

MARKET COMMENTARY

EQUITY ANALYSIS



READING THE RISK HIDDEN INSIDE GROWTH EXPECTATIONS

When most of us think about growth, the focus is usually on how quickly a company might expand in the future and, sometimes, on recent growth. But the more important question for your portfolio may actually be not how *much growth* a company might deliver — it is *how confident we can be* in that growth. We will argue here that during risk-loving bull markets (like today), focus tends to shift to the “*how much*” question, and during more normal, risk-aware markets, reverts to the “*how confident*” question.

To prove our point, we will offer three charts. The first chart in this series (Chart A, page 3), which compares market-implied 10-year growth rates across our WCA Quality Grades, puts the question of growth into sharp relief. And once you see what the data is illustrating, the implications become difficult to ignore.

DEFINING WHAT “GROWTH” MEANS

Before diving into the chart, it would be good to define what we mean by “growth” here. After all, growth is one of the most slippery concepts in finance. Ask ten people what growth is, and you are likely to get ten different answers. Some will point to the most recent quarter. Others will look back a year or five years. Analysts will give you forward estimates. Management teams will offer their own projections. All of these definitions differ, and all rely on subjective judgment about how and what we are actually measuring.

In that sense, growth is mercurial. It shifts depending on which measure you emphasize and which time horizon you choose.

Here, however, we take a different approach — one that avoids the biases baked into traditional definitions. Instead of focusing on accounting outcomes or analyst estimates, we rely on an impartial arbiter: the market itself. By examining the growth rate the market is willing to price into a stock, we get to the heart of the matter. Whatever hopes or assumptions any one person may hold, it is ultimately the market’s collective judgment that shapes valuations, expectations, and long-run outcomes. Observing the market’s implied growth rate baked into every stock, therefore, deserves first consideration when evaluating the durability of a company’s prospects, especially when comparing high- and low-quality firms.

WHAT CHART “A” REVEALS — THE SHAPE OF RISK

Now, with what we mean by growth clearly defined, consider what Chart A on page 3 shows. At first glance, note that the median implied growth rate *does not fall dramatically as you move from high-quality “A” companies to low-quality “F” companies*. Intuition might suggest otherwise. One would expect companies with stronger balance sheets, steadier cash flows,

and more predictable earnings to command meaningfully higher growth expectations. But the mechanics of implied growth explain why the medians remain relatively close.

Implied growth is calculated as a company’s weighted average cost of capital minus its operating cash-flow yield. Lower-quality companies face a higher cost of capital, reflecting their elevated risk. Yet those same risks also tend to push their valuations lower, which increases their cash-flow yields. These opposing forces partially offset each other. That is why the median implied growth rate does not collapse as quality declines. But focusing on the median growth rate misses the essential point.

THE EXPANDING DISTRIBUTION OF LOW QUALITY

The most critical insight in the chart is the *widening of the distributions*: as quality declines, the range of possible outcomes expands massively. And here we get to the crux of the issue. That widening is precisely why lower-quality companies can look so appealing in a risk-hungry market. The upside tail part of the distribution feels incredibly exciting, and that excitement can blind us to the downside tail. And just look at that downside tail part of the distribution of low-quality “F” stocks. That lower tail is just as real — and often far more damaging. What seems like rapid growth in calm conditions usually turns out to be a chimera, one that can completely unravel when risk appetite swings the other way.

Such regular yet sudden shifts betray the structural vulnerabilities embedded in many exciting but low-quality companies. Risk is not defined by the average outcome; it is defined by the range of outcomes — especially the negative ones. Lower-quality companies inhabit the widest and most dangerous part of that range. Higher-quality companies occupy the narrow, predictable center. For anyone concerned with long-term capital preservation, this distinction is fundamental. Now we would like to talk about where we are in the cycle.

RISK SHOWS ITSELF WHEN CONDITIONS CHANGE

Charts “B” and “C” on page 4 reinforce this logic by showing how markets have behaved under stress. When conditions deteriorated — as they did during the 2007–2009 financial

crisis, in the early stages of COVID-19, and throughout the rapid rate increases of 2022 — high-yield credit spreads widened sharply. In every one of those periods, high-quality companies strengthened their leadership over low-quality with near-perfect consistency.

