syntrinsic

July 2022

2022 Mid-Year Capital Markets Forecast

Executive Summary

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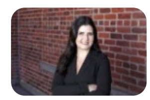

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The first half of 2022 has been tumultuous, to say the least. Year-to-date as of June 20, we have seen the S&P 500 enter bear market territory, the Federal Reserve's target interest rate rise 150 bps with further increases likely, inflation at a 40-year high, slowing growth, a protracted war in Ukraine, and an increased likelihood of a recession. In our Mid-Year Capital Markets Update, we address five themes impacting the macro environment and the capital markets: inflation, interest rate policy, recession, growth vs. value in equities, and increased correlations among certain asset classes. The outcome of our analysis has led to several changes in both sentiment and portfolio allocation.

- We are upgrading our near-term sentiment for short-term bonds to Neutral/Positive from Neutral based on the likelihood of continued rate hikes and the associated risks related to holding longer duration bonds. We previously increased the allocation to short-term bonds at the beginning of the year and are maintaining that allocation in the face of the current market environment.
- As a result of the short-term bond upgrade, we are upgrading our near-term sentiment on global fixed income to Neutral from Neutral/Negative. We are beginning to get more positive on the sector overall and think there could be some interesting investment opportunities as future rate hikes are further priced in. However, we are not increasing our allocation as we see the potential for future rate hikes leading to continued volatility within global fixed income.
- Non-US equities will continue to face a greater magnitude of macroeconomic and geopolitical challenges, including slower growth, supply chain disruptions from the war in Ukraine, and inflation, than will be felt in the US. Therefore, we are rebalancing our equity portfolios back to an overweight to US equities. While certain valuations for non-US equities look attractive relative to their US counterparts, we think US equities hold the potential for relatively higher growth and have a better risk/reward profile. We are not changing our near-term sentiment on non-US equities, however, as we see a continued role for non-US equities in client portfolios.

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Near-Term Sentiment Overview

Asset Class/Segment	3Q 2022 Near-Term Sentiment	1Q 2022 Near-Term Sentiment
Global Equities	**Neutral/Positive**	**Neutral/Positive**
US	Neutral/Positive	Neutral/Positive
Non-US Developed	Neutral	Neutral
Emerging Markets	Neutral	Neutral
Global Fixed Income	**Neutral**	**Neutral/Negative**
Short-Term Bond	Neutral/Positive	Neutral
Core Bond	Negative	Negative
Core Plus Bond	Neutral/Positive	Neutral/Positive
Non-US Developed Bond	Negative	Negative
Emerging Markets Bond	Neutral	Neutral
Real Assets	**Neutral/Negative**	**Neutral/Negative**
Real Estate	Neutral	Neutral
Commodities	Negative	Negative
Hedge Fund Strategies	**Neutral**	**Neutral**
Private Equity	**Neutral/Positive**	**Neutral/Positive**
Private Debt	**Neutral/Positive**	**Neutral/Positive**

We are maintaining the sentiment for almost all asset classes and segments consistent with the framework established earlier in 2022, except for Global Fixed Income, which we are upgrading to a Neutral from a Neutral/Negative, and Short-Term Bonds, which we are upgrading to a Neutral/Positive from Neutral.

We believe rate hikes will continue for the near-term as the US Federal Reserve (Fed) tries to tame inflation. We also believe the magnitude of individual rate hikes and the perceived ceiling of the Fed Funds Rate will remain uncertain in the near-term. Given these factors, shorter duration fixed income offers more compelling relative value than some of its longer duration peers at present due to overall lower interest rate sensitivity. Further, the US yield curve's drastic shift year-to-date has meaningfully reduced the term premium, and therefore the relative attractiveness, of intermediate and long duration bonds.

Similarly, our improved sentiment for Global Fixed Income reflects not only our upgraded view on short-term debt but also considers our wider view of the sector. We are encouraged by higher absolute levels of yield available across fixed income segments and an improved ability for bonds to offer defensive characteristics to a portfolio. That said, we are not increasing our overall allocation to either Global Fixed Income or Short-Term Bonds at this time, as we expect volatility to remain elevated for the remainder of the year in credit, particularly among credit spreads.

It is equally worth mentioning that we are maintaining our near-term sentiment for our Non-US Developed and Emerging Market Equities at Neutral despite decreasing our allocation to these segments. The consistent sentiment reflects the fact that we still see the benefit of a smaller allocation to these segments in client portfolios, especially given that a good portion of the negative news is priced in, in our view (e.g., sentiment around Russia and China in emerging markets).

Finally, we are maintaining our Neutral near-term sentiment for Hedge Funds following a correlation analysis discussed in greater detail below. While we recognize that hedge strategies need to be evaluated on a case-by-case basis, the ongoing appropriateness of specific strategies for certain client portfolios supports our current view.

