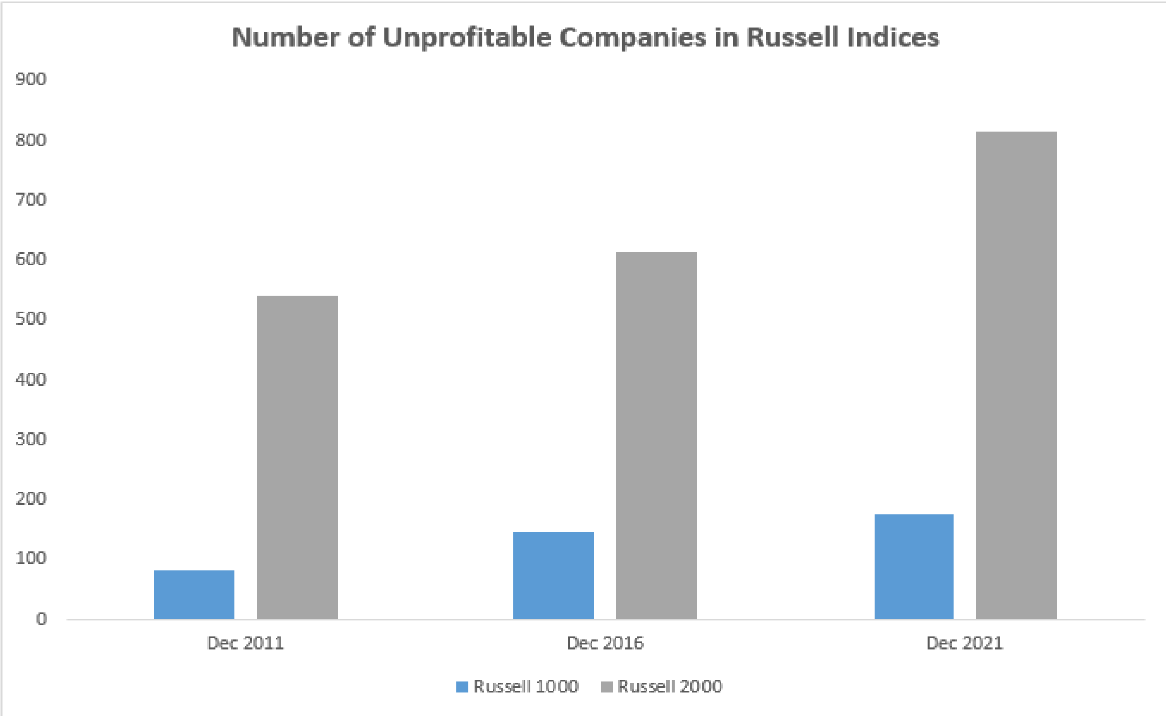
Profitable Can Be Profitable

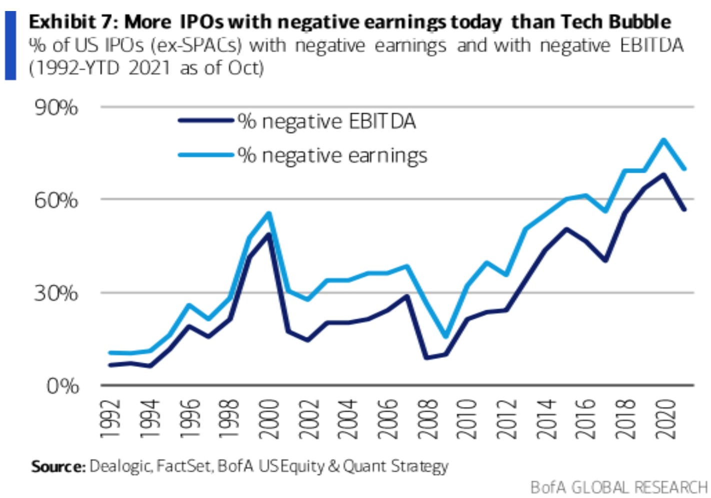
The Lead | January 2022



Source: Bloomberg, profitability over last 12 months

From March 2020 to March 2021, Federal spending on COVID-19 exceeded U.S. spending on World War II and the Global Financial Crisis combined. An observer would be correct to believe that the increased stimulus would bring about record levels of profitability for corporations and, in many cases, it has. S&P 500® Index earnings this past quarter increased 42% year-over-year, and S&P 500 profit margins are at all-time highs.

