

# EQUITY INVESTMENT CORPORATION

## *2018 Second Quarter Commentary*

### *Mid-Cap Value*

July 2018

After declining in the first quarter, stocks resumed their upward climb. The Russell Midcap<sup>®</sup> Value Index (RMCV) gained 2.4% in the second quarter, while the S&P 500<sup>®</sup> Index increased 3.4%. Our Mid-Cap Value (MCV) SMA composite increased 4.0% (gross\*). Net of a 3% hypothetical maximum annual SMA fee, results for MCV would be 3.2% for the quarter<sup>1</sup>.

Growth continued to best value (though not among small-cap stocks), as it has for six consecutive quarters. With respect to large-cap stocks, the Russell Top 200<sup>®</sup> Growth Index rose 6.6%, while the Russell Top 200<sup>®</sup> Value Index gained only 0.6%. Among mid-caps, the Russell Midcap<sup>®</sup> Growth Index outperformed the Russell Midcap<sup>®</sup> Value Index, 3.2% to 2.4%. In the small-cap space, the Russell 2000<sup>®</sup> Growth Index, up 7.2%, trailed the Russell 2000<sup>®</sup> Value Index, up 8.3%

For the three months ended June 30, 2018, eight of the eleven sectors in the RMCV posted positive returns. Energy was the top performing sector, rising 16.5%, followed by telecommunication services, up 13.5%. Real estate, utilities, and information technology also performed fairly well. Compared to our benchmark, we were underweight in energy, real estate, utilities, and information technology, and had no exposure to telecom.

Conversely, the only sectors that declined during the quarter were industrials, financials, and consumer staples. Relative to our benchmark, we were overweight in financials and consumer staples but had no exposure to industrials.

We don't target sector weightings, either in an absolute sense or relative to the market indices; they are instead principally a residual of our stock selection process. Nevertheless, it is at times instructive to see how sector allocations affected results. For the quarter, they detracted from our relative performance, as did our sizable cash position, but were more than offset by favorable stock selection.

### **Investment Environment**

"History doesn't repeat itself, but it rhymes" is a phrase often incorrectly attributed to Mark Twain. Nevertheless, we think it is appropriate as we enter the tenth year of the current bull market, now the second longest on record, trailing only the late '80s – '90s bull market.<sup>2</sup>

As we look at the investment landscape, we see similarities with past late-cycle activity. Fundamental conditions at the moment remain healthy. Unemployment and inflation are low. The corporate sector is posting strong earnings growth, though excluding one-time changes from corporate tax reform, 2018 growth expectations are significantly lower. We believe this good news is likely reflected in valuations, which, while not as high as the late '90s, are elevated by historical standards. Mid- and small-cap stocks are more expensive than their large-cap counterparts, although that divide is narrowing somewhat with small-cap companies posting stronger earnings growth. Several themes seem to dominate both conversations and investment flows as no-brainer paths to success, in particular passive over active, growth over value, and a handful of companies that lead their respective niche, regardless of profitability, valuation

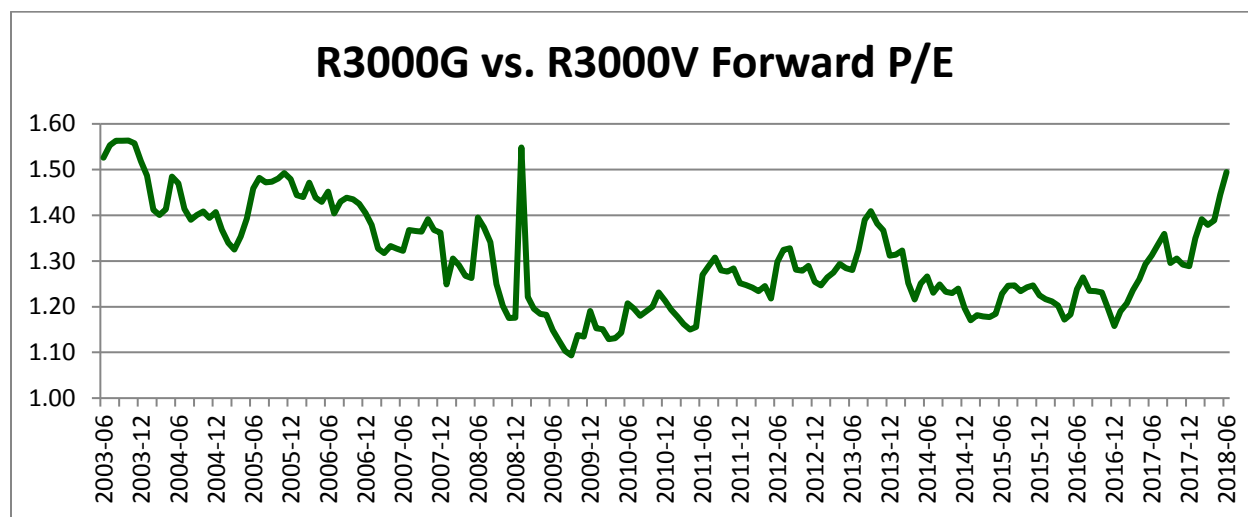
or capital structure. Finally, every dip in stocks, no matter how shallow or short, is, with hindsight, an obvious buying opportunity.