Global Macroeconomic Themes

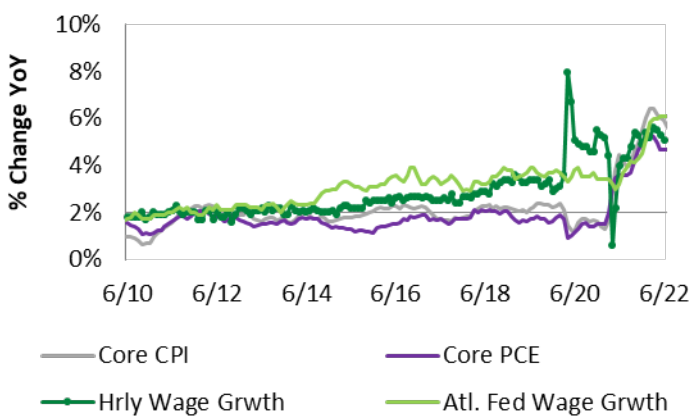
Theme	Syntrinsic Perspective	Allocation Effects
Inflation	We now expect inflation to remain elevated through the balance of the year and anticipate that any reduction would be more moderate than a decline to historical levels.	• Focus on US equities with a bias towards quality and income generation • Remain fully invested to avoid real return losses • Same as 1Q 2022
Rising Interest Rates	We expect further upward pressure on interest rates, potentially above what the Fed has telegraphed thus far, as the Fed works to control inflation.	• Maintain lower duration exposure • Maintain an allocation to floating rate debt in both public and private markets • Same as 1Q 2022
Potential Recession	A possible recession could look different than in the past given low unemployment and high inflation, which tend not to be recessionary characteristics. While we do not yet know whether we are, in fact, headed into recession, we are evaluating our portfolio positioning in case one was to occur.	• Maintain quality equity posture • Overweight US equities vs. non-US *(Increase US equity to maintain the overweight.)* • Maintain senior secured private debt investments with covenants, which are more insulated from economic downturn • Same as 1Q 2022
Growth vs. Value	Value stocks have enjoyed one of their best relative starts on record versus growth stocks, led by the energy sector, but this could be reversing as energy stock performance begins to slip. Given the high-quality growth stock sell off due to interest rate and inflation fears, there are opportunities for adept active managers to buy these companies at valuation multiples that should leave an adequate 'margin of safety' to earn future excess returns.	• Avoid equity market "tails": both high growth companies with weak balance sheets and distressed companies • Same as 1Q 2022
Asset Class Correlation	Increasing correlations between hedge funds and publicly traded equity, fixed income, and real estate has complicated traditional approaches to portfolio diversification and downside protection.	• Evaluate hedge fund inclusion in portfolios on a strategy-specific basis based on downside protection • Same as 1Q 2022

Theme: Inflation expectations are elevated

Author: Matt Kukla, Syntrinsic Alternatives Research

We have been discussing inflation since early 2021, yet it continues to plague the economy and capital markets at large. Indeed, in June, inflation had the largest gain since the end of 1981[1], coming in at 9.1% and 5.9% ex-energy and food, which remains well above the Fed's 2% target. Current market sentiment seems to be focused on both the duration and magnitude of Federal Reserve monetary policy tightening aimed at reigning in inflation. This stems partly from supply-side shocks related to the Russia/Ukraine conflict, which does not seem to be diminishing, as well as supply-chain constraints from China's Zero-Covid policy, although Shanghai has recently lifted its latest round of Covid restrictions.

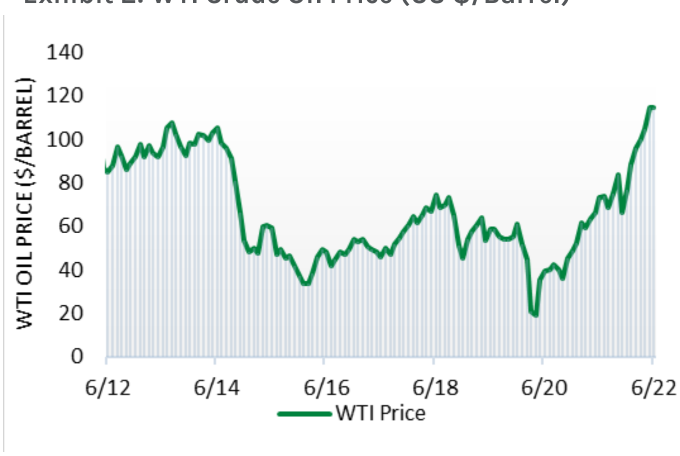
Exhibit 1: CPI Components



Source: Bloomberg

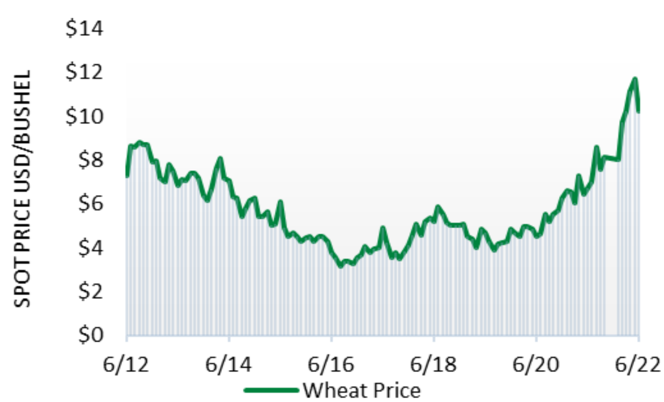
In turn, the Fed's monetary policy tightening initiatives aimed at controlling or potentially reducing inflation have provoked concerns regarding the impact on growth, notably because US GDP declined 1.4% in 1Q22 (vs. consensus estimates of a 1.0% increase). We had previously believed that inflation would peak in 2022, but our estimates did not factor in a prolonged war in Ukraine, with its significant impact on energy and food prices (see Exhibits 2 and 3) or a resurgence of COVID-related lockdowns in China, which constrained supply chains. The supply chains shocks/constraints are beyond the Fed's control. While monetary policy can be effective against some inflation measures, the Fed has recently acknowledged that higher interest rates won't fix the current supply chain disruptions because of the Russia/Ukraine war and lower food and gasoline costs.

Exhibit 2: WTI Crude Oil Price (US $/Barrel)



Source: Bloomberg

Exhibit 3: Wheat Spot Price (US $/Bushel)



Source: Bloomberg

[1] Bloomberg

Consequently, we now expect inflation to remain elevated through the balance of the year and anticipate that any reduction would be more moderate rather than a decline to historical levels. While CPI averaged 1.8% over the last decade (2009-2019), we think a return to the Fed's 2% inflation target will take some time and recognize that the new normal level may be higher given the factors that have led to lower inflation in the past (e.g., globalization, employment) have changed post pandemic.

