MARKET COMMENTARY

THE "PROFIT" / "QUALITY" CONNECTION

Imagine you have two options for investing your savings: keeping it in a piggy bank at home or investing in a local business. If the business can use your money to earn more than what it would cost you to lend it out (think of this as the interest you'd want if you just kept your money), it's a sign that investing in the business might be worth considering.

The key is the business must not just earn a profit but a sufficient profit to compensate for the cost of the capital invested in the business, both debt (borrowed money) and equity (owner's money). We refer to profit above and beyond the cost of capital as "economic profit." Today, especially with higher interest rates, many companies are not earning their cost of capital and generating an "economic profit."

Here are the main reasons why we focus heavily on profitability in this way:

- **Value Creation:** When a company earns more from its investments than what it costs to finance them, it's effectively using creditor and investor money to generate more money. It's not magic, but businesses who can do this are evidencing smart business decisions that grow value.

- **Efficient Use of Resources:** A company that can consistently turn a profit higher than its costs is doing something right. Whether it's innovative products, efficient operations, or strong customer relationships, it means they're using their resources wisely.

- **Competitive Edge:** Maintaining higher returns that cover costs while adequately compensating providers of capital can hint at a competitive advantage. They may have a better product, a stronger brand, or more efficient operations. Whatever it is, it sets them apart from the competition.

- **Growth and Stability:** We find companies that manage their investments well are generally more stable and have better prospects for growth. They might fund new projects from their earnings, reducing the need for external borrowing and possibly increasing their value over time.

When a company's returns on capital outpace its cost, it's a sign of good health and intelligent management. It doesn't guarantee success, but it's a positive indicator that the company is on the right track, making it an attractive option for inclusion in a portfolio.

A LOOK AT TODAY'S COMPANIES

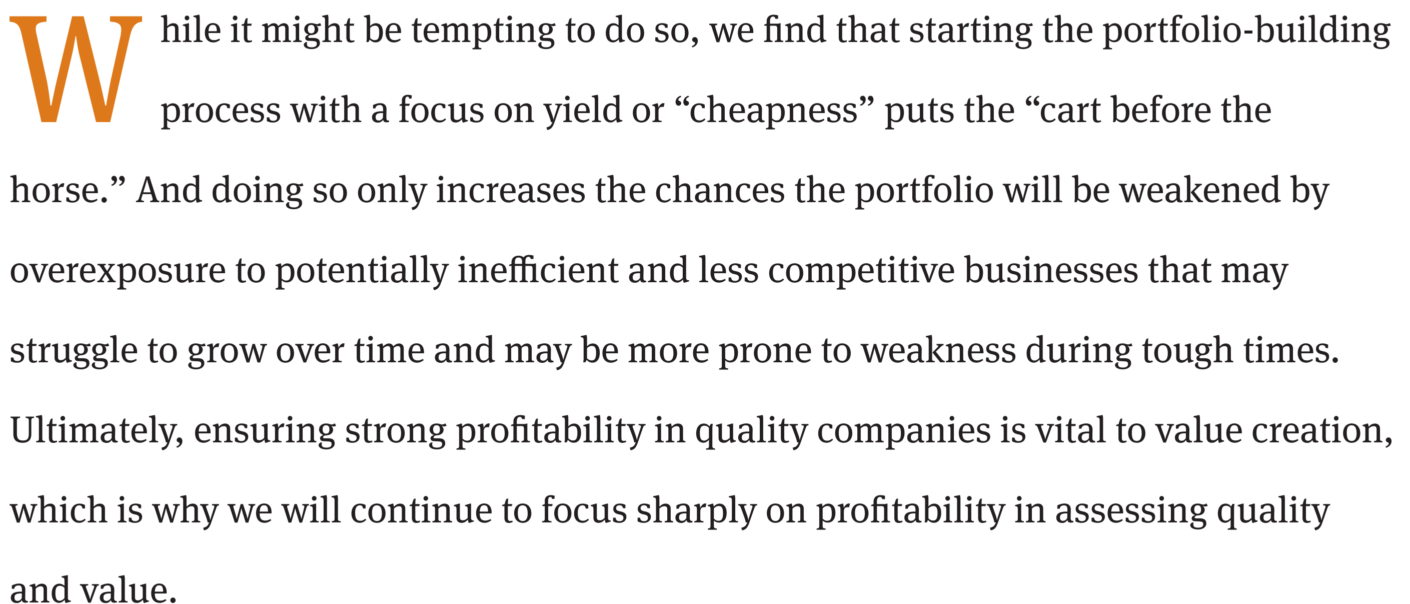
We decided to look at nearly 1,000 of the largest U.S. companies. Based on Bloomberg data, about half of companies are not earning sufficiently high return on capital to cover their cost of capital. Not surprisingly, the problem is more acute among the lower-graded companies in our study, based on our own "WCA Quality Grade." That grade considers quantitative factors ranging from profitability, profit consistency, and debt level.

Table A on page 3 breaks these companies down by "WCA Grade" from "A" to "F" and summarizes key facts. Not surprisingly, the "A" quality companies ranked highest on "economic profit," and the "F" stocks the lowest. The further we go down the scale, the less likely we find companies earning their cost of capital, and the more likely we find companies failing to earn their cost of capital (based on the most recent data). The tradeoff for buying cheap and high-yielding stocks often comes at the expense of profitability. In our view, this tradeoff can be a costly and sometimes risky one that may not pay off in the long run. Instead, we find a focus on reasonably-priced stocks with steady dividend increases is a better way to go.

TABLE A | QUALITY AND PROFITABILITY: LARGE U.S. COMPANIES BY WCA “QUALITY GRADE” Source: WCA

WCA Quality Grade	Number of Companies	Economic Profit (Median)	% Positive Economic Profit	EV to Sales (Median)	Yield (Median)
A Quality	174	8.9%	85%	4.1X	1.4%
B Quality	173	1.1%	58%	3.0X	1.6%
C Quality	164	-0.5%	45%	2.6X	2.8%
D Quality	151	-1.8%	32%	2.4X	3.2%
F Quality	184	-2.2%	35%	1.7X	2.9%

CONCLUSION



While it might be tempting to do so, we find that starting the portfolio-building process with a focus on yield or “cheapness” puts the “cart before the horse.” And doing so only increases the chances the portfolio will be weakened by overexposure to potentially inefficient and less competitive businesses that may struggle to grow over time and may be more prone to weakness during tough times. Ultimately, ensuring strong profitability in quality companies is vital to value creation, which is why we will continue to focus sharply on profitability in assessing quality and value.

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

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