BostonPartners

July 2023

Entry Points Alert | From ZIRP to ARK

Transcript

Mark E. Donovan, CFA
Senior Portfolio Manager

Inflation, Rising Rates and the Return of the Value Cycle

Senior Portfolio Manager Mark Donovan, CFA, explains how the end of the Fed's zero interest rate policy refocuses attention on value and active management.

Catalysts in Play | The Federal Reserve's zero interest rate policy ("ZIRP"), which was a powerful force fueling speculation over the past several years, is effectively coming to an end, which means the next decade for investors isn't likely to be the same.

Entry Points | ZIRP gave investors a reason to ignore valuations, with multiples for many tech stocks reaching astounding levels. The ARK Innovation ETF represents a poster child of this era, investing in companies based on predictions of what they might do in the future, even if they are losing money today. Though valuations don't always drive the markets in the short run, prices do matter in the long term, especially once speculation comes to an end.

> **Lessons of the Dotcom Bubble |** The bursting of the Internet bubble in 2000 showed that tech is no different from any other part of the market. Back then, companies like Cisco and Intel achieved peak valuation levels and, in many cases, never returned to those multiples, demonstrating that even large, household names are not immune from capitalism's competitive forces. Investors in today's market have become too complacent about the moats surrounding the biggest stocks. That could change going forward.
>
> **The End of ZIRP |** The Fed's change in interest rate policy in 2022 was the catalyst that broke the back of the speculative end of the market, with a large percentage of high-multiple stocks falling 50% or more in the calendar year.
>
> **The Road Ahead |** While the Fed will pause in the summer to see how successful rate hikes have been at driving down inflation, we're a long way from rate cuts, even if investors are hoping

for a quick Fed pivot. Meanwhile, the probability of a recession is relatively high now given credit tightening, reduced fiscal stimulus, and the lagged effect of Fed rate increases to soften the economy.

Active Strategy | This landscape sets up opportunities for active management and value investing. Due to the top-heavy nature of the S&P 500, in which five names now account for nearly a quarter of the index, success is being determined by the performance of that handful of companies. This is an opportunity for active management with an analytic edge to find neglected or overlooked stocks at a bargain.

At Boston Partners, we look for a combination of strong business fundamentals, attractive valuation, and positive business momentum. To us, these are the three laws of investment physics. We believe our focus and unwavering discipline around these principles give us an analytic edge over competitors.

Mark Donovan, Portfolio Manager at Boston Partners

The Fed zero interest rate policy was a powerful force that fueled the likes of ARC and other investors over the past decade. Will the next decade be the same? I'm Mark Donovan, portfolio manager at Boston Partners. And we believe that with the Fed's zero interest rate policy effectively coming to an end, the answer to that question is a resounding no.

The Fed's zero interest rate policy, in effect, gave investors a reason to ignore valuation multiples. We saw multiples for many what were successful companies reach astounding levels. ARK represented kind of the poster child of the recent era of the valuation doesn't matter mantra and investing. Ark has invested in a lot of companies, many of which are losing money or have negligible profits and that are really based on grandiose predictions of what they will do in the future. And through the course of my 40 year career in the investment business, I've seen this movie before. It doesn't always end well. It usually ends very badly, in fact. In the short run, there are times where valuation doesn't matter, but in the long run, valuation does matter. And so I look across the spectrum of investable ideas in the universe. Today I see a lot of companies with huge levels of optimism embedded into their valuation multiples. Given my past experience, a lot of those companies will not live up to those lofty expectations.

