# MARKET COMMENTARY

## EQUITY ANALYSIS

### QUALITY UNDER PRESSURE, PATIENCE REQUIRED

Our recent lag versus the S&P 500 reflects a market led by lower-quality and extremely highly valued companies. While challenging, this is a well-understood dynamic of quality investing. Low-quality phases can last for a time, but history has shown they were followed by renewed leadership in high quality. The current low-quality phase is already longer than average and may be nearing exhaustion. Credit and valuation signals now suggest downside risks are rising even as the economy continues to expand.

## WHERE WE ARE NOW

This has been a speculative stretch: lower rate hopes, and pro-growth policy expectations have pulled the leadership toward weaker balance sheets and more volatile earnings. In such periods, low quality has typically outperformed high quality — and our discipline can trail. Over the past year, our high-quality, "A"-Grade index rose just 2.2% versus a 31% gain for lower quality, "F"-Grade companies. This is not an aberration, but a familiar dynamic of quality investing. As we remind prospective clients in every WCA Rising Dividend fact sheet:

***"High quality styles tend to perform better in flat to down markets, but lag in strong bull markets. Because the strategy avoids high debt and volatile earnings, performance can differ substantially from traditional value strategies."***

The current environment has rewarded return-seeking with little regard for risk. However, when risk inevitably reasserts, investors have historically turned back to the durability, flexibility, and predictability of high quality. We have seen this time and time again in the past.

## WHAT ARE QUALITY CYCLES?

Our research has shown leadership rotates in multi-quarter waves that average about 22 months. We are now roughly 30 months into the current low-quality run — already longer than average (Chart A, page 4).

*According to our research:*

- **Low-quality phases can deliver strong "junk rallies"** (e.g., 2009–10: Low-Quality +227% vs. High-Quality +58%; 2020–21: Low-Quality +119% vs. High-Quality +38%).
- **Low quality carries enormous volatility, exciting on the way up but brutal on the way down.**
- **High quality provides steadier compounding and far better downside protection** (e.g., 2007–09: High-Quality –38% vs. –72% for low quality; 2014–16: High-Quality +7% vs. –27% for Low-Quality).

Today's low-quality rally has exceeded historical averages in both duration (29 vs. 22 months) and magnitude (Low-Quality is up 66% vs. 42% average Low-Quality cycle return). Patience may again be rewarded as the cycle matures. Over the past 20 years, the WCA "A"-Quality index returned 11.9% annually versus 9.1% for "F"-Quality, with far less volatility, according to Bloomberg data. One of the keys is to remain invested in high quality through a complete market cycle.

## CREDIT AS A CYCLE TELL

Credit markets often provide an early signal for cycle changes. Low-quality leadership typically coincides with tightening high-yield spreads, while high quality holds up better when spreads widen. Today, spreads sit near multi-decade lows at ~2.7% — about two standard deviations below the long-run average of 5.25%. Past episodes at similar levels (late-1990s, mid-2007) were followed by violent repricing (Chart B, page 4). Tight spreads rarely leave much margin of safety and can signal tipping points long before any singular "event" becomes apparent.

## VALUATIONS PRICING IN RAPID GROWTH

In addition to low-quality leadership, we also see momentum feeding unreasonable growth expectations and stretched valuations in some areas. Consider that U.S. public equities now are worth about $70 trillion versus a $30 trillion economy* (private equity would only add to the

$70 trillion figure). This large multiple, even without factoring in private equity, reflects optimism but also leaves little compensation for risk (Chart C, page 5). As we noted in ***"The Illusion of Perpetual Growth,"*** more than half of the S&P 500's market capitalization is priced with implied growth above 5% — faster than the 5% nominal growth rate the economy has delivered over the past decade.

Among these, the average expected growth rate is about 7.5% and can reach 16% for the most "expectation rich" growth equities.* Rising expectations and momentum have pushed valuations to levels extremely difficult to reconcile with fundamentals.

## FOCUS ON FUNDAMENTALS

Ultimately, fundamentals act as a grounding force for stock prices. Despite lagging benchmarks, our Rising Dividend portfolio has continued to deliver strong fundamental and operating results:

- EPS growth near 10.7% annualized this year through August
- No dividend cuts and ongoing dividend increases
- Average dividend growth of ~9% with payout ratios near 50% (Chart D, page 5)

This consistency reflects the defensive and compounding characteristics we seek from a group of high-quality companies.