2018 is on pace to set a new record for the dollar value of merger and acquisition (M&A) activity, besting the previous 2007 high-water mark. Many of the largest acquirers are facing some combination of stagnating revenues, margin pressure and/or a dramatically shifting competitive landscape that is pushing them towards action that may be viewed with hindsight as either bold or reckless. Activity is not disproportionate to any one corner of the market, with large, transformational deals closing or being contemplated in the technology, media, healthcare and consumer sectors. Continuing the theme of corporate leveraging that we have discussed in past commentaries, much of the capital for that M&A activity is from newly issued debt, as low rates make most deals accretive to earnings but increase business risks through more leveraged capital structures. In many cases, we think the leverage involved suggests these companies' debt should be junk rated, but the markets and the ratings agencies both appear to give them a temporary pass under a "wait and see" mentality.

Finally, similar to past periods of excess, while the economy and corporate sector are robust, the market may be overlooking signals of risk on the horizon, including but not limited to federal reserve tightening coupled with a flattening yield curve, increasing credit spreads, nascent inflationary pressures, large and expanding deficits, credit and equity market weakness in China and other emerging markets, and increased trade tariffs. In our opinion, these risks do not seem to be priced into this market and are either being downplayed or discarded entirely, while investors are exhibiting mid- to late-stages of FOMO – Fear of Missing Out.

On the portfolio front, we are finding more stocks that pass our initial valuation filters, which is encouraging, yet all require further inspection. Strong projected 2018 earnings growth, fueled in large part by tax reform, means on a forward basis stocks are less expensive than they have been in several years, though as we noted above, still elevated by historical standards.

The trend of growth outperforming value has continued in 2018. Growth has now surpassed value for the better part of twelve years, from 2007 through the second quarter of this year. Accordingly, growth stocks look richly priced versus value, as seen in the following chart.



Source: Morningstar Direct <sup>SM</sup>. Ratio of monthly Russell 3000® Growth Index (R3000G) Price/Projected Earnings to monthly Russell 3000® Value Index (R3000V) Price/Projected Earnings. Forward P/E is Price/Projected Earnings calculated by Morningstar based on the asset-weighted average of each company's month-end share price to estimated earnings per share for the company's fiscal year.

As measured by the Russell 3000® Index, the growth component of the market is now as expensive relative to value as it has been over the last 15 years. (It is worth noting that if we carried the chart back further to the late 90's tech bubble, growth was considerably more expensive than value.) At roughly 14x forward earnings, the value component of the index is reasonably priced, though valuation only tells part of the story. We are spending considerable time on accounting and earnings quality due diligence, as we find that many of the stocks that initially seem attractive have value trap characteristics, cyclically high earnings, or too much leverage for our comfort.

### **Portfolio Review**<sup>3</sup>

While we are finding more stocks to look at, our cash balances have remained roughly flat during the quarter as purchases were offset by trims based on valuation. More specifically, we trimmed both TCF Financial and Diamond Offshore.

On the purchase side, we initiated a position in Molson Coors Brewing, a name we have owned in the past. Molson Coors operates the Coors, Miller and Molson beer brands (among many others) in North America, and the Carling and Staropramen brands in Europe. It is the #2 beer brewer by market share in the U.S. and Canada, and is similarly positioned across a number of European countries. Back in 2008, Molson Coors contributed its U.S. business to a joint venture with SABMiller plc to form Miller Coors, which held ownership of the Miller and Coors brands (#2 & #3 in U.S. market share). Somewhat similar to CVS, in 2016, Molson Coors increased its leverage to acquire the remaining 58% joint-venture interest in Miller Coors. In this case, however, the company was intimately familiar with the asset purchased. Moreover, Molson Coors generates significant cash flow and has already begun paying down debt.

Our goal remains to construct portfolios that maximize our clients' odds of investment success. We seek to do so not by predicting any one investment outcome and positioning for it, but rather trying to protect against a range of possibilities, as the future is always uncertain. We will not over-bet our beliefs in any one area, preferring to reasonably diversify across sectors, outcomes and opportunities. Finally, despite diversifying and leaning against our own beliefs, we do consciously avoid what we believe are the worst risks on offer in any market environment. In the past that has been represented by extreme valuations, cyclically high or poor quality earnings, or capital structure concerns. Today's conditions don't seem as excessive as those of the past few late-cycle markets. Rather, we see similar problems in somewhat smaller quantities. Indeed, history rhymes.