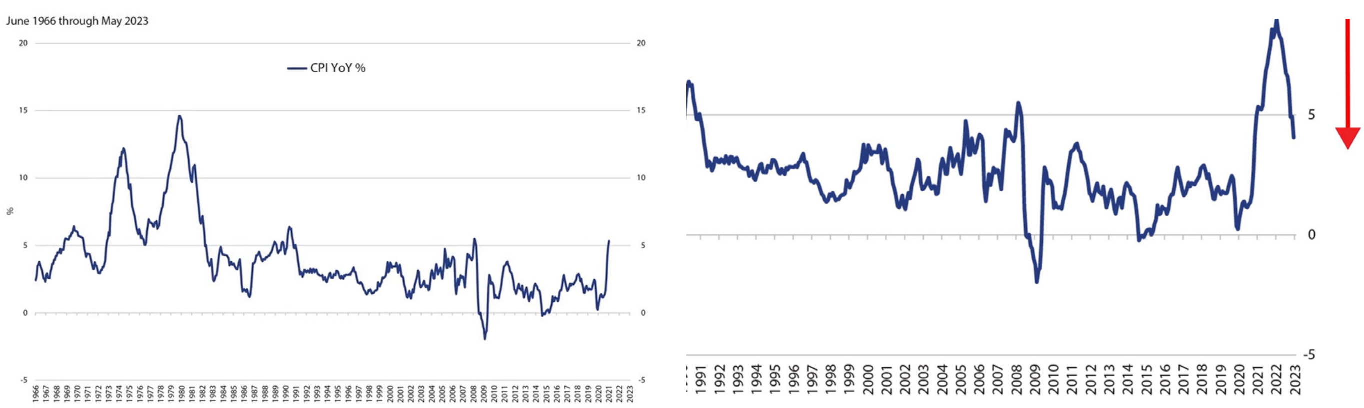
Technology seems to have at various times sucked all the oxygen out of the room of the broad marketplace, and there have been some really exciting developments in tech. And it's when you think about some of the most successful companies of the last ten, 15, 20 years, there's no question that a high percentage of those are technology companies. And so to some degree, tech does deserve the attention that it's gotten on the part of investors. That being said, technology is not any different from any other part of the market in that there is still competitive destruction. Companies like Microsoft, like Apple are not immune from competitive forces. That's the way capitalism works. I think people have gotten way too complacent about the moats around some of these businesses, which in many cases are real for today, but that could change going forward in the future. For those reasons. Some of the very high multiples that we see on many of these tech companies, to us make them not a great risk reward bet from here. As a comparison point for the bubble that we've seen in recent years, one of the most interesting periods to look back on is the Internet bubble of 1999, 2000, companies like Microsoft, Cisco, Intel, which achieved peak market valuation levels in the spring of 2000, in many cases, never returned to the prior peak levels. And in the case of the few that did Microsoft and IBM, it took in the case of IBM, 12 years, in the case of Microsoft, nearly two decades to get back to that peak market capitalization level.

Seven of the Largest Nine Tech Stocks Have Yet to Recover to their 2000 Buble Vaultaions

Data as of March 31, 2022. Source: Factset, CRSP, Bernstein Analysis.
Past performance is not an indication of future results. Please refer to the end of the document for other important disclosures.

2022, I think was the year where the shock of the end of the Fed zero interest rate policy came home to roost for investors. And we really saw through multiple Fed actions the very high multiple names in 2022 a high percentage of them really broke down in many cases by 50, 60, 70% in the calendar year. And I definitely believe that the Fed change in interest rate policy was the catalyst that brought about the breaking of the back of that very high multiple speculative end of the market. Obviously, inflation became a big part of the discussion in the latter part of 2021 and very much so in 2022, the CPI peaked at about 8% and it's now come back down to about five. Getting it from 8 to 5 wasn't that difficult. I think getting it from 5% to the Fed's target of 2% is going to be much more difficult. Nobody in Washington, DC ever admits they made a mistake and I don't think the Fed is any different. I do think that they would acknowledge that they stayed with the zero interest rate policy and the quantitative easing longer than they should have. Therefore, while the Fed will pause here in the summer of 2023 and see how the effects of past rate increases are successful at driving down inflation, we're a long way away from Fed rate cuts, and I think investors in the marketplace seem a little too complacent that that those effects could be just around the corner.

