PALLAS
CAPITAL ADVISORS

Pallas Perspective

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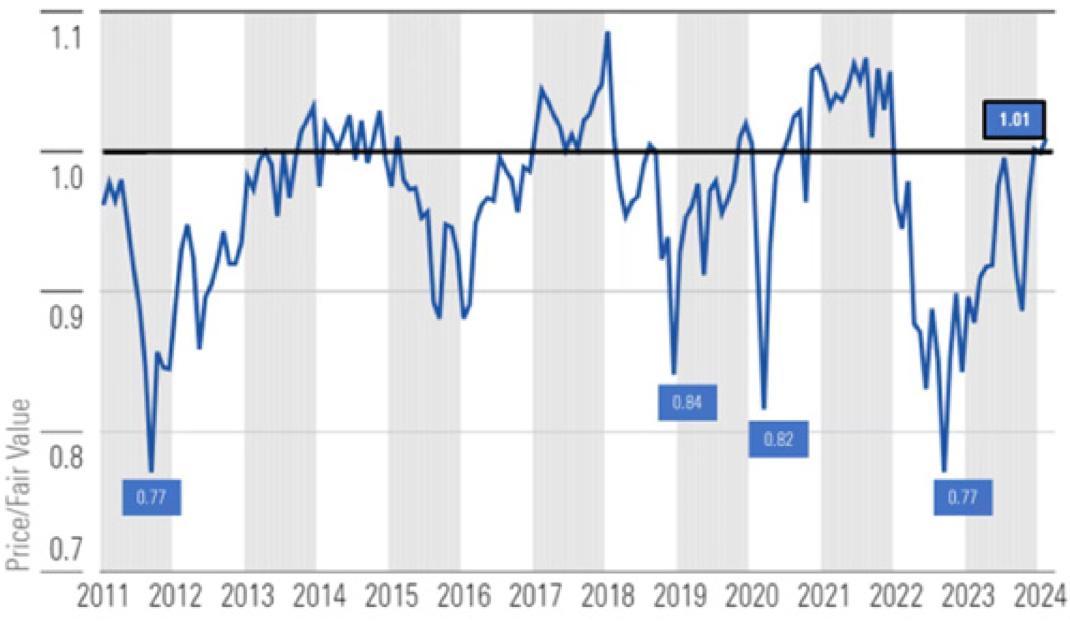
High Relative Valuations for Equities Require Valuation Discipline and Focus on Long-Term Fundamentals

Valuation within the U.S. equity market is not a static measure through time. An assessment of fair valuation considers factors in the macro environment, such as economic growth, inflation, and interest rates, as well as geopolitical and idiosyncratic factors, such as individual company market opportunity, growth, operational execution, and balance sheet strength. The result is that there is no single arbiter of fair value for equity markets at any point in time. However, a consistently applied approach can indicate relative highs and lows versus history. Morningstar's bottoms-up valuation approach for 950 stocks in the U.S. provides one such source for comparison of current equity market valuation versus history.

The following Morningstar analysis compares the ratio of the price for a stock under coverage versus Morningstar's assessment of fair value over time. As of the end of February, the analysis indicated that the U.S. stock market is trading at a 1% premium over the composite of fair values for Morningstar's coverage universe. Based on history since the end of 2010, Morningstar has only calculated market fair value at this much or more of a premium 25% of the time.

Morningstar Price/Fair Value for US Equity Coverage Universe

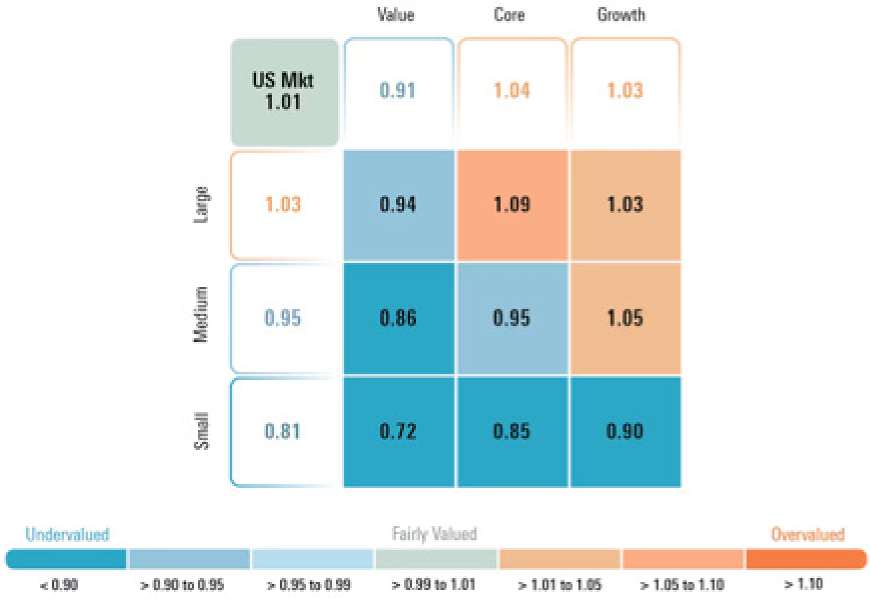


Source: Morningstar. Data as of Feb. 28, 2024.

The Morningstar results suggest that the market is trading within a range considered fair value. However, absent macro or idiosyncratic factors that could cause a material positive reassessment of fair value, the opportunity for valuation metric expansion to drive U.S. equity returns is likely limited. In this context, the importance of equity selection and allocation within the U.S. equity universe will likely be crucial for maximizing returns and minimizing risk.

One such equity selection and allocation approach is the identification of opportunities that are currently undervalued relative to the market. The current Morningstar analysis suggests that small-cap and value equities are relatively undervalued compared to the market.

Morningstar Price/Fair Value by Style Box Category



Source: Morningstar. Data as of Feb. 28, 2024.

The reasoning for the undervaluation of small-cap and value equities lies in their greater perceived sensitivity to slowing economic growth and elevated interest rates. If either of these, or preferably both factors, were to reverse, a catalyst would likely be in place for small-cap and value performance.

An alternative to the contrarian approach in equity selection and allocation should also be considered. Ultimately, what drives all stocks over the long term is growth and improving financial metrics, such as return on equity, which combine to be expressed in higher, sustainable earnings. Identifying and holding stocks in businesses that will consistently drive higher earnings growth reduces the reliance on timing valuation entry points. However, at times, even great businesses can have valuations that may require years of growth or substantial upward revisions to realize stretched valuations, with the added risk that any misstep in execution, even short term, might result in a meaningful pullback in the stock.

At Pallas Capital Advisors, we utilize valuation models such as Morningstar's fair value targets to provide useful tools for gauging attractive entry points and exit points at the margin when extremes are reached. However, we believe equity portfolios should be constructed of stocks diversified across styles and sectors, with a focus on selecting stocks of strong businesses that will deliver attractive financial results over the long term.