## WHY "QUALITY AT A REASONABLE PRICE" STILL MAKES SENSE

We continue to believe that high quality endures, even if it does not lead in every period. Our approach — buying high-quality companies with rising dividends at reasonable prices — has delivered durable, risk-adjusted returns through many cycles. With the current low-quality run extended, credit spreads very tight, and valuations stretched, the odds favor a return to the durability, flexibility, and predictability of quality companies with rising dividends. Staying disciplined, even in the face of short-term lag, has historically rewarded patient investors.

Recent market leadership has also been concentrated in a narrow set of companies with very high valuations and growth expectations. These 'expectation-rich' stocks have powered popular benchmarks higher, while more reasonably valued, high-quality businesses have lagged.

Because our Rising Dividend strategy emphasizes quality at a reasonable price, we expect to trail when markets are driven by low quality and speculation. In fact, if we were outperforming in this type of environment, it would be a ***red flag that we had strayed from our core discipline***. Our role is not to chase fads, but to remain consistent in focusing on companies with strong balance sheets, steady earnings, and rising dividends.

History has shown that while no strategy leads in every market, high-quality styles tend to fare better in flat or down environments when fundamentals reassert themselves. By staying disciplined today, we aim to compound wealth more reliably over time.

* *Source: Bloomberg, WCA*

**CHART A | WCA QUALITY CYCLES** Source: Bloomberg, WCA

| Leadership | Start | End | # Months | "A" Quality Return | "F" Quality Return |
|---|---|---|---|---|---|
| Low Quality | Sept. 2004 | July 2007 | 35 | 44% | 75% |
| High Quality | July 2007 | Feb. 2009 | 20 | -38% | -72% |
| Low Quality | Feb. 2009 | April 2010 | 14 | 58% | 227% |
| High Quality | April 2010 | Sept. 2011 | 18 | 10% | -23% |
| Low Quality | Sept. 2011 | June 2014 | 33 | 79% | 120% |
| High Quality | June 2014 | Feb. 2016 | 20 | 7% | -27% |
| Low Quality | Feb. 2016 | Jan. 2017 | 11 | 18% | 45% |
| High Quality | Jan. 2017 | March 2020 | 39 | 44% | -21% |
| Low Quality | March 2020 | March 2021 | 12 | 38% | 119% |
| High Quality | March 2021 | April 2023 | 25 | 12% | -17% |
| Low Quality | April 2023 | ??? | 29 | 36% | 66% |
| **Average:** | | | **22** | **26%** | **42%** |

Low and High Quality is proxied by the performance of the WCA Quality Grade Indices. High quality is represented by the WCA "A" Quality index and low quality by the WCA "F" Quality index. Higher quality is assigned to those companies with less debt, higher profitability, and greater operating and stock price consistency.

