BMO Capital Markets

# US Strategy Comment

## Dusting Off the Barbell

Investment Strategy

Brian G. Belski — Chief Investment Strategist
brian.belski@bmo.com (212) 885-4151

Nicholas Roccanova, CFA — Head of US Equity Strategy
nicholas.roccanova@bmo.com (212) 885-4179

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### Market Direction, Stock Picking, and Fundamental Trends Should Benefit a Barbell Approach

Market weakness during April was probably long overdue, but we disagree with the notion that the recent slide has "checked the necessary correction box" and signals an all-clear for stocks to continue their previously torrid run since Oct'23. Should the recent weakness indeed be behind us, it would represent the weakest and shortest pullback in several decades for all year twos of bull markets during the post WWII era, excluding the pandemic. Therefore, we anticipate that price choppiness and volatility will re-emerge in the coming weeks and months, particularly considering the disconnect between elevated valuation levels and the higher-for-longer interest rate outlook and would recommend that investors position portfolios accordingly for this possibility. Against this backdrop, we have continued to recommend that investors be more selective in their investment process in order to deliver outperformance and have long been staunch advocates of a barbell approach (risk + defense) for portfolio positioning, which according to our work has produced a favorable longer-term track record relative to the overall market in all sorts of market environments. Our preferred barbell approach is to combine growth-at-a-reasonable-price (risk) and dividend growth and yield (defense) strategies.

### Main Points:

- Barbell Approach Has Been Working Well Lately
  - ✓ A risk + defense approach to portfolio positioning has slightly outperformed so far this year
  - ✓ Underlying market trends and fundamentals of the strategy suggest continued outperformance
- Risk Barbell: Growth-At-A-Reasonable-Price
  - ✓ Focus on stocks with below-market valuation (NTM P/E and PEG) and above-market earnings growth expectations
- Defense Barbell: Dividend Growth and Yield
  - ✓ Focus on stocks with long track records of dividend increases, as well as above-market dividend yield and growth characteristics

### Implementation Strategies:

- US Tactical Equity, US Dividend Growth, and US Disciplined Value portfolios
- Please see US Strategy Portfolios and Investment Strategy Portfolios for recent changes

**US Strategy – S&P 500 Targets**

| Price Target Model | 2024E |
|---|---|
| DDM | 5,175 |
| Fair Value P/E | 5,050 |
| **Price Target** | **5,100** |
| **EPS Target Model** | **2024E** |
| Macro Regression | $240 |
| Bottom-Up Consensus | $245 |
| Normalized EPS | $205 |
| **EPS Target** | **$250** |
| **Implied P/E** | **20.4x** |

Source: BMO Capital Markets Investment Strategy

**US Strategy – Recommended S&P 500 Sector Weightings**

| Sector | Opinion | Tgt. Wgt. |
|---|---|---|
| Communication Services | MW | 9% |
| Consumer Discretionary | MW | 11% |
| Consumer Staples | UW | 5.5% |
| Energy | UW | 3.5% |
| Financials | OW | 13.5% |
| Health Care | MW | 12.5% |
| Industrials | MW | 8.5% |
| Information Technology | OW | 30% |
| Materials | UW | 1.5% |
| Real Estate | MW | 2.5% |
| Utilities | MW | 2.5% |

Source: BMO Capital Markets Investment Strategy

OW: Overweight
MW: Market Weight
UW: Underweight

09:32 ET~

# Dusting Off the Barbell

## Market Direction, Stock Picking, and Fundamental Trends Should Benefit a Barbell Approach

As we have been discussing in recent reports, we continue to think US stocks have run a little too far, too fast since the most recent price low for the S&P 500 in Oct'23 and believe that the market was overdue for a breather. Indeed, April is on track to be the first negative month of index performance since Oct'23 despite a strong rebound in recent days. In fact, many investors seemingly believe that the recent weakness has "checked the necessary correction box" and that stocks will resume their previous momentum in the months ahead based on our client conversations. Unfortunately, we are not so sure. If the recent slide is in fact behind us, it would represent the weakest pullback (-5.2%) in four decades and the shortest one (less than one month) in 27 years for all year twos of bull markets during the post WWII era, excluding the pandemic period (Exhibit 1). Therefore, we anticipate that price choppiness and heightened volatility will re-emerge in the coming weeks and months particularly considering the divide between elevated valuation levels and the higher-for-longer interest rate outlook. To be clear, we remain optimistic about stocks longer term, but from our perspective, stocks appear to be pricing a "perfect" scenario in the current environment and our experience has taught us that outcome almost never materializes.