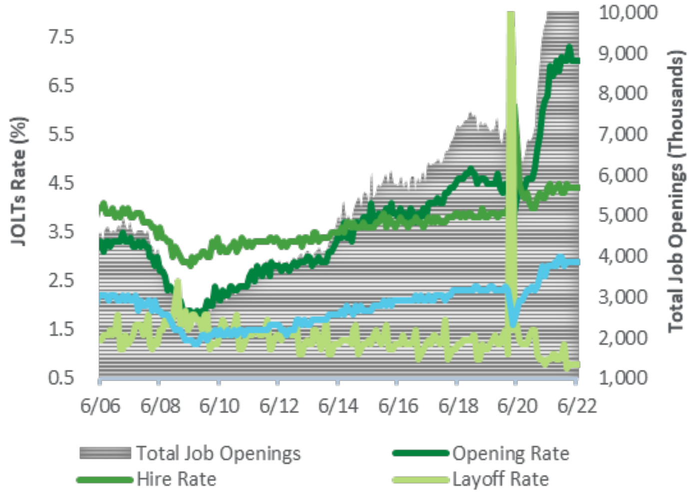
As we wrote in our 2020 and 2021 Capital Markets Forecasts, globalization has come under pressure since the pandemic. In the past two years, global supply chains across industries have been disrupted and/or severed because of the pandemic, geopolitical issues, and most currently the war between Russia and Ukraine. Historically, globalization was about price and manufacturing efficiencies creating mutual dependencies across regions and has led to lower inflation[2]. Those mutual dependencies are now causing fear and significant inflation in key food and energy prices. As a result, more companies are focused on supply chain resilience and prioritizing regionalization[3], as well as protectionist measures by global governments. We anticipate that will continue and add to inflation risks. Brexit, which led to higher inflation in the UK, was an early case study of de-globalization.

Despite the current environment of relatively high inflation and the potential for slowing growth, an area of the economy that has thus far held up has been the labor market. Recent economic data indicate unemployment rates remain at low levels, 3.6%[4] as of June 2022. However, it is worth noting that slowing economic growth could lead to an increase in unemployment, which could impact consumer spending and dampen inflationary pressures. Indeed, the healthy employment picture has partly been offset by both dwindling consumer and business confidence, which have declined by 8.3% and 7.2% from 1Q22 respectively (Exhibits 6 and 7), while the S&P 500 has entered bear market territory, which is defined as a decline of at least 20% from its peak. This has raised concern by some that we could be headed for a recessionary environment.

Given our expectations for ongoing, elevated levels of inflation and the potential for continued tighter monetary policy in the near-term, we think that exposure to short-term debt, floating rate fixed income, and senior tranche private credit are appropriate. We move to Neutral/Positive on short-term bonds and remain Neutral/Positive on core plus, which includes floating rate exposure, as we think there is the potential future rate hikes above what is currently priced in the market to contain inflation which will heighten volatility. Similarly, our move to Neutral for global fixed income as an asset class is partly because of the positive Neutral/Positive sentiment on short-term bonds and core plus bonds.

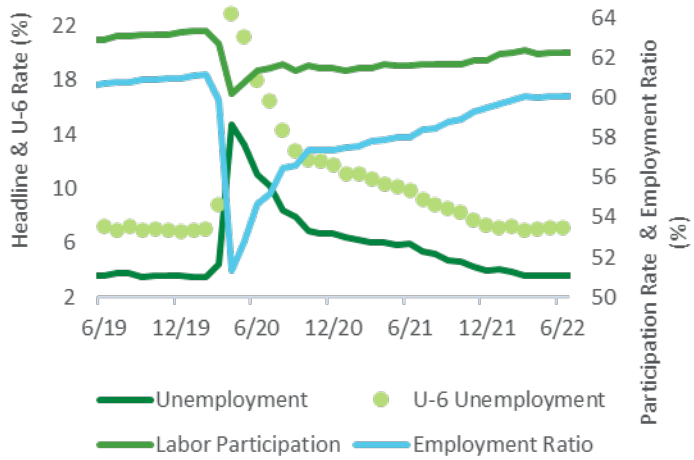
[2] MIT, Kristin J. Forbes, Inflation Dynamics: Dead, Dormant or Determined Abroad? Fall 2019
[3] McKinsey, How COVID-19 is reshaping supply chains, November 2021
[4] Bloomberg