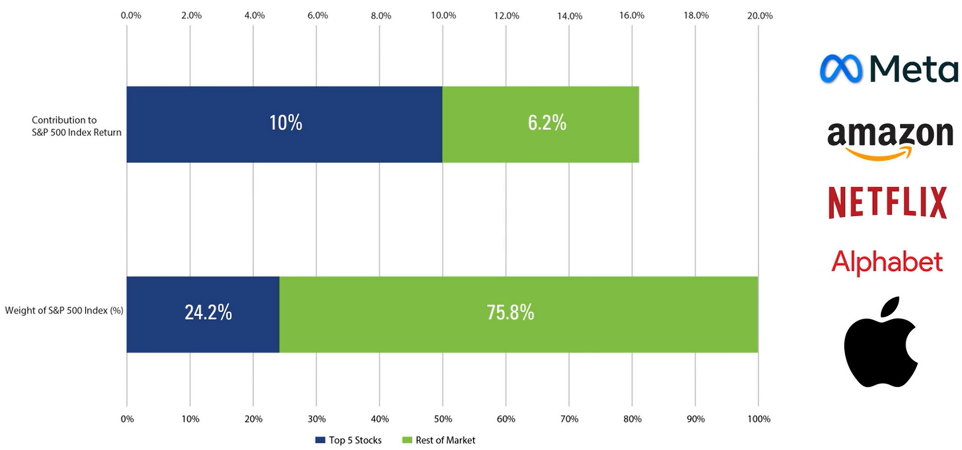
U.S. Consumer Price Index Yearly Change



Data as of May 1, 2022. Source: Federal Reserve Bank of St. Louis.
Past performance is not an indication of future results. Please refer to the end of the document for other important disclosures.

When we think about the possibility of recession going forward, we tend to think much more in terms of probabilities than in terms of absolute predictions. I do think the probabilities of a recession are relatively high right now, and I base that on looking at the shape of the yield curve. I base that on the fact that the Fed rate increases over the last 15 months tend to work with a lagged effect on softening in the economy. I also base it on the fact that particularly in the post Silicon Valley Bank, Signature Bank problems, credit has really tightened up and credit is the lifeblood of the economy. And finally, there's unquestionably a desire on the part of several individuals in the US government to rein in the very high levels of spending that have taken place over the last several years. I think going forward there's a high probability of less fiscal stimulus coming from the federal government and that too would be a source of potential weakening in the economy. So you add all those things together, and I would say we certainly have a higher than average risk of recession either in the second half of this year or the early part of next year. From where we sit today, we have a good set up for active management. And you look at particularly the top heavy nature of the S&P 500 where five names account for nearly a quarter of the S&P 500 index.

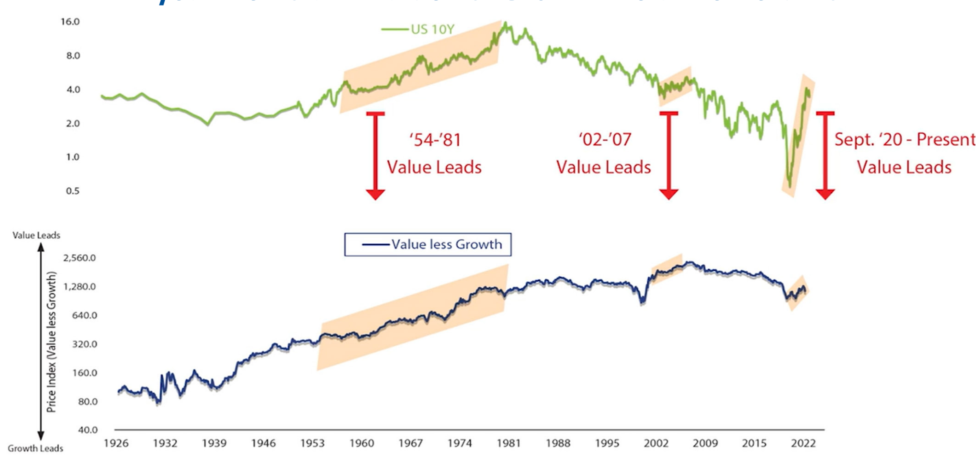
Narrow Market: Top 5 Stocks in the S&P 500 Index Contribute Most to its Return



Data as of June 15, 2023.
Source: FactSet; Boston Partners.
Past performance is not an indication of future results. Please refer to the end of the document for other important disclosures.