Against this backdrop, we have continued to recommend that investors be more selective in their investment process in order to deliver outperformance and have long been staunch advocates of a barbell approach (risk + defense) for portfolio positioning. Our work shows that this type of strategy has produced a favorable longer-term track record relative to the overall market with recent underlying market and fundamental trends bolstering the case for this strategy, in our view. Our preferred barbell approach is to combine growth-at-a-reasonable-price (risk) and dividend growth and yield (defense) strategies. As a result, we are recommending that investors consider these areas to capitalize on the market environment we anticipate developing throughout the remaining months of 2024.

**Exhibit 1: S&P 500 Average Performance Before, During, and After Max Drawdown During Second Year of Bull Market**

| Bull Market Start Year | Months to Max Drawdown Start | Months Max Drawdown Lasted | Months from Max Drawdown End to End of Yr2 | Perf to Max Drawdown Start | Perf during Max Drawdown | Perf from Max Drawdown End to End of Yr2 | Yr2 Performance |
|---|---|---|---|---|---|---|---|
| 1946 | 0.3 | 4.8 | 6.9 | 3.5% | -12.3% | 14.9% | 4.2% |
| 1949 | NA | 1.1 | 10.9 | NA | -13.4% | 29.2% | 11.9% |
| 1957 | 9.4 | 1.7 | 1.1 | 18.9% | -9.2% | 1.6% | 9.7% |
| 1962 | 4.1 | 0.9 | 7.1 | 7.3% | -6.5% | 17.0% | 17.4% |
| 1966 | 0.0 | 4.9 | 7.2 | 0.3% | -10.0% | 18.2% | 6.6% |
| 1970 | 3.5 | 2.6 | 6.2 | 1.8% | -11.0% | 22.5% | 11.1% |
| 1974 | 1.5 | 0.6 | 10.0 | 6.4% | -5.1% | 20.0% | 21.2% |
| 1982 | 1.9 | 9.6 | 0.6 | 6.5% | -14.4% | 11.9% | 2.0% |
| 1987 | 10.3 | 1.0 | 0.9 | 32.4% | -7.6% | 5.7% | 29.0% |
| 1990 | 3.1 | 2.8 | 6.2 | 10.3% | -6.2% | 2.1% | 5.6% |
| 2002 | 4.1 | 6.1 | 1.9 | 11.5% | -8.2% | 5.5% | 8.0% |
| 2009 | 1.5 | 2.4 | 8.3 | 6.7% | -16.0% | 29.1% | 15.7% |
| 2021 | 5.5 | 1.0 | 3.1 | 16.0% | -5.2% | 11.5% | 22.6% |
| **Average** | **3.8** | **3.0** | **5.4** | **10.1%** | **-9.6%** | **14.5%** | **12.7%** |
| **Current** | **5.0** | **??** | **??** | **16.6%** | **-5.2%** | **??** | **??** |

Source: BMO Capital Markets Investment Strategy Group, FactSet.

