Starlight Capital Diversified Equities 2024 Outlook

Starlight™ CAPITAL Focused Investing

January 2024

Sean Tascatan, CFA

Senior Portfolio Manager
Diversified Equities

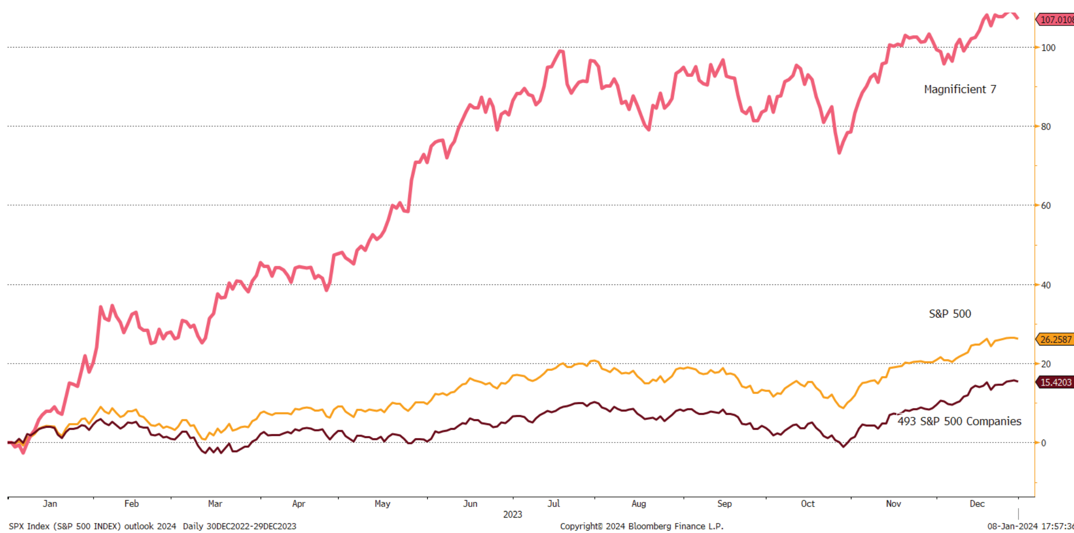
2023 Review

2023 was a tumultuous year in equity markets, but ultimately concluded on a strong note in both Canada and the United States. The surprise upside in economic performance, driven by resilient consumer spending and low unemployment, contrasted with the normalization of inflation.

The initial half of the year featured a regional bank liquidity crisis that had reverberations throughout the market. Investors were apprehensive about the potential contagion risk that could escalate into a full-blown banking crisis. Notably, four regional banks (Silicon Valley Bank, Signature Bank, First Republic Bank, and Heartland Tri-State Bank) collapsed, prompting a reevaluation of regional banking business models. Subsequently, there was a substantial outflow of cash from the banking system, with funds flowing into Money Market Funds and Treasuries. To stabilize the markets, the Federal Reserve Bank ("Fed") responded by providing support to the banking system through multiple programs, designed to offer liquidity to banks in need.

The S&P 500 returned 26% in 2023 mainly driven by the Magnificent Seven ("Mag 7") which consist of Apple (AAPL), Alphabet (GOOGL), Microsoft (MSFT), Amazon.com (AMZN), Meta Platforms (META), Tesla (TSLA) and Nvidia (NVDA). Together the group drove 60% of the S&P 500's total return and accounted for 28% of the index by weight.