The success of index investors is going to sink or swim with the success of those five companies. This is an opportunity for active management to find names that have been neglected and ignored in this narrow market advance, to really position portfolios to strongly outperform the benchmark. The setup for value today is very good. So even in a market with overall high levels of aggregate multiples, there are still some bargains out there. In most periods of time when interest rates were rising, value tended to lead growth as a preferred investment style. I do think that the valuation metrics, which frankly have been fairly unimportant on the mind of many

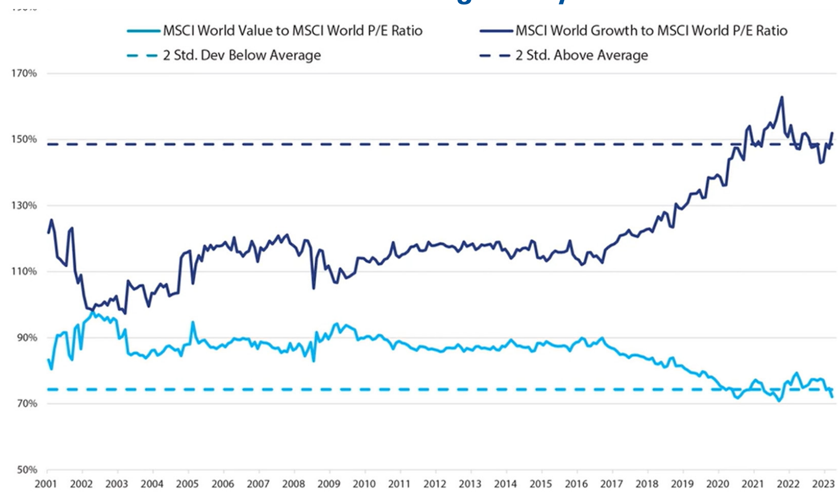
Rising Cost of Capital Environments Comparison of U.S. 10-year Yields and Value vs. Growth Relative Returns



Data as of March 31, 2023.
Source: Value and growth relative returns use FAMA database prior to 1978 and Russell Indices thereafter. Russell Indices used are Russell 100, Value and Russell 100 Growth. Past performance is not an indication of future results.

investors over the last decade will become very important again. The valuation gap between growth stocks and value stocks is close to two standard deviations above normal right now, suggesting that over time a reversion to the mean trend would seem to suggest a good backdrop for value investing.

Forward Price/Earnings Ratio Comparison
March 2001 throught May 2023



Data as of March 31, 2023.

Source: Value and growth relative returns use FAMA database prior to 1978 and Russell Indices thereafter. Russell Indices used are Russell 100, Value and Russell 100 Growth. Past performance is not an indication of future results.

We at Boston Partners have never believed that we have an information edge because we think nobody has an information edge. What we believe we have is an analytic edge. We follow very diligently the same roadmap for every company, regardless of sector, where we're looking for the combination of strong business fundamentals, attractive valuation and positive business momentum. These are the three laws of investment physics in our mind. These are the three most powerful factors that increase the probability of superior investment returns. It's our focus on that and unwavering discipline around that. That we believe gives us an analytic edge versus those competitors who believe they can win through an informational edge.

Mark E. Donovan, CFA | *Senior Portfolio Manager*

Mr. Donovan is a senior portfolio manager for the Boston Partners Large Cap Value strategy, a role he has held since the firm's inception in 1995. Previously, he had served eleven years as Co-Chief Executive Officer, where he was responsible for strategic and tactical operating decisions affecting the firm. Mr. Donovan was one of the founding partners of Boston Partners Asset Management. He joined the firm from The Boston Company where he was Senior Vice President and equity portfolio manager. He also spent five years as a consulting associate with Kaplan, Smith & Associates, and two years as a securities analyst for Value Line Inc. For ten years, Mr. Donovan was a trustee at St. Sebastian's School, where he served on the Investment and Long Range Planning Committees. He holds a B.S. degree in management from Rensselaer Polytechnic Institute and the Chartered Financial Analyst® designation. Mr. Donovan began his career in the investment industry in 1981.