When concerns arose, the market systematically abandoned fragility in favor of durability, stability, and resilience. This process is not episodic; it has been a persistent feature of market behavior.

TODAY'S ENVIRONMENT: UNCOMPENSATED RISK IN A LONG LOW-QUALITY CYCLE

Now consider where things stand today (Chart C, page 4). For more than 30 months, the environment has rewarded greater risk-taking. High-yield spreads have fallen to unusually low levels, meaning the compensation for bearing risk is historically thin. Predictably, low-quality companies have led during this stretch. But the first chart exposes the underlying fragility: these companies sit atop the broadest and most

precarious distribution of possible outcomes. When conditions eventually change — and history suggests they will — the adjustments tend to be swift.

WHY QUALITY MATTERS BEFORE THE CYCLE TURNS

Maintaining a focus on quality is not about chasing what worked last month or last quarter. It is about understanding the structural vulnerabilities inherent in low-quality companies and choosing not to expose your portfolio to unnecessary downside. If you are allocating new capital or rebalancing after a period of speculative gains, this may be an especially prudent moment to lean toward financially stronger, more predictable businesses.

Cycles turn. When they do, quality leadership tends to reemerge with speed and conviction. The evidence borne out time and again in history compels a choice. That choice comes down to one of quality. And we at Washington Crossing Advisors remain committed to choosing quality over uncompensated, low-quality risk or ephemeral growth.