As always, thank you for your continued partnership with EIC.

**Investment Team**  
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**Please see disclosures on the next page.**

**VALUE DISCIPLINE • QUALITY FOUNDATION • GROWTH OBJECTIVE**

## Disclosures

<sup>1</sup>EIC's MCV results are those of our Mid-Cap Value SMA composite gross\* (before) and net (after) assumed maximum annual SMA fees of 3% (0.25% per month). SMA fees include transaction costs, portfolio management, custody, and other administrative fees.

\*Gross returns for EIC SMA composites are "pure" gross returns, do not reflect the deduction of any expenses, including trading costs, and are presented as supplemental information to the full disclosure presentations which are considered an integral part of this report. All returns include reinvestment of dividends and interest. Indices are unmanaged, do not incur management fees, costs or expenses, and cannot be invested in directly. Past performance is not indicative of future results. **Individual account results may differ from those of a composite. Client net returns are reduced by EIC's management fees and may possibly be reduced by brokerage firm wrap fees, which include transaction costs, portfolio management, custody, and other administrative fees.**

<sup>2</sup>As measured by the S&P 500<sup>®</sup> Index, since 1928 the longest bull market on record was 4,494 calendar days from December 4, 1987 to March 24, 2000. The current bull market began on March 9, 2009.

<sup>3</sup>The securities identified and described above do not represent all of the securities purchased, sold or recommended for client accounts. Actual portfolio holdings may vary for each client, and there is no guarantee that a particular client's account, "wrap," or advisory program will hold any, or all, of the securities identified. The reader should not assume that an investment in the securities identified was or will be profitable.

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## Mid-Cap Value SMA Composite Performance Description

Equity Investment Corporation (EIC) is an SEC registered independent investment advisor incorporated in the state of Georgia. EIC was founded in 1986. Effective September 30, 2016, substantially all of the assets and liabilities of the firm were acquired by three members of the investment team who collectively have more than 40 years of experience at EIC. Accounts continue to be managed using the same investment process, and the firm continues to operate as EIC. Performance numbers are the value-weighted, time-weighted, total return composite results of fully discretionary Mid-Cap Value wrap (SMA) accounts. The strategy invests in high-quality, well-managed mid-cap companies, while at the same time avoiding those that look inexpensive relative to their historical record but are actually in structural decline. Prior to January 1, 2013, the composite was called the Mid-Cap Value Wrap Composite. Returns are generally presented net of foreign withholding taxes on dividends, interest income, and capital gains; however, returns for some accounts are presented gross of foreign taxes depending on the treatment by their custodian. All accounts included in the composite are managed according to similar investment guidelines. The composite creation date is January 1, 2004, and SMA accounts comprise 100% of the composite. Performance includes reinvestment of dividends, and EIC's returns also include interest earned on cash. The benchmark index is the Russell Midcap® Value Index (which excludes an advisory fee), and was chosen because it is representative of the composite's investment style. The Russell Midcap® Value Index measures the performance of the mid-cap value segment of the US equity universe. It is a subset of the Russell Midcap® Index and includes approximately 800 of the Russell 1000® companies with lower price-to-book ratios and lower expected long-term mean earnings growth rates.