Exhibit 4: US JOLTS Labor Market Statistics



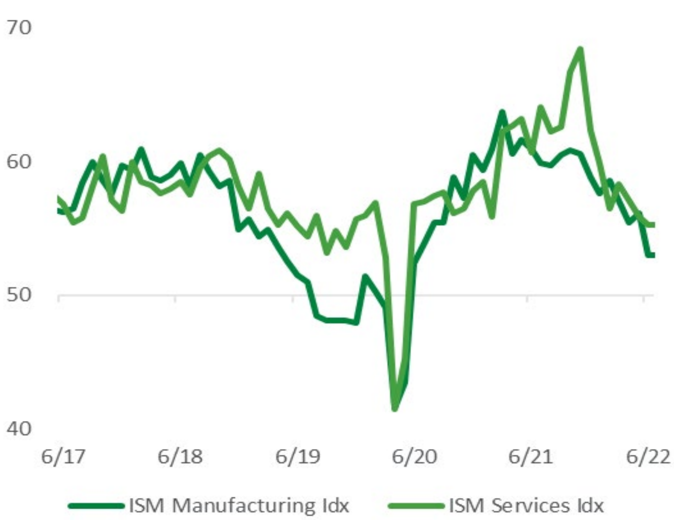
Source: Bloomberg

Exhibit 5: US Unemployment and Labor Participation



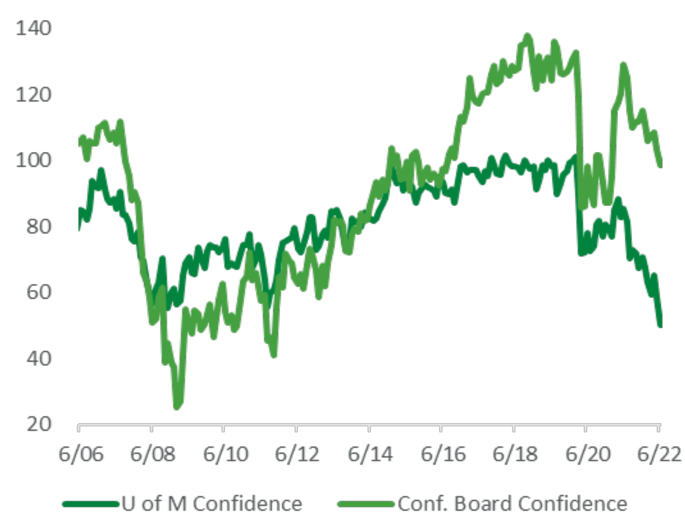
Source: Bloomberg

Exhibit 6: US ISM Manufacturing Index and US ISM Services Index



Source: Bloomberg

Exhibit 7: US Consumer Confidence



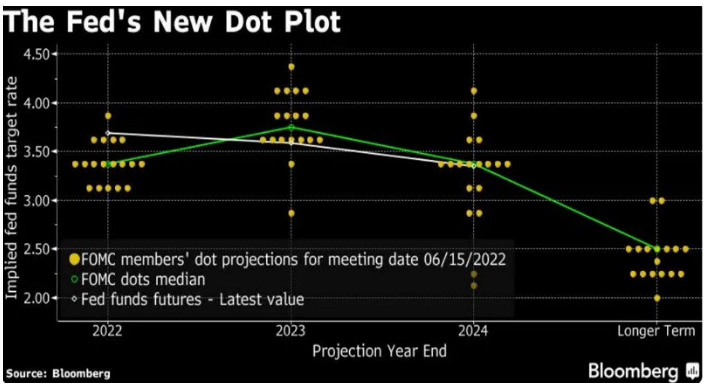
Source: Bloomberg

Theme: Fed tightening to continue in the near-term

Author: Robin Meyer, CFA, Syntrinsic Fixed Income Research

Global financial markets are in the initial stages of a very meaningful monetary tightening cycle, particularly surrounding G-7 countries. Domestically, the Fed kicked off a US tightening cycle mid-March with an increase of +0.25% to the Fed Funds Rate, the first upward move in the Fed Funds Rate since 2018. Subsequent hikes of +0.50% in early May and +0.75% in mid-June have followed. The Fed has indicated further hikes of a similar magnitude may be in store for the near future, but that these decisions will be very data dependent. On top of hikes to the Fed Funds Rate, as of June the Fed has begun to unwind its bloated balance sheet by allowing maturing Treasury and Agency MBS securities to "roll-off" without reinvesting the proceeds. This dynamic removes the most substantial buyer (the Fed) from both markets, with implications yet to be seen.

Exhibit 8: Fed's Dot Plot



Source: Bloomberg

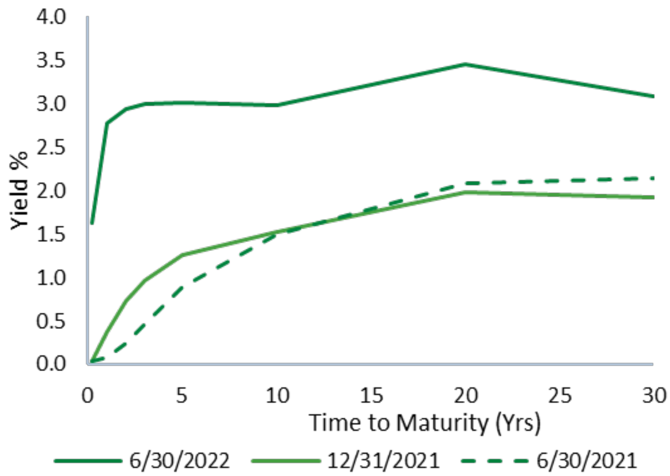
As it stands now, the hawkish stance of the Fed is certainly appropriate. Fed chair Jerome Powell and other FOMC members have remained hawkish. Members have tried to drive home the point that inflation is the absolute #1 priority for the Fed at this point and everything else is secondary. This stance is important as all indications are that the Fed is willing to tolerate a recession to keep inflation under control. The fear that Fed tightening will persist to and through a potential economic downturn has negatively impacted fixed income markets year-to-date while also keeping would-be bond investors predominantly on the sidelines.

One of the benefits of the move higher in treasury rates alongside a widening of credit spreads, is that we now have some of the more attractive yield levels across the fixed income landscape than we've seen in several years. Corporate fundamentals also remain strong with ample cash on balance sheets, strong debt service ratios, and in some instances (namely the high yield credit market) a better overall quality than during previous cycles.

One additional benefit of the move higher in the Fed Funds Rate is that the Fed has now regained the ability to move in the opposite direction should a crisis unfold. This positions the Fed to address of any number of potential economic or geopolitical risks looming in the background. Bonds being used in a traditional defensive portfolio allocation is much more relevant than just six months prior, which is why we continue to maintain an allocation to some intermediate fixed income even with the potential for higher rates.

Much of the same fixed income positioning themes entering 2022 are still relevant as we approach mid-year. We remain positive on floating rate exposures at this stage as interest rate risk is still very much present. This reinforces our Neutral/Positive sentiment on core plus bond. Along that note, we similarly remain positive on a shorter duration profile overall, which is reflected in our upgrade to a Neutral/Positive sentiment on short-term debt. Spread sector opportunities have shifted slightly and while we remain positive towards structured credit, traditional investment grade credit has become more attractive. This environment of higher market yields will ultimately translate into higher financing costs for corporate borrowers. Higher costs of financing will put stress on margins and will pressure those companies that are not in great financial shape. Avoiding poor quality credits will be important, further stressing the need for active managers with strong credit selection skills.

Exhibit 9: US Treasury Yield Curve



Source: Bloomberg

However, despite an improvement in our overall sentiment for fixed income, we do not recommend increasing the allocation to fixed income as headwinds remain. We continue to expect a challenging bond market for the remainder of the year as the fear of further Fed tightening increases the volatility of the asset class. In addition, if interest rates were to increase from current levels, which is a definite possibility, bond prices would decline, causing negative performance. Further upward pressure on credit spreads is also a possibility, as higher credit spreads coincide with tighter financial conditions, which the Fed is striving to achieve.