Exhibit 1 - 2023 S&P 500 Returns Largely Driven by the Magnificent Seven



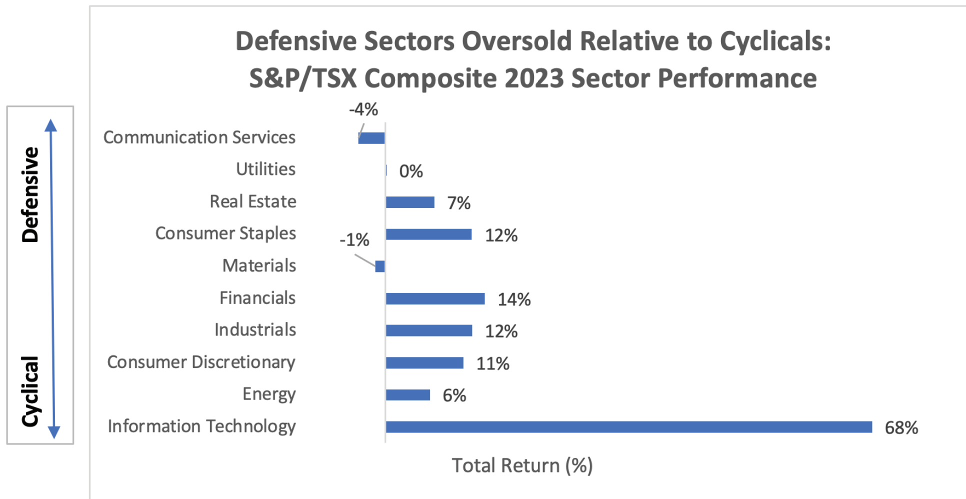
Source: Bloomberg Finance L.P.

Concentration levels were extreme throughout the year and Q4 saw a broad market rally where the Mag 7 also participated strongly. Only in December did the group underperform the rest of the market as the Fed signaled the end of rate increases and the market celebrated a pivot in policy. The S&P 500 as well as the Toronto Stock Exchange ("TSX") had a powerful rally which saw rate sensitives and cyclicals rebound off their lows which is typical behaviour during a Fed pivot.

The TSX initially appeared set for modest gains in 2023. However, a robust rally in the fourth quarter propelled the market to achieve a total return of nearly 12%. This remarkable performance can be attributed to the cyclical and rate-sensitive makeup of the index, as the pivot in policy by the Fed drove a substantial 12.5% surge during the fourth quarter alone. Additionally, the technology sector made a significant positive contribution to index returns in Canada, while defensive sectors were a source of funds.

240208-9

Exhibit 2 - Defensive Sectors Oversold Relative to Cyclicals



Source: Bloomberg Finance L.P.

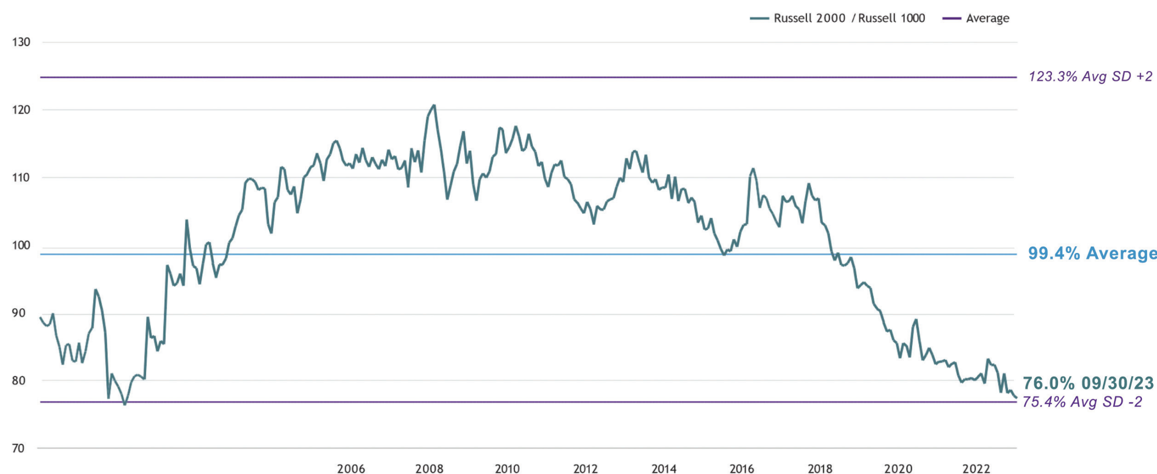
2024 Outlook

Despite the recent conclusion of interest rate hikes, there remains a concern that, unless inflation stabilizes, global economies may be vulnerable to an extended period of elevated interest rates. The trajectory of yields will continue to be an important economic variable throughout 2024, particularly for Canada, where interest rate sensitivity is elevated.