Disclosure

Boston Partners Global Investors, Inc. ("Boston Partners") is an Investment Adviser registered with the Securities and Exchange Commission under the Investment Advisers Act of 1940. Registration does not imply a certain level of skill or training. Boston Partners is an indirect, wholly owned subsidiary of ORIX Corporation of Japan ("ORIX"). Boston Partners is comprised of two divisions, Boston Partners and Weiss, Peck & Greer Partners ("WPG").

This video is not an offering of securities nor is it intended to provide investment advice. It is intended for information purposes only.

Index Definitions

Index returns are provided for comparison purposes only to show how the composite's returns compare to a broad-based index of securities, as the indices do not have costs, fees, or other expenses associated with their performance. In addition, securities held in indices may not be similar to securities held in the composite's accounts.

The S&P 500® Index is an unmanaged index of the common stocks of 500 widely held U.S. companies.

All Russell® Indices are registered trademarks of the Frank Russell Company. The Russell® Value Indices typically measure the performance of universes of stocks displaying low price-to-book ratios and low forecasted growth values. The Russell® Growth Indices typically measure the performance of universes of stocks displaying high price-to-book ratios and high forecasted growth values. The Russell 1000® Index measures the performance of the large-cap segment of the U.S. equity universe. It includes the1,000 largest companies in the Russell 3000® Index. The Russell 3000® Index measures performance of the 3,000 largest U.S. companies based on total market capitalization. The Russell 2500™ and 2000® Indices measure performance of the 2,500 and 2,000 smallest companies in the Russell 3000® Index respectively. The Russell Midcap® Index measures the performance of the 800 smallest companies in the Russell 1000® Index.

The MSCI Indices cover the full range of developed, emerging and All Country MSCI International Equity Indices across all size segmentations. MSCI style indices use a multi-factor approach, which uses three variables (book value to price, 12-month forward earnings to price and dividend yield) to define the value investment style characteristics and fi ve variables(long-term forward earnings per share ("EPS") growth rate, short-term forward EPS growth rate, current internal growth rate and long-term historical EPS growth trend and long-term historical sales per share growth trend) to defi ne the growth investment style characteristics. The MSCI EAFE Index captures large and mid-cap equities across developed markets around the world, excluding the U.S. and Canada. The MSCI World Index represents large and mid-cap equity performance across 23 developed markets countries, covering approximately 85% of the free fl oat-adjusted market capitalization in each. The MSCI Emerging Markets Index captures large and mid cap representation across 27 emerging market countries covering approximately 85% of the free fl oat-adjusted market capitalization in each country. The MSCI ACWI (All Country World Index) captures both the MSCI World and MSCI Emerging Markets Index covering approximately 85% of the global investable equity opportunity set. The MSCI ACWI ex-U.S. Index excludes the equity opportunity set within the U.S.

The HFRI Equity Hedge (Total) Index constituent funds typically maintain at least 50% exposure to, and may in some cases be entirely invested in, equities or equity derivative securities, both long and short. Constituents use a wide variety of investment processes and techniques, net exposure levels, leverage employed, holding periods, market capitalizations concentrations, and valuation ranges. Data cannot be shared or distributed without written consent.

Net total return indexes reinvest dividends after the deduction of withholding taxes, using (for international indexes) a tax rate applicable to non-resident institutional investors who do not benefit from double taxation treaties.

Boston Partners | One Beacon Street, Boston, MA 02108 tel: 617-832-8200

www.boston-partners.com

Boston Partners (UK) Ltd. | 32 Cornhill, London, EC3V 3SG tel: +44 (0)20 3356 6225

www.boston-partners-uk.com