## Risk Barbell – Growth-at-a-Reasonable Price

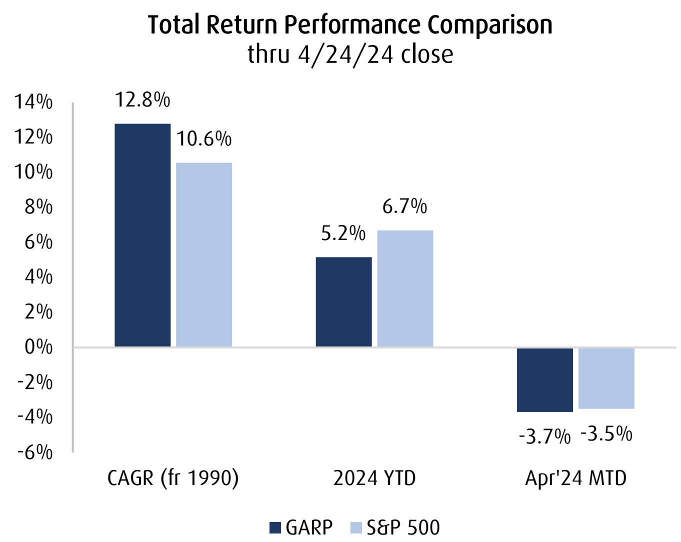
To maximize return potential, we typically try to identify opportunities that offer the greatest growth potential at reasonable valuations (i.e., growth-at-a-reasonable-price or GARP). We have found through our work that GARP strategies tend to perform much better over longer periods than singularly focused growth or value strategies. One simple approach we use to identify such stocks is to screen the S&P 500 based on the following characteristics:

- NTM P/E less than the median S&P 500 value;
- NTM EPS growth greater than the median S&P 500 value; and
- NTM PEG ratio less than the median S&P 500 value.

As Exhibit 2 illustrates, this sort of strategy has produced favorable results since 1990. For instance, the CAGR (based on total returns) of this strategy has been 12.8%, compared with 10.6% for the S&P 500 since 1990. Unfortunately, this strategy has struggled so far this year on a relative basis, gaining only 5.2% compared to the 6.7% for the S&P 500 with the underperformance continuing during April's slide. We view these trends as a buying opportunity given the underlying fundamentals of these stocks.

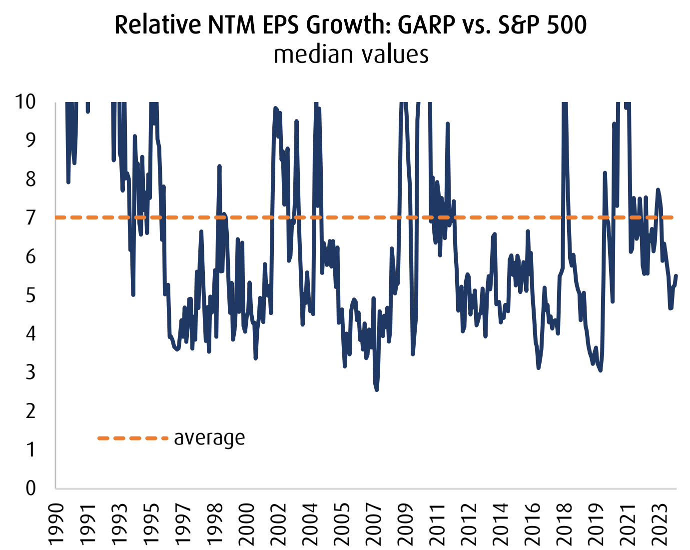
As analyst earnings optimism has continued to improve throughout the year for US stocks overall, the NTM earnings growth differential for GARP stocks has dipped to below-average levels, although the trend has started to reverse in recent months (Exhibit 3). While the absolute level could be viewed as a negative, we believe it needs to be put into proper context. For instance, despite a significant increase in relative NTM P/E in recent months, the latest level remains about average compared to historical norms (Exhibit 4). More important, even with the deterioration in relative earnings growth and valuation expansion, the NTM PEG ratio has declined sharply and is only slightly above a historically low level (Exhibit 5), which to us suggests a quite favorable backdrop for GARP stocks.