We expect that higher interest rates will have a greater negative impact on Canadian households versus US households. The savings rate in Canada has already risen as households brace for higher renewal mortgage rates in 2024 through 2026. In contrast, Morgan Stanley estimates that 75% of US households have 30-year fixed-rate mortgages below 5%. The Bank of Canada may be forced to cut rates sooner than the Fed to compensate. We therefore, remain constructive on the US economy and market relative to Canada given pressures on the Canadian consumer as well as the cyclical nature of the TSX.

By the end of October, small-cap stocks entered a bear market, with the Russell 2000 index declining -30% from its prior peak. Earnings and cash flow multiples in the small cap space seem to indicate that these businesses are already pricing in a recession. Compared to valuations in the large cap space, we see compelling opportunities in the small cap space for 2024.

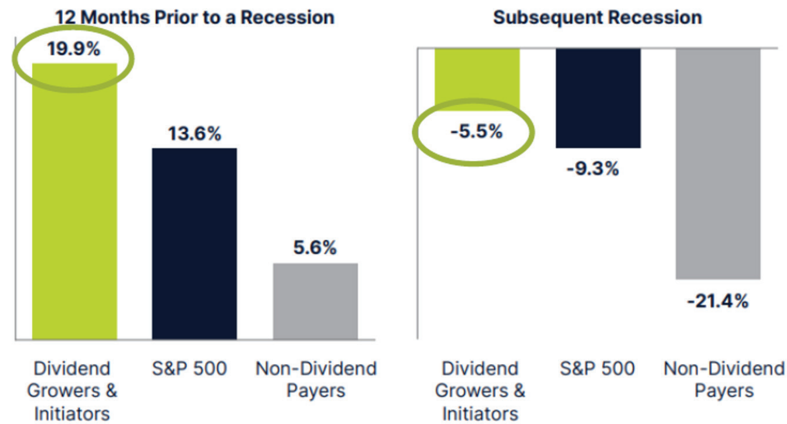
Exhibit 3 - Relative Valuations for Small Caps vs. Large Caps Are Near Their Lowest in 25 Years
Russell 2000 vs. Russell 1000 Median LTM EV/EBIT* (ex. Negative EBIT Companies) From 9/30/98 through 9/30/23



Source: FactSet, Russell Investments. *Last twelve months Enterprise Value/Earnings Before Interest and Taxes. Past performance is no guarantee of future results.

As global growth moderates, potential opportunities may emerge in companies driven by secular growth trends with strong competitive positioning. Earnings growth will drive stock performance as inflation continues to cool and cost cutting ramps up. We maintain our view that quality will be a leading factor in 2024 with a shift towards cheaper pockets of quality as measured by free-cash-flow yields. Investors concerned about the potential for a recession should look to dividend compounders as they have historically outperformed prior to and after recessions.

Exhibit 4 - Dividend Growers Prior and During Recessions
Average Cumulative Return Over the Last 5 Recessions (January 1, 1979 - December 31, 2018)

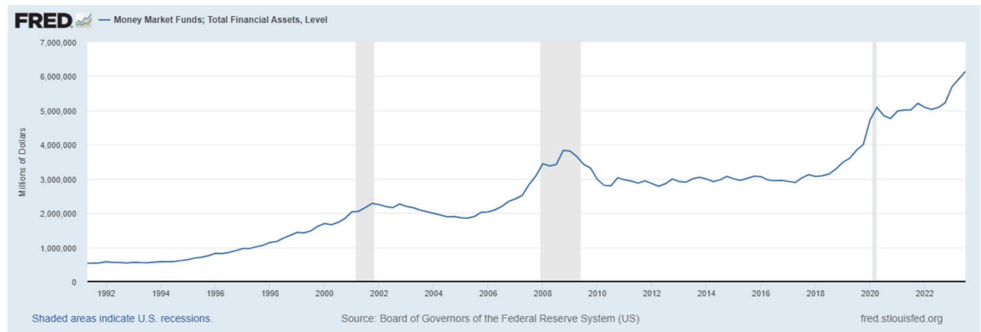


Source: National Bureau of Economic Research and Ned Davis Research, Inc., 1/1/79-12/31/18, based on the five most recent recessions. Past performance is no guarantee of future results. The average total return performance of each group and the S&P 500 are based on equal-weighted geometric average, computed monthly.