**CHART B | HIGH YIELD CORPORATE BOND SPREAD OVER TREASURIES** Source: Bloomberg, WCA

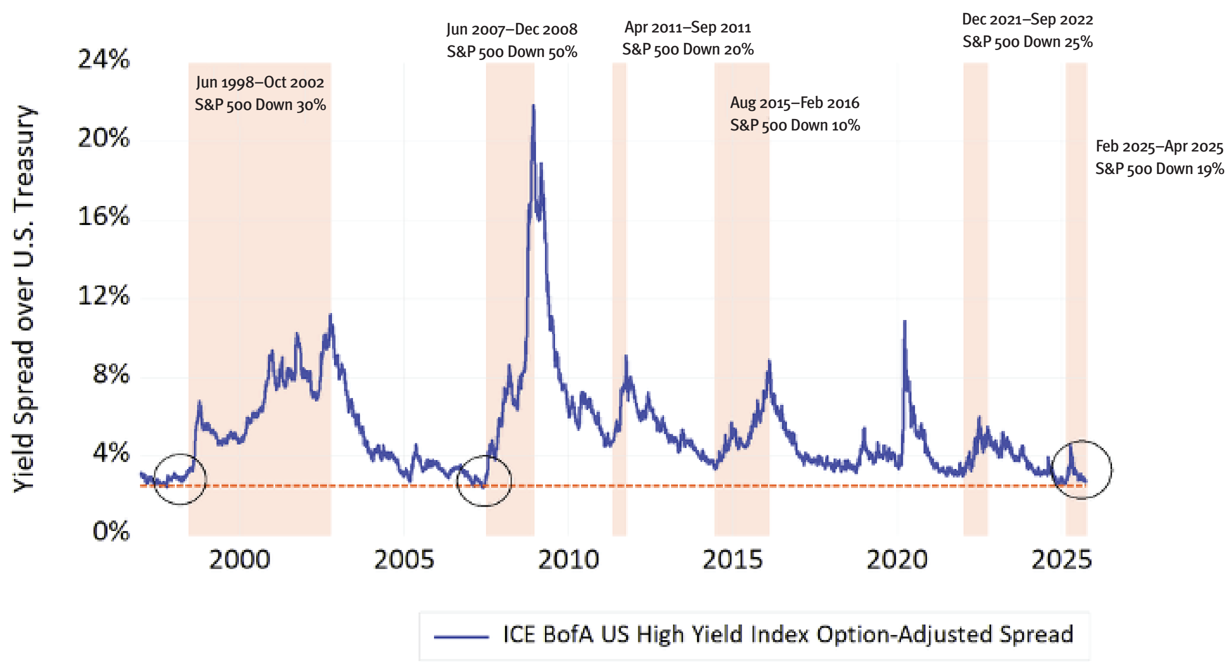


**CHART C | HIGHLY VALUED STOCK MARKET** Source: Bloomberg, WCA

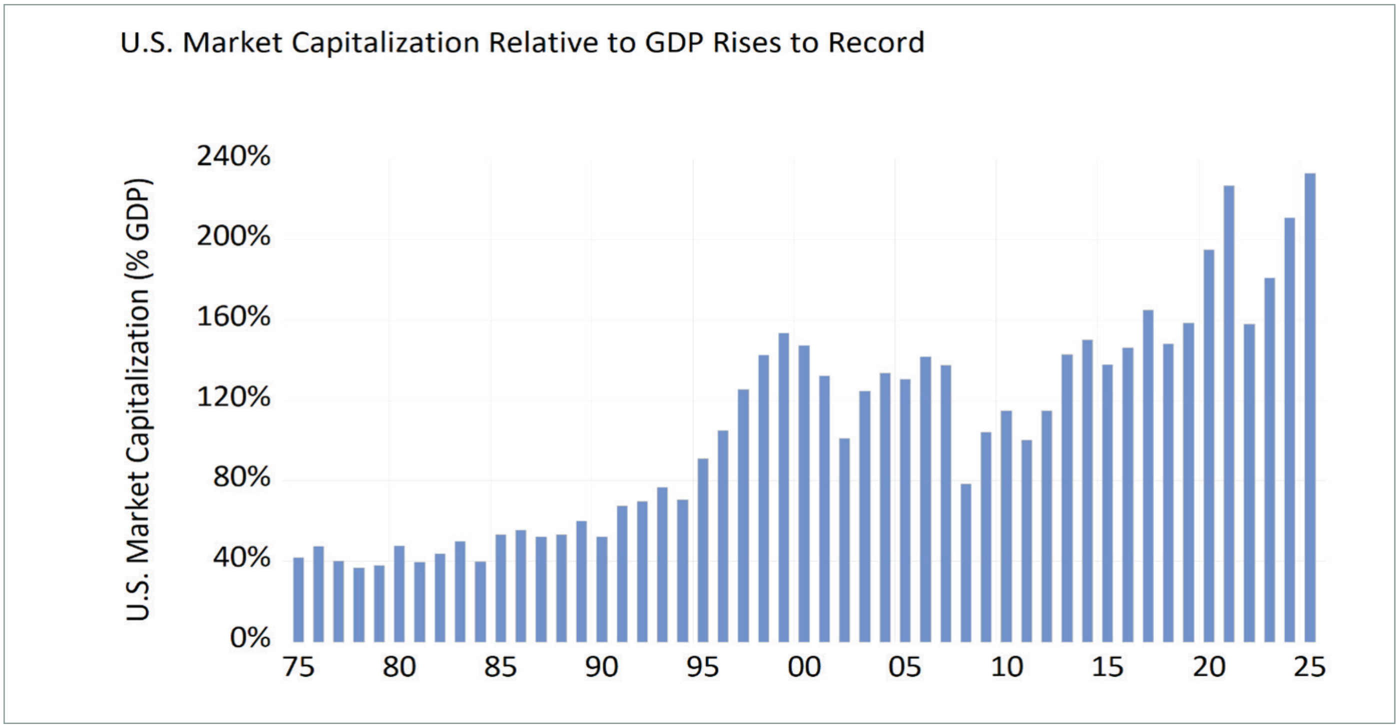
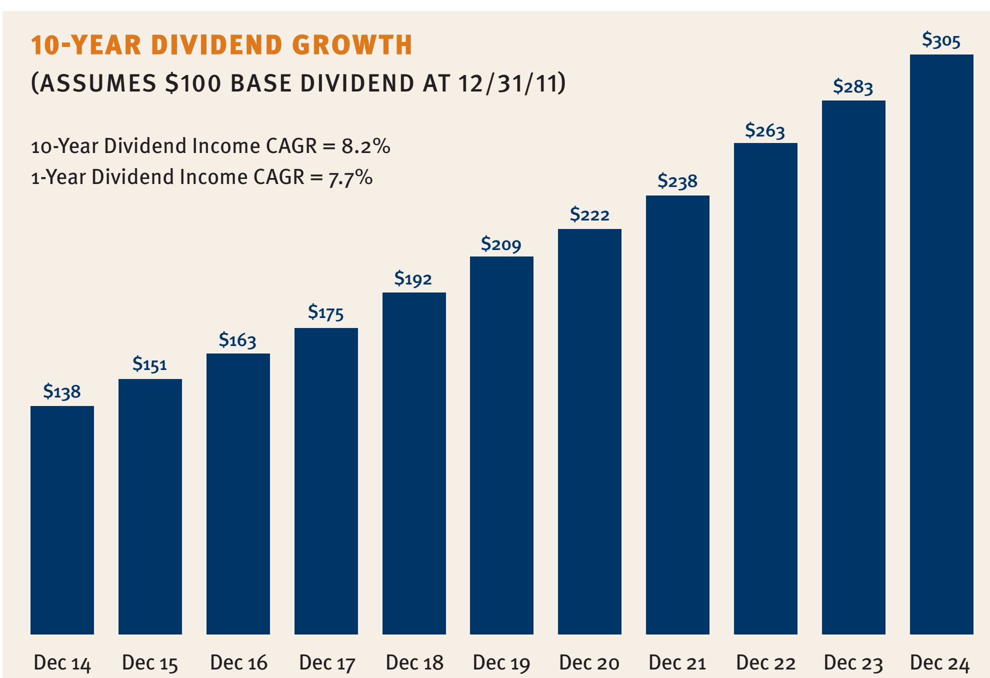



**CHART D | WCA RISING DIVIDEND 10-YEAR DIVIDEND GROWTH** Source: Bloomberg, WCA




*Data as of 6/30/25.*

*Dividend growth chart is inclusive of, but not pictured, dividend per share growth of 13.4% in 2012, 9.8% in 2013, and 11.1% in 2014.*

*Click here for full dividend history refer to the WCA dividend behavior piece.*

*CAGR = Compound Annual Growth Rate*

## IMPORTANT DISCLOSURES

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.

The Washington Crossing Advisors' High Quality Index and Low Quality Index are objective, quantitative measures designed to identify quality in the top 1,000 U.S. companies. Ranked by fundamental factors, WCA grades companies from "A" (top quintile) to "F" (bottom quintile). Factors include debt relative to equity, asset profitability, and consistency in performance. Companies with lower debt, higher profitability, and greater consistency earn higher grades. These indices are reconstituted annually and rebalanced daily. For informational purposes only, and WCA Quality Grade indices do not reflect the performance of any WCA investment strategy.

The ICE BofA U.S. High Yield Index is an unmanaged index that tracks the performance of U.S. dollar denominated, below investment-grade rated corporate debt publicly issued in the U.S. domestic market.

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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.

Standard deviation is a measure of the volatility of a security's or portfolio's returns in relation to the mean return. The larger the standard deviation, the greater the volatility of return in relation to the mean return.

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