Year Ended Dec - 31	Gross* Rate of Return <sup>1</sup> (Supplemental)	Hypothetical 3% annual Net Rate of Return <sup>1</sup>	Benchmark Return of Russell Midcap® Value Index	Composite 3-Yr St Dev	Benchmark 3-Yr St Dev	Dispersion <sup>2</sup> of Annual Returns (St Dev)	Number of Portfolios	Composite Assets (\$ Millions)	Advisory-Only (UMA) and Managed Assets		
									UMA Assets <sup>3</sup> (\$ Millions) (Supplemental)	GIPS® Firm Assets (\$ Millions)	Total Assets <sup>3</sup> (\$ Millions) (Supplemental)
2018 (through 6/30)	3.9%	2.4%	-0.2%	7.6%	10.4%	0.3%	21	\$5.6	\$1,935.0	\$2,531.9	\$4,466.9
2017	12.6%	9.3%	13.3%	7.5%	10.3%	1.0%	20	\$5.4	\$2,044.9	\$2,790.7	\$4,835.6
2016	16.6%	13.2%	20.0%	8.4%	11.3%	1.0%	15	\$4.3	\$2,044.5	\$2,994.4	\$5,038.9
2015	-2.1%	-5.0%	-4.8%	8.9%	10.7%	1.0%	9	\$2.3	\$1,590.0	\$3,658.9	\$5,248.9
2014	15.2%	11.8%	14.8%	8.9%	9.8%	N/A	5	\$1.8	\$1,657.7	\$3,862.6	\$5,520.3
2013	33.6%	29.7%	33.5%	10.5%	13.7%	N/A	3	\$1.1	\$1,009.2	\$3,286.3	\$4,295.5
2012	11.3%	8.0%	18.5%	10.7%	16.8%	N/A	3	\$0.9	\$665.6	\$2,301.1	\$2,966.7
2011	5.3%	2.2%	-1.4%	15.3%	22.8%	N/A	1	\$0.2	\$314.5	\$1,127.9	\$1,442.5
2010	22.8%	19.3%	24.8%	17.9%	27.1%	0.4%	7	\$1.7	\$77.9	\$836.9	\$914.8
2009	28.1%	24.4%	34.2%	17.6%	25.0%	0.9%	8	\$1.5	\$10.5	\$541.2	\$551.8
2008	-20.4%	-22.8%	-38.4%	13.0%	18.7%	1.2%	11	\$1.7	\$0.0	\$362.6	\$362.6
2007	4.4%	1.3%	-1.4%	8.3%	9.1%	0.7%	16	\$3.2	\$0.0	\$448.1	\$448.1
2006	12.2%	8.9%	20.2%	7.3%	8.7%	0.5%	20	\$6.6	\$0.0	\$487.2	\$487.2
2005	6.0%	2.9%	12.7%	N/A	N/A	0.8%	29	\$8.6	\$0.0	\$463.6	\$463.6
2004	19.8%	16.3%	23.7%	N/A	N/A	N/A	32	\$10.5	\$0.0	\$388.1	\$388.1

<sup>1</sup> \*Gross returns, presented as supplemental information, are “pure” gross and do not reflect the deduction of any expenses, including trading costs, for SMA accounts. Net returns are calculated by reducing gross returns with an annual SMA fee of 3.0% (0.25%/month).

<sup>2</sup> Dispersion is an asset-weighted standard deviation for the accounts in the composite the entire year (or year-to-date). “N/A” represents when dispersion is not statistically meaningful due to an insufficient number of portfolios in the composite for the entire year.

<sup>3</sup> “Total Assets” include our regulatory assets under management (“GIPS® Firm Assets”) and our advisory-only “UMA Assets”. EIC has no trading discretion for UMA accounts and provides a model portfolio to the program sponsor or overlay manager. The “UMA Assets” and “Total Assets” amounts are shown as supplemental information.

Additional Notes: The three year annualized standard deviation measures variability of the composite and the benchmark returns over the preceding 36 month period.

## Mid-Cap Value SMA Composite Performance Description *(cont.)*

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Performance has been measured on a monthly basis from January 1, 2004, to present. Periods are geometrically linked to obtain the quarterly and annual results. Eligible new accounts are added to the composite at the beginning of the first full quarter under EIC management. Trade date accounting with monthly valuations and adjustments for large cash flows are used. Results are based on fully discretionary accounts under management, including those accounts no longer with the firm. The US Dollar is the currency used to express performance. Returns include the reinvestment of all income. There are no non-fee paying accounts. Economic and market conditions have differed over the time period displayed, and likewise will be different in the future. Policies for valuing portfolios, calculating performance and preparing compliant presentations are available upon request.

EIC claims compliance with the Global Investment Performance Standards (GIPS®) and has prepared and presented this report in compliance with the GIPS® standards. EIC has been independently verified for the periods January 1, 1986, through March 31, 2018. Verification assesses whether (1) the firm has complied with all the composite construction requirements of the GIPS® standards on a firm-wide basis and (2) the firm's policies and procedures are designed to calculate and present performance in compliance with the GIPS® standards. Verification does not ensure the accuracy of any specific composite presentation. The verification reports, as well as a complete list and description of all the firm's composites, are available upon request by contacting Equity Investment Corporation, 1776 Peachtree Street NW, Suite 600S, Atlanta, GA 30309. Prospective clients should be aware that results are historical and do not imply future rates of return or volatility for EIC or the indices, which may be materially different from the past and from each other.

Investment management fees are based on market values of the assets under management. In addition to a management fee, some accounts pay an all-inclusive fee based on a percentage of assets under management. Other than brokerage commissions, this fee includes portfolio monitoring, consulting services, and in some cases, custodial services. EIC's maximum annual fees for SMA accounts (charged quarterly) are 0.75%. Total fees charged may equal 3% per year. SMA schedules are provided by independent SMA sponsors and are available upon request from the individual sponsor. Further information about fees and compensation is discussed in EIC's form ADV Part 2 ([www.adviserinfo.sec.gov](http://www.adviserinfo.sec.gov)).

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