**Exhibit 2: GARP Has Provided Favorable Long-Term Results Despite Lagging This Year So Far**



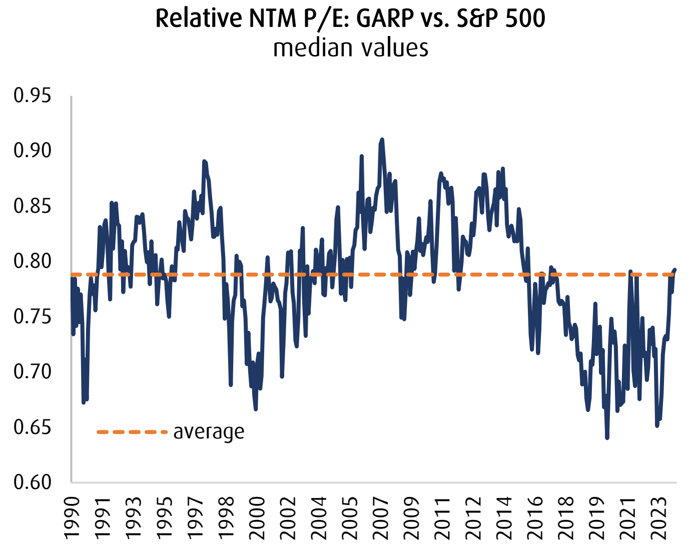

Source: BMO Capital Markets Investment Strategy Group, FactSet.

**Exhibit 3: Earnings Growth Differential for GARP Has Weakened And Is Below Average**



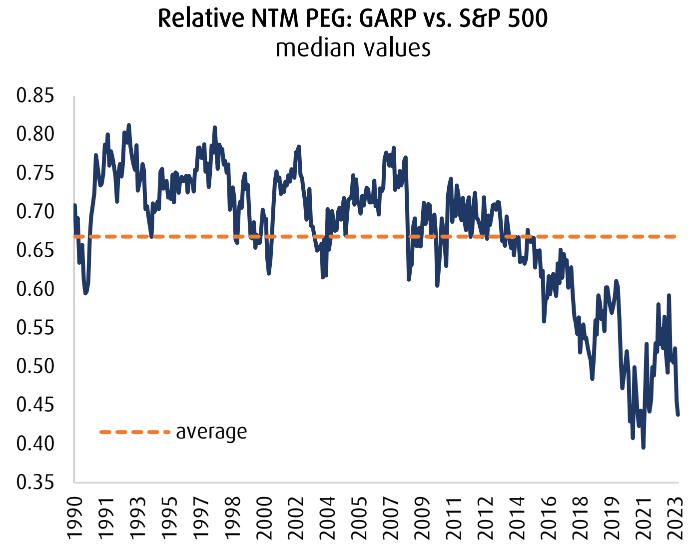

Source: BMO Capital Markets Investment Strategy Group, FactSet, IBES.

Exhibit 4: Despite a Sharp Increase in Recent Months GARP Relative PE Is About Average




Source: BMO Capital Markets Investment Strategy Group, FactSet, IBES.

Exhibit 5: Relative PEG for GARP Has Declined Sharply And Is Approaching a Historically Low Level




Source: BMO Capital Markets Investment Strategy Group, FactSet, IBES.

## Defense Barbell – Dividend Growth and Yield

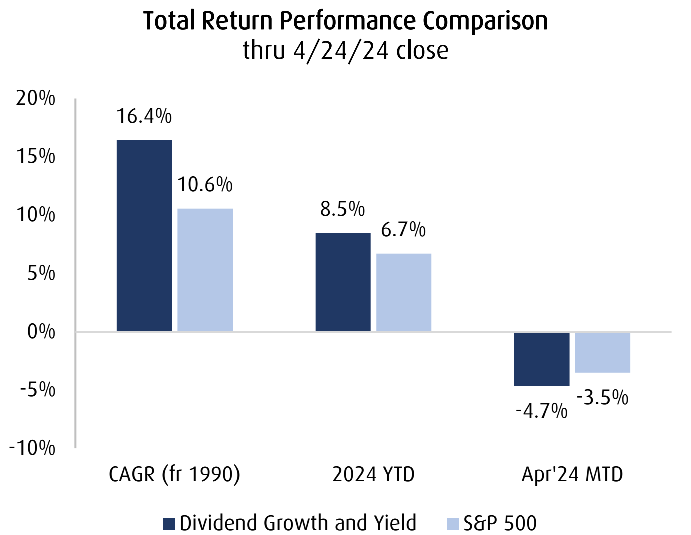
As readers of our work are well aware, we have maintained a dividend preference for quite some time. We have found that not only do these stocks help to guard against periods of market volatility, but they also tend to perform extremely well over longer timeframes. As a result, we continue to recommend that investors always have some exposure to these areas. While dividend yield is a primary factor in considering dividend opportunities, we believe it is important for investors to consider other factors as well. By focusing solely on high current dividend yield, investors could be missing potential recovery and/or dividend growth opportunities. Besides, high dividend yields by themselves are sometimes a sign of impending trouble (e.g., dividend cuts). For a more complete screen, we focus on growth in dividend payouts and free cash flow as well since we have found that trends in these factors make dividend yields more believable. As such, one approach we use to identify dividend opportunities is to focus on S&P 500 companies demonstrating the following characteristics:

