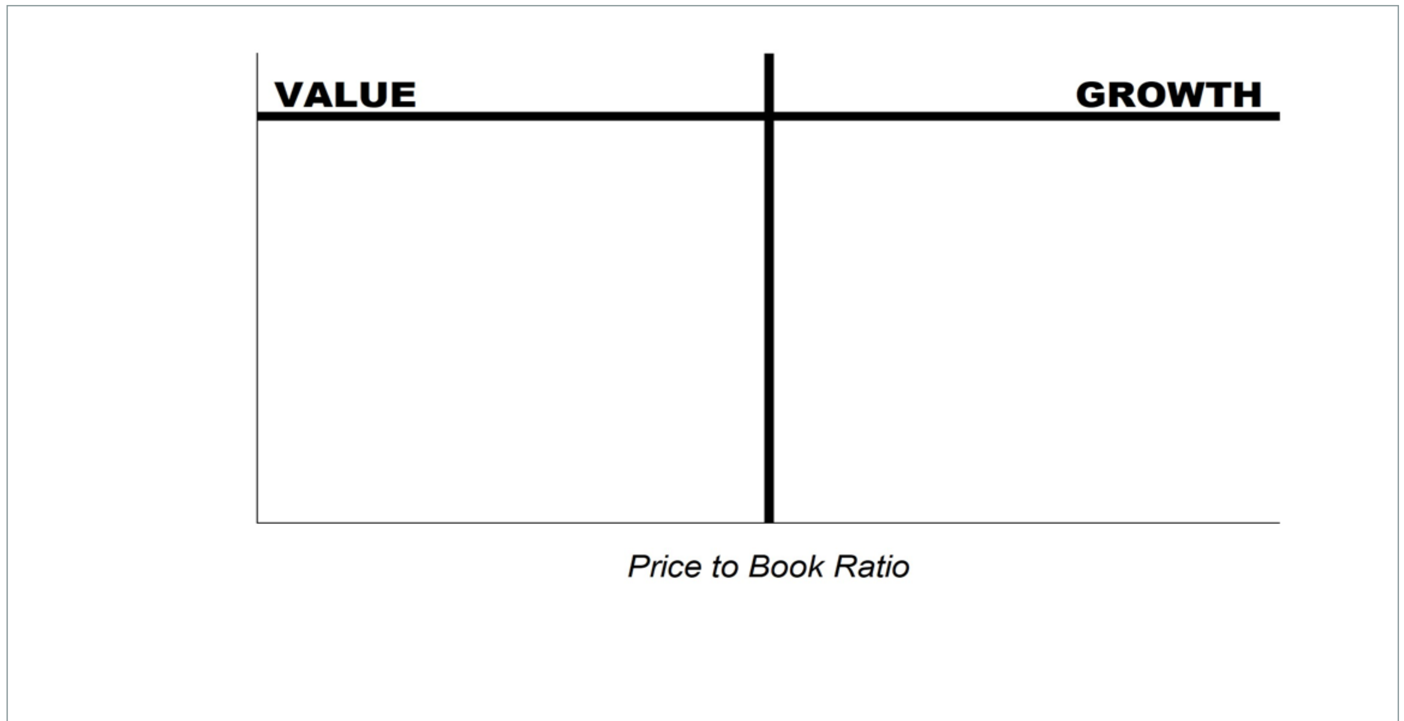


CHART B | RISK (BETA) ALONG THE