We believe it is too early for a full risk on rotation, however we also don't believe portfolios should be overly defensive. A balanced portfolio of high-quality businesses makes the most sense to us, especially in the face of market uncertainties associated with the anticipated normalization of economic indicators such as inflation and interest rates. Investors can navigate this inflection point in the market by focusing on companies that maintain a strong balance sheet, benefit from strong secular growth trends, and maintain industry leading competitive positions.

As rates have risen, money market funds and treasuries have attracted flows away from dividend paying stocks. Dividend paying stocks were under pressure in 2023 as risk-free yields hit 5% and provided a safe alternative to equity risk. We expect that as rates normalize, dividend growth stocks will become a more attractive option, as they can offer comparable yields with the embedded optionality of strong growth in dividends as well as capital appreciation.

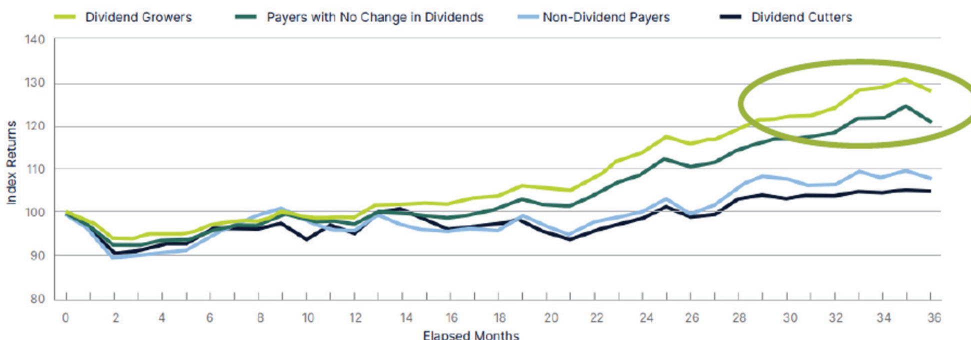
Exhibit 5 - All-Time High Cash Positions Support Future Equity Allocations



Source: Board of Governors of the Fed System (US).

As interest rates normalize, dividend growth stocks are poised to regain appeal, offering yields on par with alternative investments while also providing the potential for meaningful growth in dividend payouts and capital appreciation. Historically, dividend compounders have outperformed at the end of rate hike cycles.

Exhibit 6 - Dividend Growers After Fed Rate Hike Cycles
Subsets of S&P 500, All Rate Hikes Since 1972



Source: Ned Davis Research, Inc. Past performance is no guarantee of future results. Data shown is based on the average 36 month performance after all rate hikes since 1972 which occurred on the following dates: 1/15/73, 8/31/77, 8/31/80, 9/4/87, 2/4/94, 6/30/99, 6/30/04, 12/16/15.

Starlight Capital's strategy for diversified equities centers around four core areas of emphasis:

1. Emphasizing high-quality growth at a reasonable price for growth portfolios.
2. Concentrating on high-quality dividend growth stocks for equity income portfolios.
3. Maintaining a balanced approach to risk management and portfolio construction.
4. Paying close attention to valuation levels, particularly Free Cash Flow (FCF) yields.

The Starlight Dividend Growth Class is a concentrated portfolio of 44 high-quality companies with a track record of increasing dividends by 10% annually. As at December 31, 2023, the portfolio holdings' had a dividend CAGR of 11.6%, 14.3% and 10.8% for the one-year, three-year and five-year periods.[1] The fund's distribution currently yields 4.0% of which 60.6% was taxed as return of capital in 2022.

We invite you to partner with us.