- No dividend cuts in the past five years;
- Latest one-year dividend per share growth greater than the S&P 500;
- Current dividend yield greater than the S&P 500;
- Free cash flow yield greater than the dividend yield; and
- Dividend payout ratio lower than the S&P 500.

Much like our GARP methodology, this sort of strategy has produced favorable results since 1990. In fact, the CAGR (based on total returns) of this strategy has been even higher compared to the GARP screen at 16.4% (Exhibit 6). Unlike the GARP strategy, this strategy has performed quite well this year on a relative basis gaining 8.5% compared to the 6.7% for the S&P 500. However, the outperformance has reversed sharply during April with the strategy shedding 4.7% or 1.2% less than the S&P 500. Nonetheless, we expect these stocks to shake off their recent weakness and continue to perform well, especially considering that the dividend characteristics that we focus on are showing favorable trends.

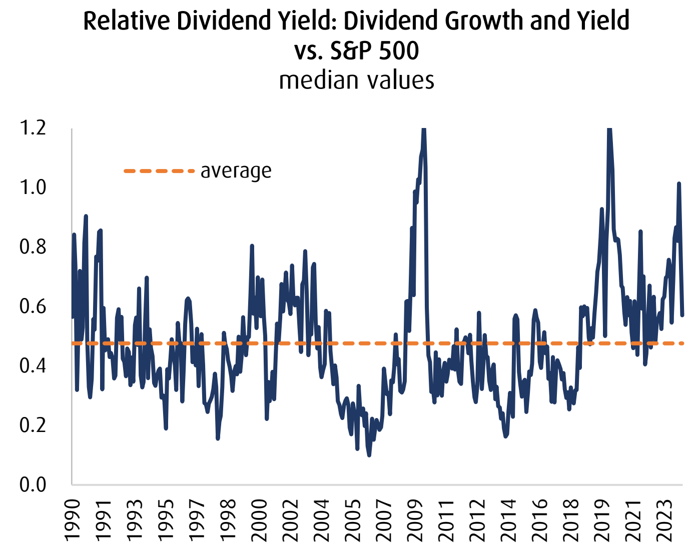
For instance, the relative dividend yield of the strategy has been above average for much of the last two years even with the sharp decrease in recent months (Exhibit 7). In addition, DPS growth expectations have improved considerably since the start of the year with the latest estimates about 0.8% higher than the start of the year, which compares to the marginal increase of 0.3% for the S&P 500 (Exhibit 8). Finally, despite some recent deterioration, the relative free cash flow yield remains well above average (Exhibit 9) – a characteristic that we believe makes DPS growth expectations more believable.

**Exhibit 6: Dividend Growth and Yield Has Provided Excellent Long-Term Results and Has Rebounded Sharply in 2023**



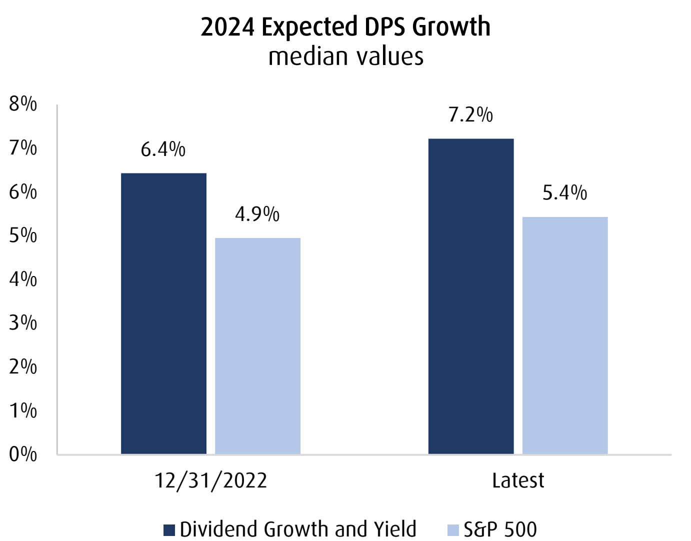

Source: BMO Capital Markets Investment Strategy Group, FactSet.