VALUE-GROWTH "CONTINUUM" Source: WCA

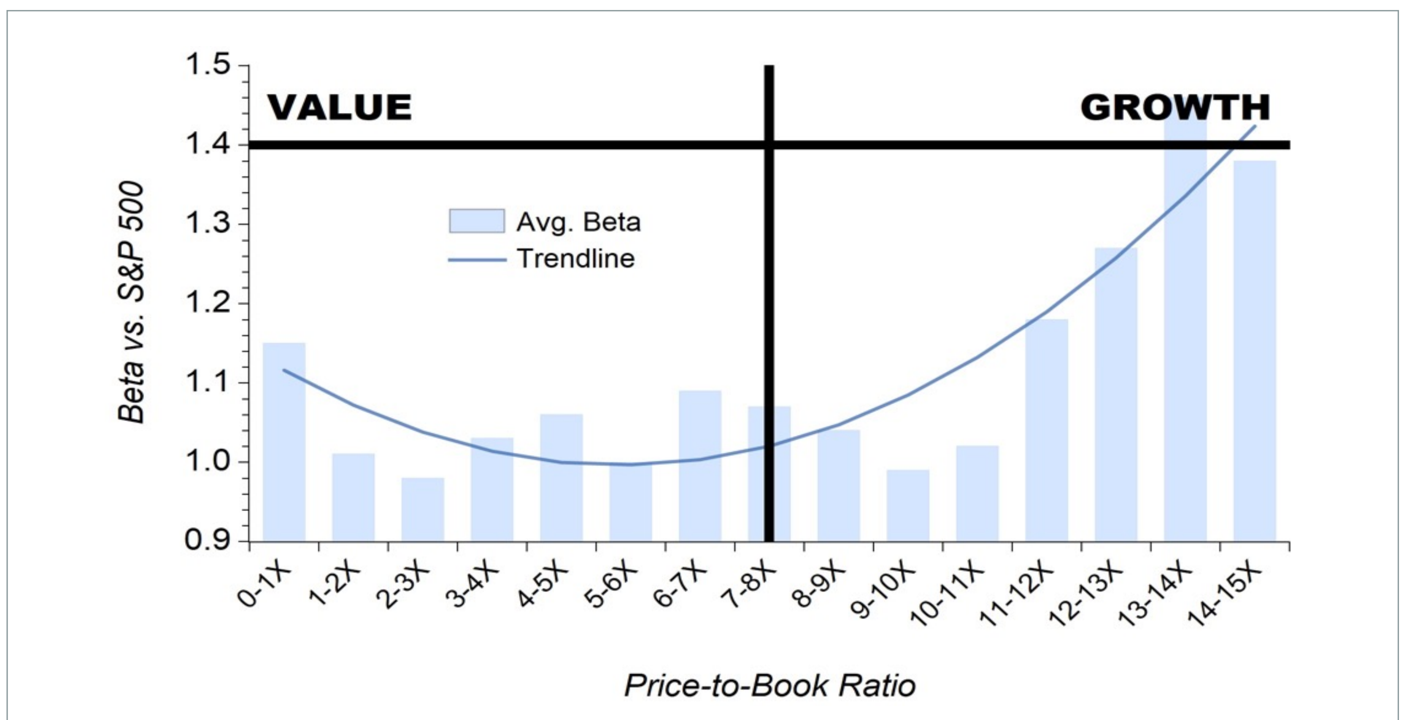