CHART A | GROWTH EXPECTATIONS BECOME HARDER TO ESTIMATE AS QUALITY DECLINES

Source: WCA, Bloomberg

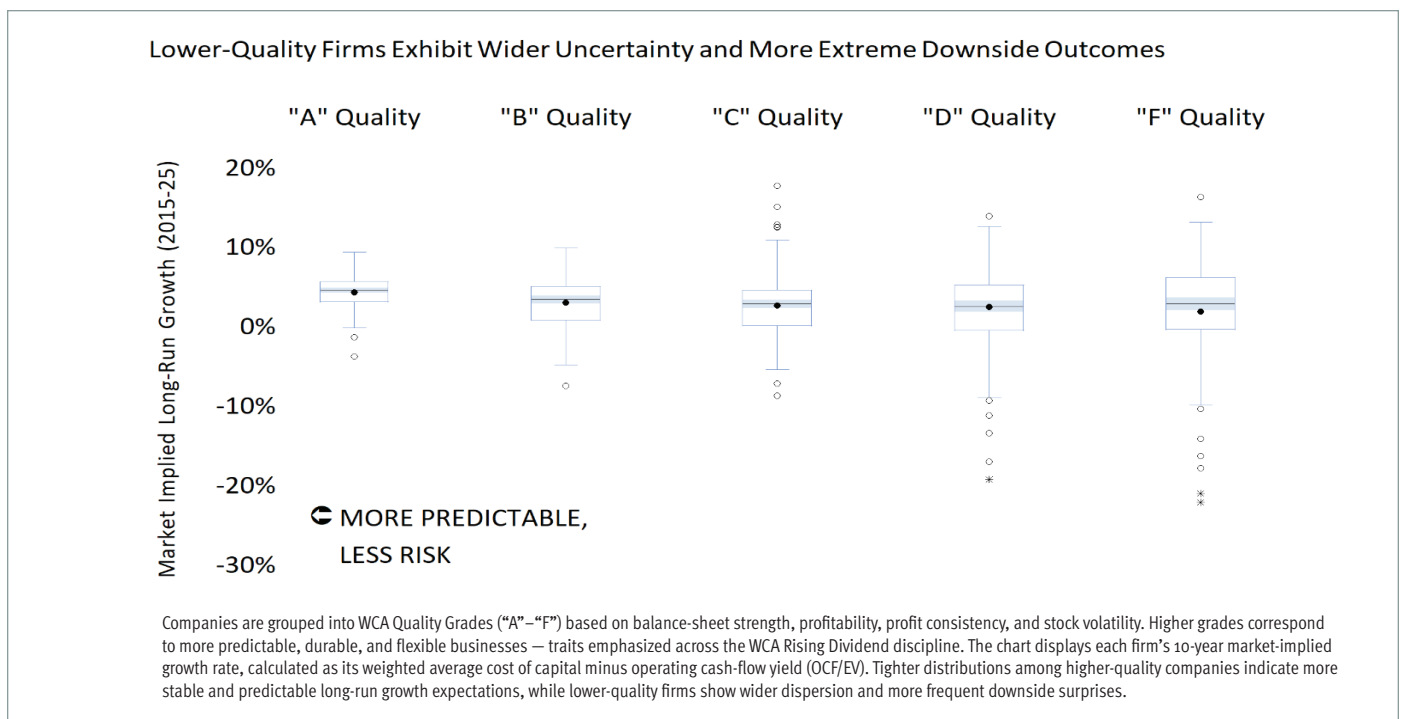
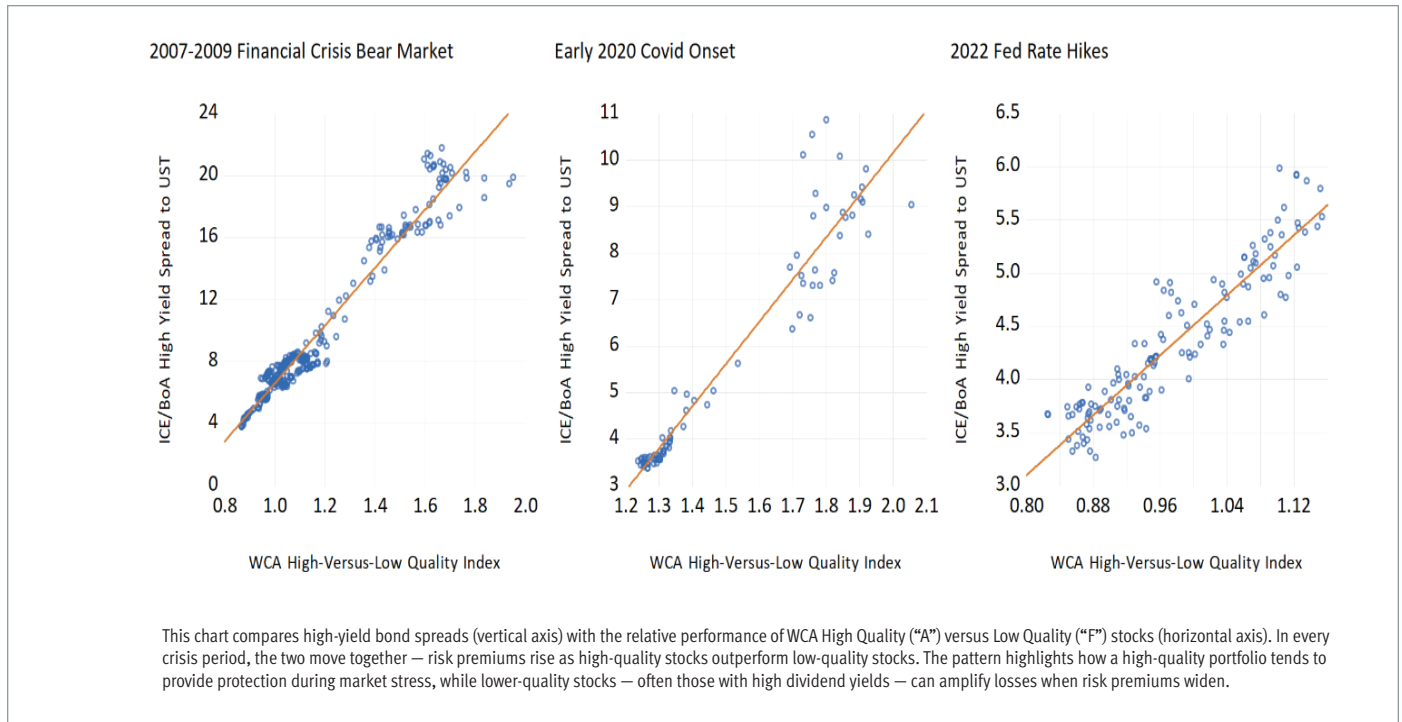
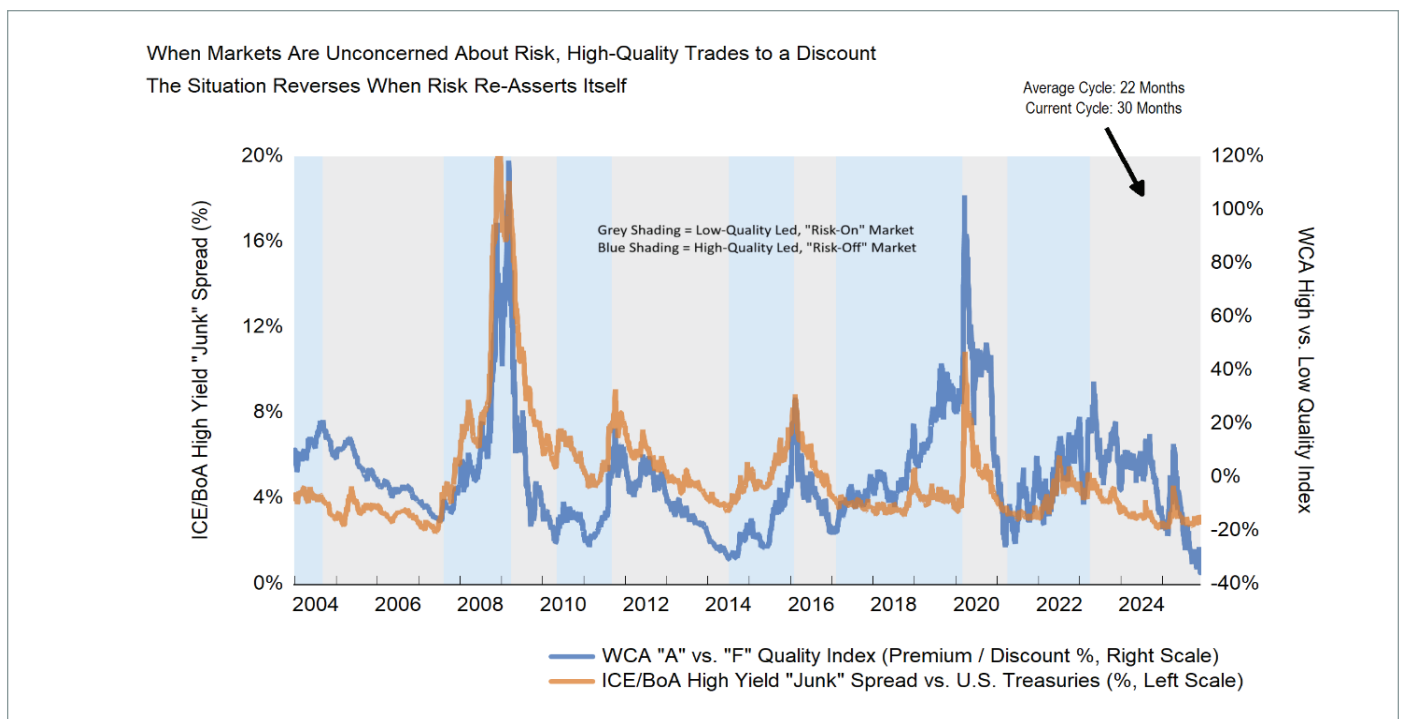


CHART B | HIGH QUALITY OUTPERFORMED LOW QUALITY DURING RISK-OFF PERIODS

Source: WCA, Bloomberg

**CHART C | TODAY: UNCOMPENSATED RISK IN A LONG LOW-QUALITY CYCLE**

Source: WCA, Bloomberg



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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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.

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.

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