2022 Fourth Quarter All-Cap Value Commentary
February 10, 2023

Summary of 2022's Market

2022's market was driven primarily by the Ukraine war's impact on energy prices and fears of recession from the Federal Reserve's actions to curb inflation. The energy sector rose 66%+ while consumer staples, utilities, and health care were generally positive as investors sought "safe harbors" from the economy due to fears that higher interest rates would bring recession. (See sector returns table below).

Despite these increases, the S&P 500 fell 18.1%, and the Russell 1000 Value (R1000V) and 3000 Value (R3000V) indices fell 7.5% and 8.0%, respectively, due to significant declines in sectors more affected by any spending slowdown, particularly technology, communication services, and consumer discretionary.

2022 % Returns by Sector

Sector	2022 % Return	
	SP500	R1000V
Energy	66.3%	66.1%
Consumer Staples	-0.6%	1.6%
Utilities	1.3%	1.4%
Health Care	-1.9%	0.4%
Materials	-12.2%	-7.3%
Industrials	-5.7%	-7.6%
Financials	-10.6%	-10.5%
Consumer Discretionary	-37.1%	-19.8%
Communication Services	-39.7%	-25.6%
Real Estate	-26.3%	-26.1%
Information Technology	-28.2%	-28.5%

These sector return disparities largely explain the divergence between the S&P 500 and Russell Value indices last year. For example, the S&P 500 has less exposure to 2022's top-performing energy, utilities, and healthcare sectors than the R1000V (31% vs. 39) but more exposure to technology, communications, and consumer discretionary (43% vs. 22%). Our All-Cap Value (ACV) results were similarly affected since our 23% weighting in energy, utilities, and health care was below the Russell value indices while our 35% allocation to technology, communications, and consumer discretionary was above. Nonetheless, our ACV model portfolio results tracked close to our R3000V benchmark due to positive stock selection and cash, declining 8.5% gross of fees (or 10.3% after a hypothetical fee of 2%) [1] versus 8.0% for the R3000V.

Ours Was Never "*A Random Walk Down Wall Street*"

Burton Malkiel wrote "*A Random Walk Down Wall Street*" 50 years ago and recently gave a 50th anniversary interview with Barron's. It was gospel at Wharton when I attended two years later, despite its unpalatable conclusion that active managers cannot beat a passive index because the market quickly and efficiently reflects all publicly available information. Malkiel told Barron's he was even more confident in the theory today, noting that over 20-year periods, less than 10% of active investment managers match a simple index fund.

I accepted Malkiel's view that stock analysts cannot provide consistently superior judgments about future stock prices and instead launched a "*structural investment*" approach in 1986. This relied on a more stable and robust valuation model based on Buffett's 1977 article "*How Inflation Swindles the Equity Investor*." This valuation model focuses on obtaining a fixed real return above inflation over a specified time horizon through a business' reinvestment process. In 1996, I added "graphical value trap avoidance tools" to reduce our error rate in making growth assumptions by identifying financial "footprints" associated with structural and managerial health or decline. Rather than feign superior insights into the future, this approach tries to ignore public information as much as possible and instead rely on a business' structural health to invest in companies where future growth is overly discounted.

Thirty-seven years later, the below results confirm the difficulty of adding value over passive indices via a diversified portfolio of stocks but also show that it is consistently possible. This approach outperformed the Russell 3000 Value and S&P 500 indices during my 30+ years managing the strategy at the original Equity Investment Corporation (Original-EIC) and again since my management ended there in 2016, as shown below [1]:

Barksdale-Managed ACV Portfolio Returns Since 1986 [1]				
	January 1, 1986 -December 31, 2022 [1]			
	Gross	Net of 2%	R3000V	S&P 500
At Original EIC *	11.9%	9.7%	10.5%	10.4%
Since Original EIC *	12.3%	10.1%	8.5%	11.6%
Since 1986	11.9%	9.7%	10.2%	10.6%
	Gross	Net of 2%	R3000V	S&P 500
5 Year	10.2%	8.1%	6.5%	9.4%
10 Year	11.3%	9.1%	9.5%	12.0%
20 Year	10.5%	8.3%	8.8%	9.8%
30 Year	10.7%	8.6%	9.5%	9.6%
Since 1986	11.9%	9.7%	10.2%	10.6%