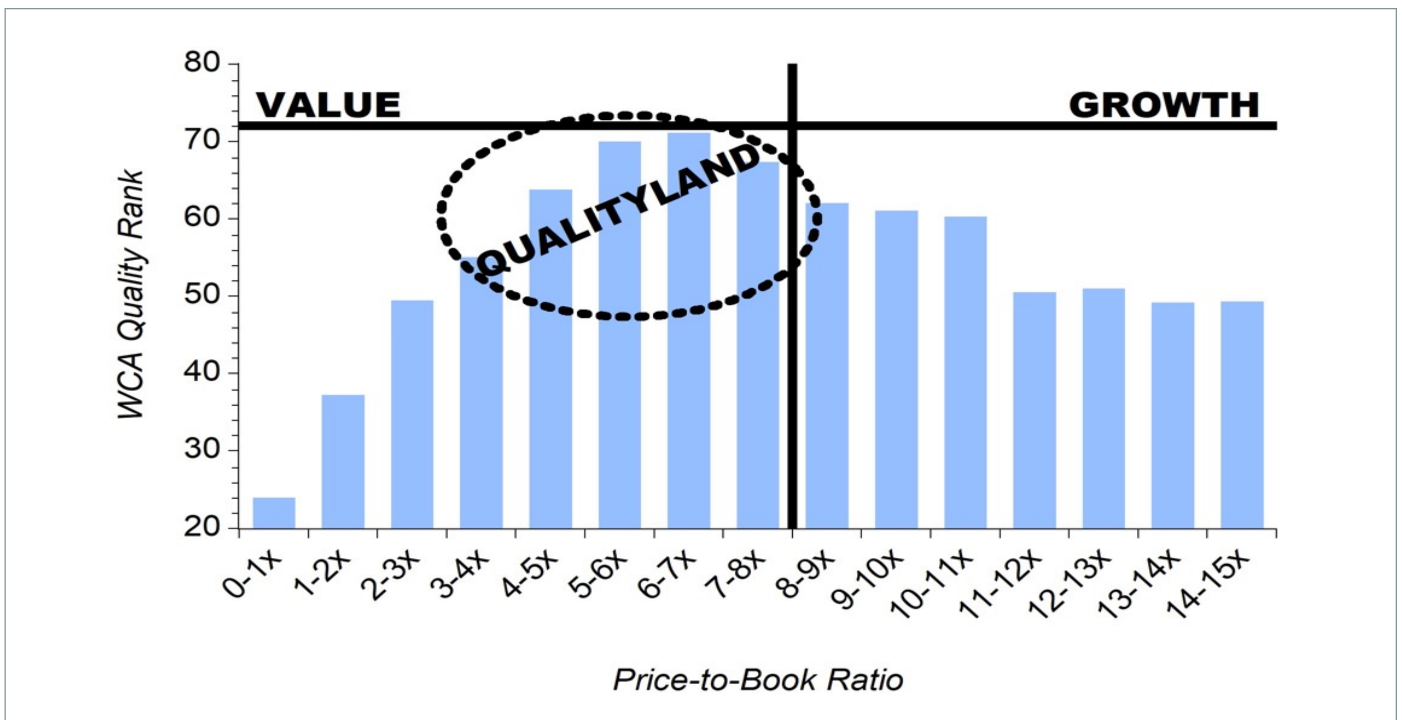
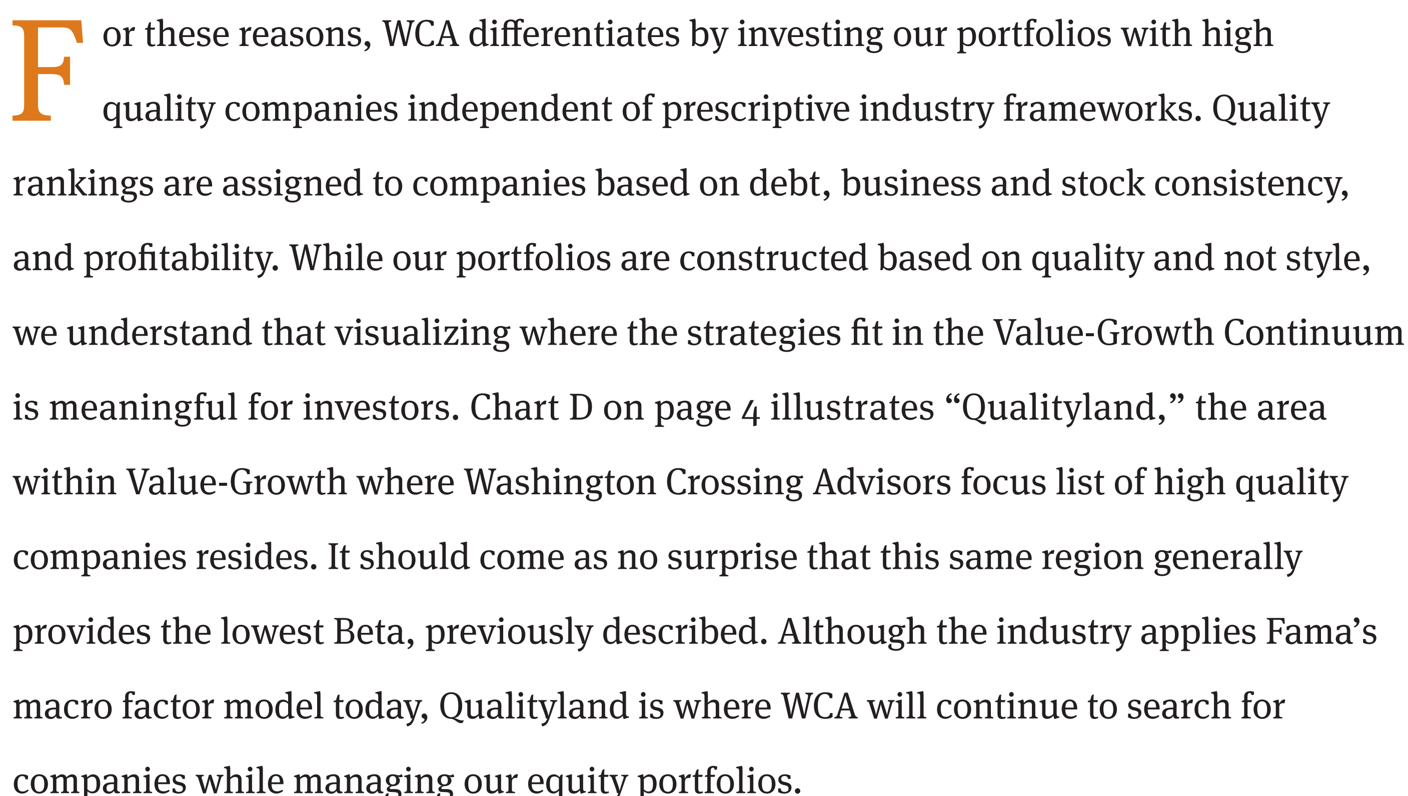