**Exhibit 7: Dividend Yield Spread Has Narrowed Sharply but Remains Firmly Above Historical Average**



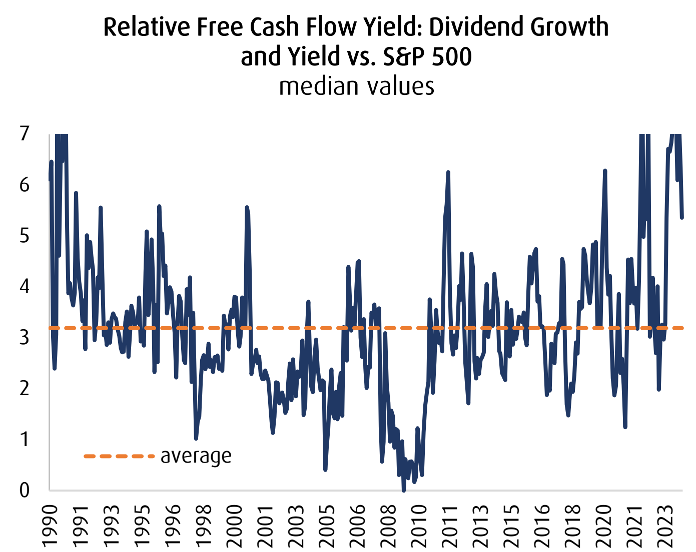

Source: BMO Capital Markets Investment Strategy Group, FactSet, IBES.

**Exhibit 8: Dividend Per Share Growth Expectations Have Improved Sharply Especially Relative to S&P 500**




Source: BMO Capital Markets Investment Strategy Group, FactSet, IBES.

**Exhibit 9: Relative Free Cash Flow Yield Remains Well Above Average Despite Some Recent Deterioration**

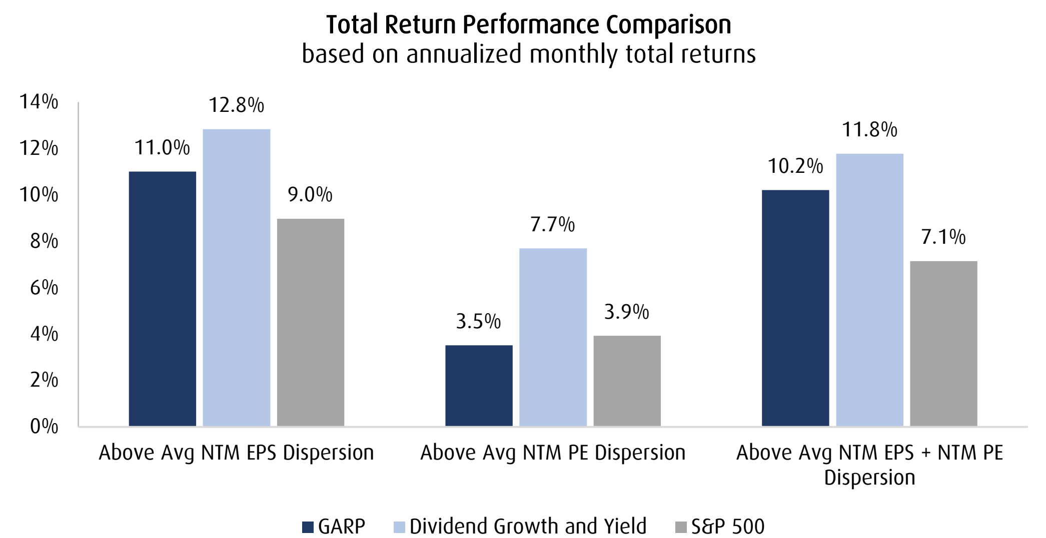



Source: BMO Capital Markets Investment Strategy Group, FactSet, IBES.