Theme: Navigating a recession

Author: Jennifer Leonard, CFA, Syntrinsic Markets Research

The rumblings about a potential recession are getting louder. We saw negative GDP in 1Q22, a decline of -1.4%[5] which fell well short of the +1.0% consensus expectation. However, this was partly driven by a trade imbalance with China that resulted from attempts to restock inventories in the US. Given that a popular measure used to gauge whether we are in a recession[6] is two quarters of consecutive GDP decline, we could indeed be in for a recession if 2Q22 GDP growth is again negative (current consensus is for positive growth of 2.1%). However, the National Bureau of Economic Research (NBER) evaluates not only GDP but also rising levels of unemployment, falling retail sales, and contracting measures of income and manufacturing that lasts for more than a few months – and that current economic data is mixed (see Exhibit 10).

Exhibit 10: Economic Update Summary

Purchasing Manager's Index (PMI)

	6/30/22	3/31/22	12/31/21	9/30/21	6/30/21	3/31/21	12/31/20	
US Composite	51.2	57.7	57.0	55.0	63.7	59.7	55.3	↓
DM Composite	53.7	56.0	54.8	53.8	59.3	55.9	52.0	↓
EM Composite	46.9	46.8	53.2	52.3	50.8	52.5	54.1	↑

Retail Sales, Annual % Change

	6/30/22	3/31/22	12/31/21	9/30/21	6/30/21	3/31/21	12/31/20	
US	8.1	7.1	16.8	14.3	19.4	30.3	3.2	↑
Eurozone	3.9	1.6	2.3	2.7	5.6	13.7	1.8	↓
China	-6.7	-3.5	1.7	4.4	12.1	34.2	4.6	↓

Consumer Confidence

	6/30/22	3/31/22	12/31/21	9/30/21	6/30/21	3/31/21	12/31/20	
US	98.7	107.6	115.2	109.8	128.9	114.9	87.1	↓
Eurozone	-23.6	-21.6	-9.3	-3.8	-1.8	-9.5	-12.2	↓
China	86.8	113.2	119.8	121.2	122.8	122.2	122.1	↓

Unemployment Rate

	6/30/22	3/31/22	12/31/21	9/30/21	6/30/21	3/31/21	12/31/20	
US	3.6	3.6	3.9	4.7	5.9	6.0	6.7	-
Eurozone	6.6	6.8	7.0	7.3	7.9	8.2	8.2	↓
China	4.0	4.0	4.0	3.9	3.9	3.9	4.2	-

US Financial Conditions

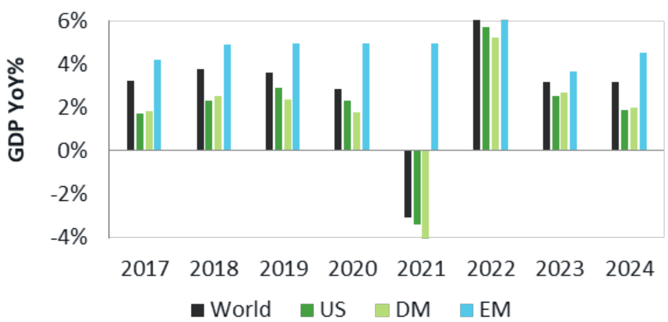
	6/30/22	3/31/22	12/31/21	9/30/21	6/30/21	3/31/21	12/31/20	
US Financial Conditions	-1.1	-0.1	1.1	0.9	1.3	0.9	0.6	↓

Sources: Bloomberg, Markit, US Census Bureau, Eurostat, National Bureau of Statistics China, US Conference Board, European Commission, and US Bureau of Labor

[5] Bloomberg
[6] Forbes, What is A Recession, June 20, 2022

According to NBER data[7], from 1945 – 2009, the average recession lasts 11 months. However, excluding the brief economic downturn in 2020 (2 months) that was pandemic driven, the US has not experienced a true recession since the recession that started in December 2007 and ran until June 2009, according to the St. Louis Federal Reserve. This implies that the recent period of economic growth has lasted well beyond the typical economic cycle.

Exhibit 11: Realized and Forecast GDP Growth (Bloomberg Consensus)



Source: Bloomberg

Looking at growth globally, The World Bank[8] just cut 2022 global growth estimates to 2.9% from 4.1% (it was 5.7% in 2021). For the US, the 2022 growth estimate declined by 1.2 percentage points to 2.5% overall. To achieve this target, US GDP growth for the remainder of 2022 must be at least 3.9%, which could be challenging. For the Euro area, the forecast declined by 1.7 percentage points to 2.5% as well.

At this point, it appears as if the global equity market is factoring in the potential for a current recession given the 20.2% decline in performance as of June 30, 2022, and the growth to value rotation. In the US, equity markets declined by 21.1% as evidenced by the Russell Index 3000, and non-US equity markets declined 18.4% as evidenced by the MSCI All Country World Index ex US.

If a recession were to occur, we anticipate that this recession would have a different playbook as the starting point for consumers and corporations is better than in the past. In addition to the hallmark negative growth, as mentioned previously, recessions are marked by a decline in economic activity which includes rising levels of unemployment and contracting measures of income. That said, we are currently in a situation of near full employment, high inflation, and consumer and corporate balance sheets are strong.

With tightening monetary policy globally to combat inflation, lingering damage from the COVID-19 virus and its variants on growth, increasing geopolitical concerns, and the protracted war between Russia and Ukraine, there is distinct possibility that there will be recession in the US and Europe. In view of that possibility, we continue to recommend an overweight to US equities and an allocation to higher yielding fixed income such as private debt.