However, despite this record profitability, there was also a steady rise in the number of companies that are not making a profit in the market. As seen in the chart above, over the past five and ten years, the number of constituents in the Russell large cap and small cap indices witnessed a steady incline in terms of the number of unprofitable companies. The rise in the number of negative earning companies intensified because of Wall Street, which rapidly introduced the number of unprofitable companies into the public markets. Bank of America tracks the number of negative earning initial public offerings (IPOs) and noted that the percentage of negative earning IPOs eclipsed that of the Tech Bubble in the late 1990's. They also note that this calculation excludes special purpose acquisition company (SPAC) offerings.



Source: Bank of America

Wall Street appeared to supply these companies to meet a certain segment of the market's appetite for unprofitable stocks. One of our favorite indices to track is the Goldman Sachs Non-Profitable Technology Index on the next page. This index rose over 200% in 2020, led by hydrogen fuel cell company Plug Power and Chinese electric car company Nio.

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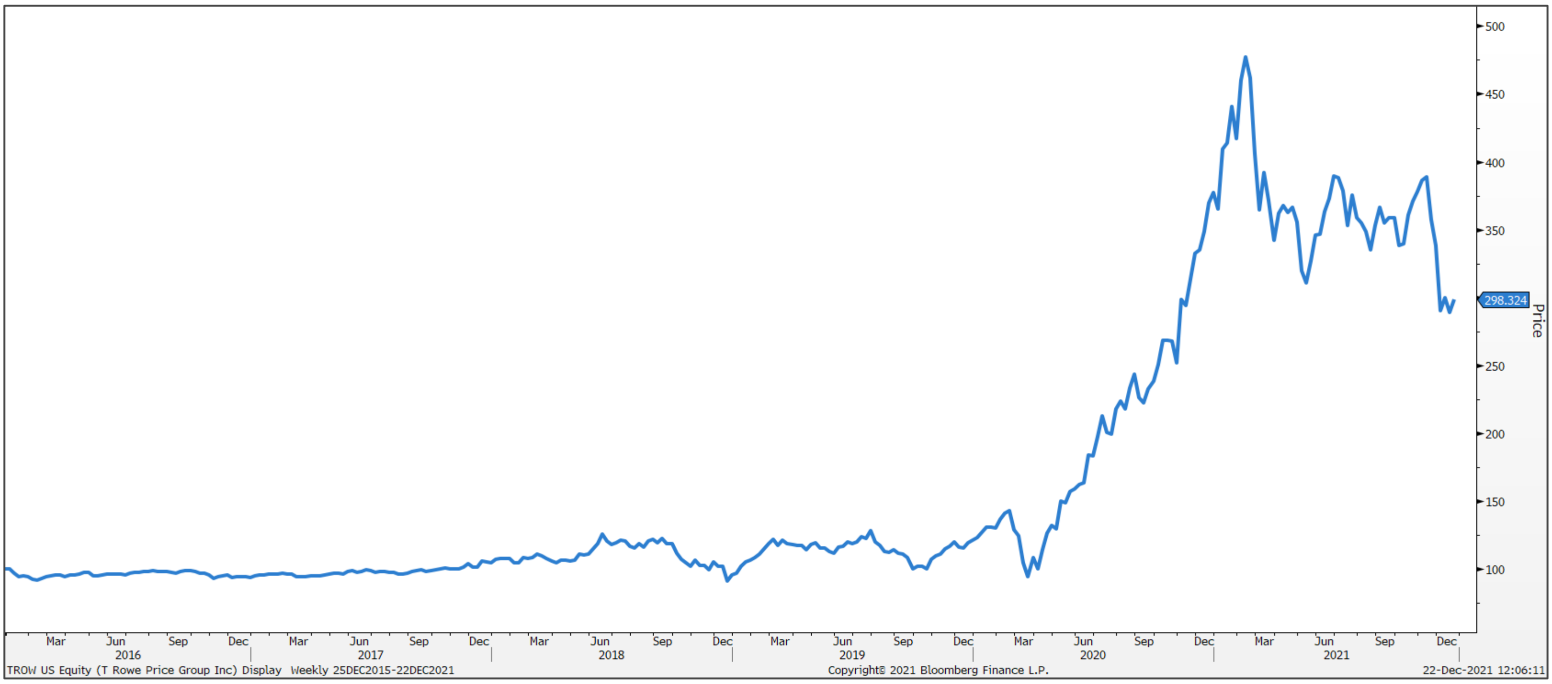
Goldman Sachs Non-Profitable Technology Index