CHART C | YIELD ALONG THE VALUE-GROWTH "CONTINUUM" Source: WCA

CHART D | QUALITY ALONG THE VALUE-GROWTH "CONTINUUM" Source: WCA



CONCLUSION



For these reasons, WCA differentiates by investing our portfolios with high quality companies independent of prescriptive industry frameworks. Quality rankings are assigned to companies based on debt, business and stock consistency, and profitability. While our portfolios are constructed based on quality and not style, we understand that visualizing where the strategies fit in the Value-Growth Continuum is meaningful for investors. Chart D on page 4 illustrates "Qualityland," the area within Value-Growth where Washington Crossing Advisors focus list of high quality companies resides. It should come as no surprise that this same region generally provides the lowest Beta, previously described. Although the industry applies Fama's macro factor model today, Qualityland is where WCA will continue to search for companies while managing our equity portfolios.

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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Asset allocation and diversification do not ensure a profit and may not protect against loss. There are special considerations associated with international investing, including the risk of currency fluctuations and political and economic events. Investing in emerging markets may involve greater risk and volatility than investing in more developed countries. Due to their narrow focus, sector-based investments typically exhibit greater volatility. Small company stocks are typically more volatile and carry additional risks, since smaller companies generally are not as well established as larger companies. Property values can fall due to environmental, economic, or other reasons, and changes in interest rates can negatively impact the performance of real estate companies. When investing in bonds, it is important to note that as interest rates rise, bond prices will fall. High-yield bonds have greater credit risk than higher-quality bonds. The risk of loss in trading commodities and futures can be substantial. You should therefore carefully consider whether such trading is suitable for you in light of your financial condition. The high degree of leverage that is often obtainable in commodity trading can work against you as well as for you. The use of leverage can lead to large losses as well as gains.

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. Beta is a measure of the volatility, or systematic risk, of a security or a portfolio relative to the market as a whole. A beta of one is considered as risky as the benchmark and is therefore likely to provide expected returns approximate to those of the benchmark during both up and down periods. A portfolio with a beta of two would move approximately twice as much as the benchmark. A forward contract is a type of customizable derivative contract that involves two parties who agree to buy or sell a specific asset at a set price by a certain date in the future. Forwards are similar to futures contracts, but they are made over the counter (OTC) and settle only once, on their expiration date.

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FOR MORE INFORMATION, PLEASE CONTACT US:

Washington Crossing Advisors
- **Kevin R. Caron, CFA,** Senior Portfolio Manager | (973) 549-4051
- **Chad Morganlander,** Senior Portfolio Manager | (973) 549-4052
- **Matthew Battipaglia,** Portfolio Manager | (973) 549-4047
- **Steve Lerit, CFA,** Senior Risk Manager | (973) 549-4028
- **Thomas J. Serzan,** Senior Equity Analyst | (973) 549-4335
- **Suzanne Ashley,** Internal Relationship Manager | (973) 549-4168

Sales and Marketing
- **Eric Needham, Director,** External Sales and Marketing | (312) 771-6010
- **Jeffrey Battipaglia,** External Sales and Marketing | (973) 549-4031

About Washington Crossing Advisors | Washington Crossing Advisors a wholly owned subsidiary of Stifel Financial Corp. (NYSE-SF). The WCA team has been helping individual and institutional investors build wealth for more than 25 years.

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