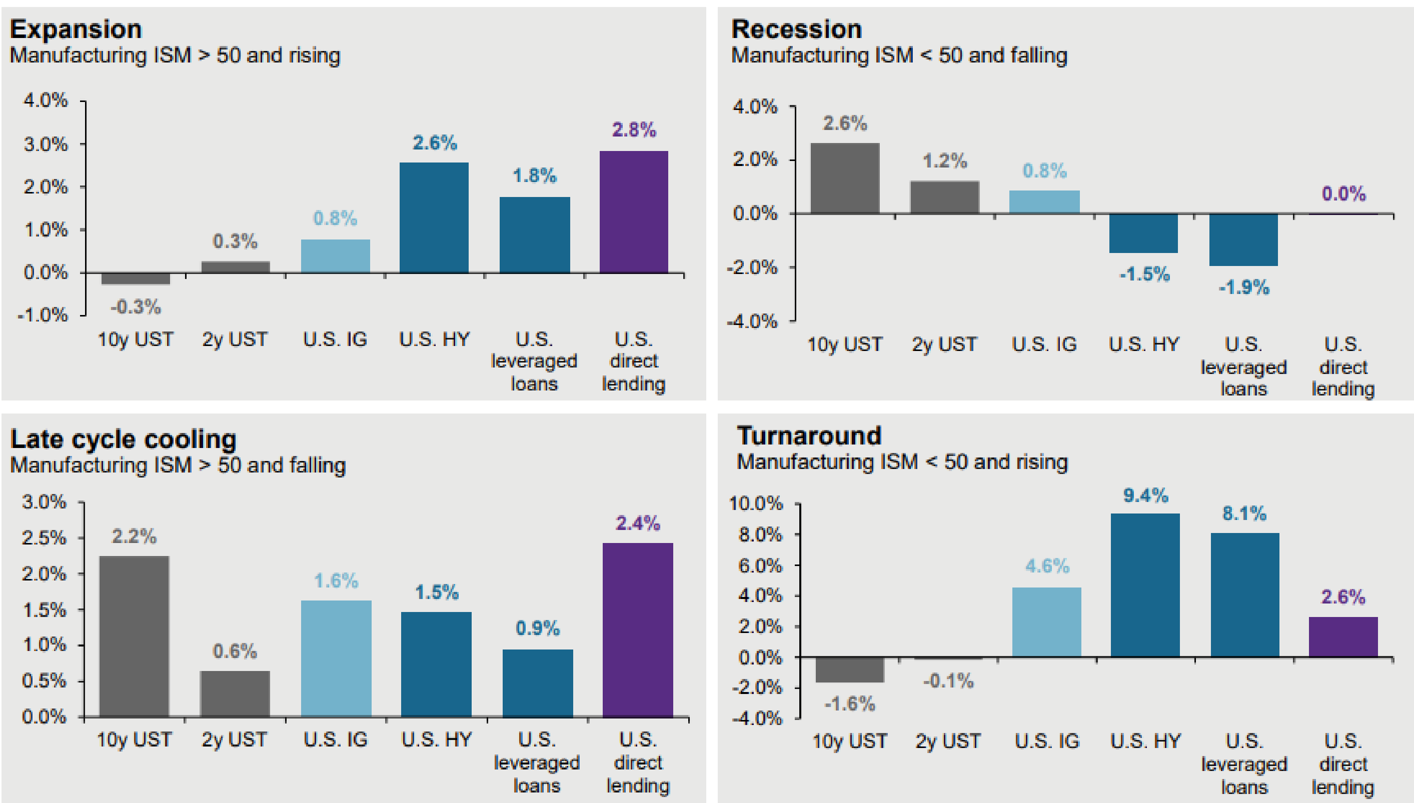
We remain Neutral/Positive on US equities vs. Non-US developed and emerging market peers, where we are Neutral, and advocate rebalancing equity allocations back to a relative overweight in US stocks vs. the broader market. We believe that US equities are better positioned and hold the potential for higher growth and have a better risk/reward profile. Within equities, historically value usually outperforms growth going into a recession, and consistent with this, value stocks have outperformed growth peers since November 2021. At this time, we are not advocating a switch into value as that trade has already played out and we

[7] National Bureau of Economic Research, Business Cycle Dating
[8] The World Bank, Stagflation Risks Rises Amid Sharp Slowdown in Growth

believe over the long-term a core allocation (mixture of growth and value) with a quality bias will outperform during a full economic cycle (see Theme: Growth vs Value in 2022).

Private debt investments in senior secured loans with strong covenants remain attractive in this environment given the higher yields and floating rates. We were initially concerned that middle market companies could be significantly impacted by a potential recession. Yet despite the market downturn in 2020, the Cliffwater Direct Lending Index – Senior Debt still managed to return 5.5% for the year, with realized losses being more than offset by realized income. Historically, US direct lending has outperformed in a recession, expansion, and late cycle cooling (see Exhibit 12). As a result, we maintain our sentiment on private debt of Positive/Neutral.

Exhibit 12: Private Debt Returns Across Economic Cycles (2004 – 2021)



Source: Institute for Supply Management, Credit Suisse, Cliffwater. J.P. Morgan Asset Management

Theme: Growth vs. Value in 2022

Author: Jared Hobson, CFA, Syntrinsic Global Equity Markets Research

Value stocks have historically been delineated from growth stocks by their price-to-book (P/B) ratios, which is a measure of the market capitalization relative to shareholder's equity on the balance sheet. Value stocks have low P/B ratios for various reasons including (a) the company is not growing or is shrinking; (b) it has not shown an ability to provide an adequate Return on Equity (ROE) to justify a market cap premium to its balance sheet book value; and (c) the company is in an out-of-favor sector and thus its valuation is depressed. Growth stocks have higher P/B ratios because they are presumed to continue growing in the future at a relatively high ROE. Indices tend to add a few other metrics in categorizing growth versus value stocks. For example, the US Russell indices break stocks into their value or growth indices based not only on P/B ratios but also historical sales growth and forecasted earnings growth.

Through June 2022, value stocks have enjoyed one their best relative starts on record versus growth stocks (See Exhibit 13). Value performance has been led by the energy sector with equities tied to oil & gas prices having benefited from strong commodity trends (e.g., restarting the economy and geopolitical issues) and the view that these equities can play a role as an inflation hedge. In fact, the S&P 500 energy sector has increased 31.8% YTD, the only sector with positive returns in the index. With the value factor back in favor, a key question to ponder is "how should equity portfolios be positioned going forward?" Although value stocks have outperformed in prior periods of multi-year, above-trend inflation, there have only been two such data points post-WW2 with the most recent over 40 years ago. With most investors and company management never having operated in an inflationary environment there is a tremendous amount of uncertainty.