Starlight Capital

[1]CAGR excludes private investments and cash and cash equivalents. CAGR is Portfolio Annual Growth Rate.
Source: Bloomberg Finance L.P. As of December 31, 2023.

Investment Management Team

Sean Tascatan
CFA
Senior Portfolio Manager, Diversified Equities

Sean Tascatan joined Starlight Capital in January 2023 as Senior Portfolio Manager. He has over 10 years of experience in the investment industry.

Mr. Tascatan most recently held a position at Caldwell Investment Management as the lead portfolio manager of numerous dividend funds, including a U.S. Dividend Growth Fund where he specialized in high-quality, dividend paying U.S. equities. Prior to that, he worked at Sentry Investments where he was a key member of an award-winning Equity Income team that garnered multiple Lipper Fund and Morningstar Investment Awards. There, he was the co-manager of a $3B U.S. Growth and Income Fund and a $500MM Diversified Equity Fund.

Mr. Tascatan holds the Chartered Financial Analyst designation and has completed the Options Licensing Course and has an Honours Bachelor of Arts degree in Economics and Financial Management from Wilfrid Laurier University.

About Starlight Capital

Starlight Capital is an independent Canadian asset management firm with over $1 billion in assets under management. We manage Global and North American diversified private and public equity investments across traditional and alternative asset classes, including real estate, infrastructure and private equity. Our goal is to deliver superior risk-adjusted, total returns to investors through a disciplined investment approach: Focused Business Investing. Starlight Capital is a wholly-owned subsidiary of Starlight Investments. Starlight Investments is a leading global real estate investment and asset management firm with over 360 employees and $28B in AUM. A privately held owner, developer and asset manager of over 66,000 multi-residential suites and over 7 million square feet of commercial property space. Learn more at www.starlightcapital.com and connect with us on LinkedIn at www.linkedin.com/company/starlightcapital/

Invest With Us

For more information on our investment solutions, learn more at **starlightcapital.com** or speak to our Sales Team.

Important disclaimer.

The views in this update are subject to change at any time based upon market or other conditions and are current as of January 22, 2024. While all material is deemed to be reliable, accuracy and completeness cannot be guaranteed.

Certain statements in this document are forward-looking. Forward-looking statements ("FLS") are statements that are predictive in nature, depend upon or refer to future events or conditions, or that include words such as "may," "will," "should," "could," "expect," "anticipate," "intend," "plan," "believe," or "estimate," or other similar expressions. Statements that look forward in time or include anything other than historical information are subject to risks and uncertainties, and actual results, actions or events could differ materially from those set forth in the FLS. FLS are not guarantees of future performance and are by their nature based on numerous assumptions. Although the FLS contained herein are based upon what Starlight Capital and the portfolio manager believe to be reasonable assumptions, neither Starlight Capital nor the portfolio manager can assure that actual results will be consistent with these FLS. The reader is cautioned to consider the FLS carefully and not to place undue reliance on FLS. Unless required by applicable law, it is not undertaken, and specifically disclaimed that there is any intention or obligation to update or revise FLS, whether as a result of new information, future events or otherwise. Commissions, trailing commissions, management fees and expenses all may be associated with investment funds. Please read the prospectus before investing. Investment funds are not guaranteed, their values change frequently, and past performance may not be repeated.

The content of this document (including facts, views, opinions, recommendations, descriptions of or references to, products or securities) is not to be used or construed as investment advice, as an offer to sell or the solicitation of an offer to buy, or an endorsement, recommendation or sponsorship of any entity or security cited. Although we endeavour to ensure its accuracy and completeness, we assume no responsibility for any reliance upon it. Please read the offering documents before investing. Investors should consult with their advisors prior to investing.

Starlight, Starlight Investments, Starlight Capital and all other related Starlight logos are trademarks of Starlight Group Property Holdings Inc.

Starlight Capital
1400–3280 Bloor Street West
Toronto, Ontario, Canada M8X 2X3
info@starlightcapital.com
1-833-752-4683
starlightcapital.com

Starlight™ CAPITAL
Focused Investing