* Original EIC = 1/1/1986 to 09/30/2016; Since EIC = 10/1/2016 to 12/31/2022

How Inflation Reduces Business Value

Higher inflation reduces a business's ability to increase an owner's purchasing power through future reinvested earnings. Since our approach seeks a fixed *real* return on our invested capital over a fixed *time horizon*, we must compensate for higher inflation by reducing the amount we pay to acquire each earnings dollar. In other words, the real value of each earnings dollar declines as inflation increases.

The table below shows this process at work using our valuation approach for businesses with different ROE and growth characteristics. Our long-term inflation assumption has risen from 2.0% to 3.5% since COVID, reducing our valuation of each dollar of earnings by approximately 20%, similar to last year's market decline.

Barksdale Valuation of $1 Earnings In ROE, Growth, Inflation Scenarios						
		Inflation Rate (%)				
Description	Valuation Assumption	2	3	3.5	4	5
"Growth"	20% ROE - 10% Growth	$ 23.40	$ 19.76	$ 18.29	$ 16.98	$ 14.79
"U.S. Norm"	12% ROE - 6% Growth	$ 18.34	$ 15.43	$ 14.24	$ 13.20	$ 11.44
"Value"	6% ROE - 2% Growth	$ 15.22	$ 12.91	$ 11.97	$ 11.15	$ 9.75

Portfolio Changes During Q4

We added back positions in Northern Trust and Taiwan Semiconductor after significant price declines and began new positions in Toronto Dominion Bank and Jones, Lang, LaSalle, Inc. However, AMC Entertainment (AMCX) and Lincoln National were removed following disappointing earnings developments. As a result, our ACV model portfolio held 16.5% cash as of year-end, as shown by our 2022 year-end model portfolio.

Barksdale Investment & Research publishes model portfolios used by F/m Investments to implement the F/m Growing Value All-Cap strategy, available through separate accounts or model delivery.

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Disclosures

[1] Jim Barksdale founded the original Equity Investment Corporation in 1986 (CRD # 108510 / SEC # 801-27781, or Original EIC). From January 1, 1986, through September 30, 2016, Barksdale held and exercised sole veto and decision authority over investment decisions for all investment strategies at Original EIC and was thus the individual "*primarily responsible*" for the performance results for all strategies. (See page 232 of SEC Marketing Rule, Release # IA-5653, which states, "*A person or group of persons is "primarily responsible" for achieving prior performance results if the person makes, or the group makes, investment decisions*." Results shown from January 1, 1986, until September 30, 2016, are Barksdale's period as the individual *primarily responsible* for investment decisions for Original EIC's All-Cap Value strategy and are publicly available via Morningstar.

Barksdale was assisted by three investment team members who joined Original EIC in 1999, 2003, and 2005. On May 2, 2016, these individuals formed BZI Partners (BZI), which received its SEC registration on June 15, 2016 (CRD # 283930 / SEC # 801-107945). On October 1, 2016, BZI Partners purchased certain assets from Original EIC and changed its name to Equity Investment Corporation (New EIC**)**.

At New EIC, Barksdale managed four socially responsible (SRI) value strategies (Environmental, Human Rights, Catholic, and Protestant). Strategy results from October 1, 2016, until December 31, 2018, are those of a Protestant Value account – the least restrictive of the four SRI strategies. Since January 1, 2019, the results have been from a separately managed account whose holdings and weightings follow BI&R's recommended U.S. All-Cap Value Model Portfolio.

All figures are time-weighted returns, gross of management or administrative expenses, and have been independently verified through December 31, 2021. Cumulative results include reinvestment of dividends. Past results do not imply nor guarantee future results. Barksdale Investment & Research publishes model portfolios, does not tailor investments to client circumstances, and is not a Registered Investment Advisor. Subscriber results may vary depending on the individual implementation of published model portfolios. All investing involves risk, including the risk of loss. Results are also shown net of hypothetical annual fees of 2%, billed monthly.