Source: Bloomberg

2021 has not been kind to this index, reporting a negative double-digit return, while the S&P 500 is up over 20, with this year's top five gainers in the S&P 500 reporting double-digit net income growth year-over-year.

A core pillar in our investment process is owning companies that generate and grow earnings. While owning these high fliers can be entertaining, over time it comes at a cost. Non-earners underperformed the Russell 3000® Index by over 2% per year according to Bloomberg over the same time period set forth on the first page, despite an exciting 2020. Rather than providing clients with costly excitement, we prefer to invest in unique companies that generate and grow their earnings. And why not? As Ned Davis Research notes, since 1984 the top 10% of earners beat the market (S&P 500) by over 6% per year. We believe companies that generate profits can be profitable for our clients.

As always, thank you for your interest and trust in managing your investments.

Charles J. Wittmann, CFA®, Executive Director, joined Sterling Capital Management in 2014 and has investment experience since 1995. Chip is co-portfolio manager of the Global Leaders strategy and associate portfolio manager of the Equity Income strategy. Prior to joining Sterling, he worked for Thompson Siegel & Walmsley as a portfolio manager and (generalist) analyst. Prior to TS&W, he was a founding portfolio manager and analyst with Shockoe Capital, an equity long/short hedge fund. Chip received his B.A. in Economics from Davidson College and his M.B.A. from Duke University's Fuqua School of Business. Chip earned the Certificate in ESG Investing, which is developed, administered and awarded by the CFA Society of the United Kingdom. He holds the Chartered Financial Analyst® designation.

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Disclosures

The securities described are neither a recommendation nor a solicitation. Security information is being obtained from resources the firm believes to be accurate, but no warrant is made as to the accuracy or completeness of the information.

The volatility of an index varies greatly. All indices are unmanaged and investments cannot be made directly in an index.

The S&P 500® Index is a readily available, carefully constructed, market-value-weighted benchmark of common stock performance. Currently, the S&P 500 Composite includes 500 of the largest stocks (in terms of stock market value) in the United States and covers approximately 80% of available market capitalization.

The Russell 3000® Index measures the performance of the largest 3,000 U.S. companies representing approximately 98% of the investable U.S. equity market. The Russell 3000® Index is constructed to provide a comprehensive, unbiased and stable barometer of the broad market and is completely reconstituted annually to ensure new and growing equities are included.

The **Chartered Financial Analyst® (CFA)** charter is a graduate-level investment credential awarded by CFA Institute — the largest global association of investment professionals. To earn the CFA charter, candidates must: 1) pass three sequential, six-hour examinations; 2) have at least four years of qualified professional investment experience; 3) join CFA Institute as members; and 4) commit to abide by, and annually reaffirm, their adherence to the CFA Institute Code of Ethics and Standards of Professional Conduct.

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