But this current widespread in value/growth has been at least as much about the magnitude of the growth stock selloff, especially in unprofitable small and mid-cap stocks. This speculative growth bubble was popped in late 2021 by the Fed when it first signaled that interest rates would be increasing in 2022 driven by higher economic growth and inflation. With inflation continuing to surprise to the upside in early 2022, the growth stock selloff broadened out into the high-quality, large cap growth space.

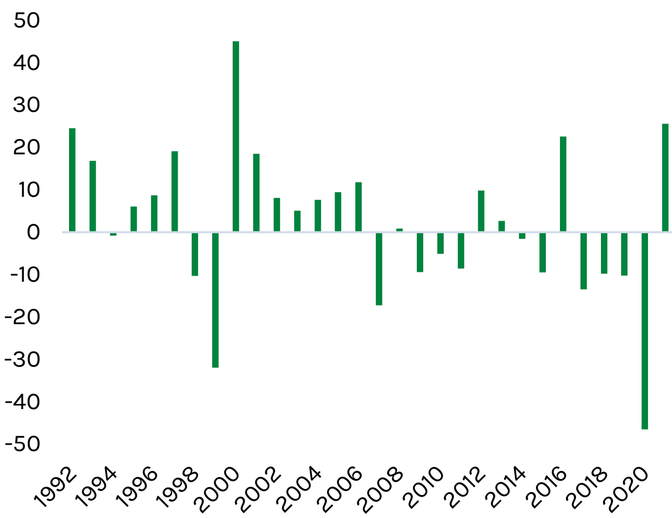
Exhibit 13: Growth vs Value

	YTD thru 6/30	5-year	10-Year
ACWI Value	-12.3%	4.3%	6.9%
ACWI Growth	-28.3%	8.1%	9.0%
S&P 500 Value	-11.4%	8.2%	11.0%
S&P 500 Growth	-27.6%	13.5%	14.4%

Source: MSCI; as of 6/30/22; the All-Country World Index is a proxy for global large- and mid-cap stock performance, encompassing over 2,900 stocks across 23 developed and 24 emerging markets. S&P Down Jones Indices; as of 6/30/22; the S&P 500 tracks the 500 largest exchange-traded companies in the US.

Despite the painful growth stock sell-off year-to-date, growth has outperformed value over both the trailing 5 and 10-year periods (Exhibit 13). In fact, prior to 2021, growth stocks had an almost uninterrupted 15-year run of outperformance versus value stocks. This was capped off in 2020 when growth outperformed value by the largest magnitude in the last 30 years (see Exhibit 14). Growth stocks stayed in favor for so long because growth was such a scarce asset in the sub-par economic aftermath of the late 2000s Great Financial Crisis. Central banks had to stay accommodative as deflation was viewed as the primary risk in a lower demand world. Interest rates were lower for longer and equity investors were trained to ‘buy the dip’ as the Fed came to the rescue of any risk asset selloff. As a result, complacency developed around equity valuations as a new era of momentum investing was upon us. The final top in speculative growth stocks occurred in 2020, when a flood of stimulus to prop up the economy during COVID contributed to an unhinged rally in unprofitable but fast-growing software, Internet, and biotech stocks that were being valued at price-to-revenue multiples not seen since the late 1990s tech and telecom bubble. Higher quality, profitable growth stock valuations were also lifted during this period.

Exhibit 14: Value minus Growth Factor; US markets (%) 1992 - 2021



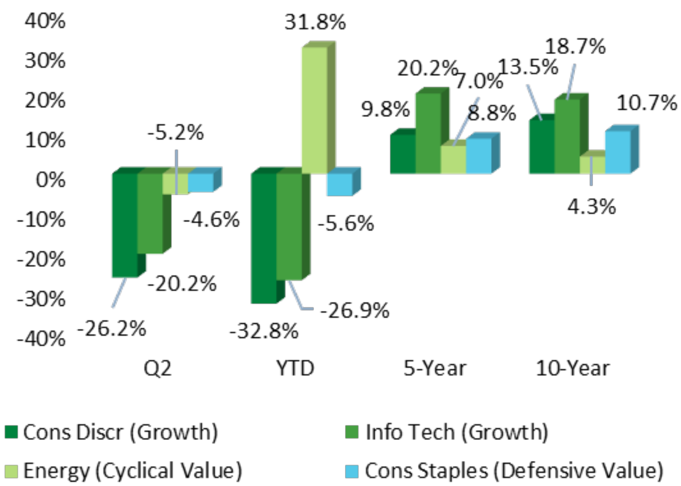
Source: Fama/French Research Factors data; Kenneth R. French - Description of Fama/French Factors (dartmouth.edu)

The subsequent multi-year underperformance of tech and telecom stocks in the early 2000s is an important period to understand to gain insight on what could be on the horizon over the next several years. Similar to what has occurred recently, the late 1990s saw a significant amount of capital plowed into unprofitable private and public technology companies. The Fed began raising rates in 1999 through mid-2000 which helped pop that speculative bubble. As a result, during the early 2000s, growth stocks had a multi-year hangover as valuation multiples compressed and investors rotated into neglected value stocks. In fact, value stocks outperformed growth stocks every year from 2000 thru 2006 (Exhibit 14). Technology will remain a secular growth area based on how much productivity it brings to corporations and consumers. But the capital markets window has closed shut for the near future, and companies will need to adjust their business models to focus on self-sustaining growth with profitability. With many companies just beginning to come to grips with this realization, valuations remain vulnerable as growth forecasts get slashed. A company that now trades at a 10x forward revenue multiple vs. 30x six months ago is no more attractive than six months ago, especially when its growth outlook is less certain (we evaluate revenue multiples given that many of these companies are still unprofitable, and thus cannot be evaluated on any profit metrics). As shown in Exhibit 14, style investing tends to cluster over multi-year periods. It takes a while for irrational exuberance to unwind and often it gets overdone in the opposite direction. It should be noted that the data captured is split equally between large cap and SMID stocks. SMID value, in particular, significantly outperformed growth in 2021, which is why this variance is so significant, despite the fact that large-cap value outperformed large-cap growth only marginally.

The High-Quality Growth Opportunity

Although growth stock investing may continue to face incremental headwinds, it is important to remember that there are differentiated, wide-moat companies in wide-ranging industries (including tech!) capable of growing at multiples of GDP with above-average margins and cash flow generation. Valuation multiples of these 'growth at a reasonable price' companies also expanded when the growth factor was in favor in the prior low-rate environment. But, unlike the unprofitable companies valued on sales multiples, these companies can be valued on multiples of earnings and cash flow, providing valuation support. These companies' ability to compound capital at a higher rate means they will trade at a premium to the market on an earnings or cash flow multiple. With these high-quality growth stocks selling off this year due to interest rate and inflation fears, adept active managers can buy these companies at valuation multiples that should leave an adequate 'margin of safety' to earn excess returns in future years.

Exhibit 15: S&P 500 Growth versus Value Sectors (June 30, 2022)



Source: Morningstar, Dow Jones

We believe that the equity allocations should have a well-diversified representation of style factors, including value and growth stocks. However, in general, we cut off the tails, tending to avoid investment managers that traffic in either higher risk deep value stocks (commodities, high debt) or high growth stocks (unprofitable companies valued on revenue multiples). We prefer active managers that view valuation as one leg of a three-legged stool along with business quality and business momentum. Our goal is to identify managers that may place a different weight on these three legs but when blended result in a well-balanced stool that can withstand the test of time.

Theme: Portfolio diversification in a correlated world

Author: Jennifer Leonard, CFA, Syntrinsic Markets Research

As we finish the second quarter, we are seeing that correlations among hedge funds and many other asset segments in the public markets – global equities, global fixed income, listed real estate, and short-term debt – have increased, making a traditional approach to diversification less effective overall. This is evident in our correlation analysis, where we compared a ten-year correlation study using data as of March 2022 with one from March 2017 (see Exhibit 18).

Indeed, on a year-to-date basis we seem to be in a market where presently there is nowhere to hide, even if correlations have statistically declined. In our recent piece, This is a Test. This is Only a Test, we discussed several investment options that can seem like uncorrelated safe havens but could be losing propositions. This included energy, which we think has already enjoyed the bulk of its run up. We think that the same logic can also be applied to all commodities; our near-term sentiment remains Negative on that segment of the market.

The correlation exercise also implies that hedge funds are currently less effective as a source of downside protection in a diversified portfolio than in prior periods, although we note that they had been already highly correlated to the performance of global equities prior to this year. It is worth mentioning that there are different types of hedge funds with differing goals in diversifying a portfolio and adding downside protection. These include equity hedge, which are more correlated to the performance of equity markets given that managers are taking long and short positions in stocks of companies; macro hedge, which look to hedge out the macro risk of a portfolio; event driven, where funds attempt to profit from corporate events such as mergers; and relative value, where managers attempt to profit from relative price dislocations in similar securities.

As a result of this analysis, we re-evaluated our use of hedge funds within client portfolios. We continue to see value in certain hedge funds as a downside mitigator but are looking at strategies on a case-by-case basis for portfolio inclusion. For example, we continue to use an equity-based strategy that integrates options selling, as this has performed relatively decently during the YTD period. Overall, we are maintaining our near-term Neutral recommendation at the present time for this asset segment, reflecting increased caution but selective, attractive investment opportunities for certain strategies.

Exhibit 17: 1Q 2022 Correlation Matrix (10 Year)

	Global Equity	Private Equity	Private Debt	Listed Real Estate	Global Fixed Income	Short-Term Fixed Income	Cash	Hedge Fund
Global Equity	1.00	0.25	0.14	0.80	0.33	(0.01)	(0.18)	0.86
Private Equity		1.00	0.87	0.19	0.17	0.00	(0.14)	0.22
Private Debt			1.00	0.17	0.17	0.05	(0.12)	0.11
Listed Real Estate				1.00	0.49	0.17	(0.17)	0.69
Global Fixed Income					1.00	0.69	0.10	0.26
Short-Term Fixed Income						1.00	0.28	0.02
Cash							1.00	(0.24)
Hedge Fund								1.00

Source: Morningstar

Exhibit 18: Correlation Change between 1Q 2017 and 1Q 2022 (10 Year)

	Global Equity	Private Equity	Private Debt	Listed Real Estate	Global Fixed Income	Short-Term Fixed Income	Cash	Hedge Fund
Global Equity	-	(0.22)	(0.21)	(0.08)	(0.10)	(0.09)	0.14	0.06
Private Equity		-	-	(0.12)	(0.10)	(0.12)	(0.05)	(0.21)
Private Debt			-	(0.05)	(0.04)	(0.10)	0.00	(0.24)
Listed Real Estate				-	(0.07)	(0.08)	(0.12)	0.10
Global Fixed Income					-	(0.04)	(0.02)	0.07
Short-Term Fixed Income						-	0.02	0.06
Cash							-	(0.06)
Hedge Fund								-

Source: Morningstar

Insights Archive

Podcast: Market Trends and Portfolio Positioning
Jennifer Leonard, CFA
July 11, 2022

Russell 100 Value 2022 Observations
Syntrinsic Investment Committee
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Podcast: The Fixed Income Markets
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1Q 2022 Capital Markets Update
Syntrinsic Investment Committee
April 30, 2022

Podcast: Syntrinsic's 2022 Capital Market Views
Akasha Absher and Anna Todorova
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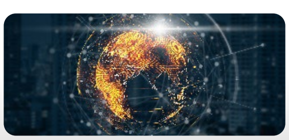

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Syntrinsic Investment Committee
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Matt Kukla
February 10, 2022

Disclosures

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