## Barbell Performs Well When Fundamentals Are Highly Dispersed

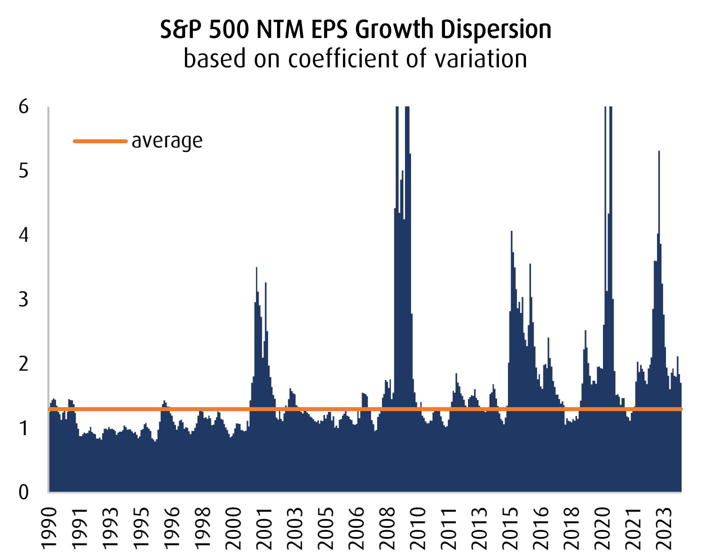
We also found that a GARP + dividend growth barbell historically has been well-suited for stock picking environments, such as those periods when earnings growth and valuations among companies are highly dispersed like they are currently (Exhibits 11-12). For instance, we analyzed all monthly periods since 1990 in which S&P 500 NTM EPS growth dispersion and NTM P/E dispersion were above their historical averages and calculated the annualized total returns for each side of our barbell strategy and the S&P 500. As shown in Exhibit 10, our GARP + dividend growth barbell recorded the strongest relative performance (10.2% and 11.8% vs 7.1%) when both dispersion measures were above historical norms as they are now.

**Exhibit 10: Barbell Has Historically Delivered Above-Market Average Returns When NTM EPS Growth & P/E Dispersion Levels Were Elevated**



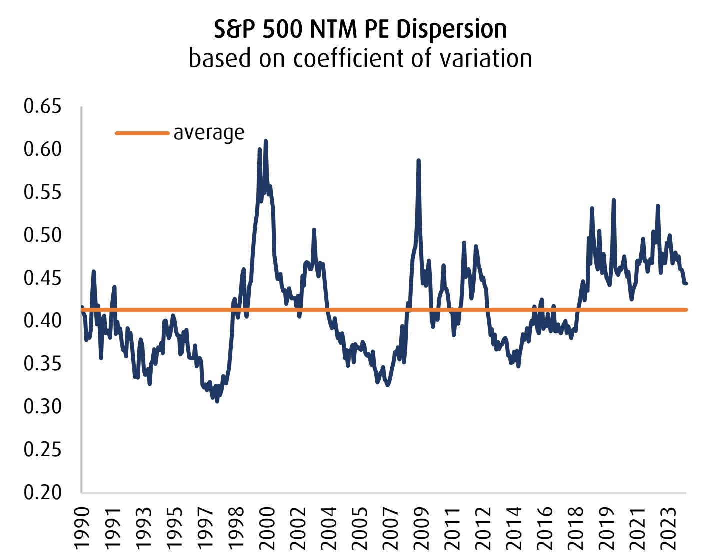

Source: BMO Capital Markets Investment Strategy Group, FactSet, IBES.

**Exhibit 11: NTM EPS Growth Differentiation Remains Elevated Despite a Decline in Recent Months**




Source: BMO Capital Markets Investment Strategy Group, FactSet, IBES.

**Exhibit 12: NTM P/E Dispersion Among S&P 500 Stocks Also Remains Well-Above Historical Norms**

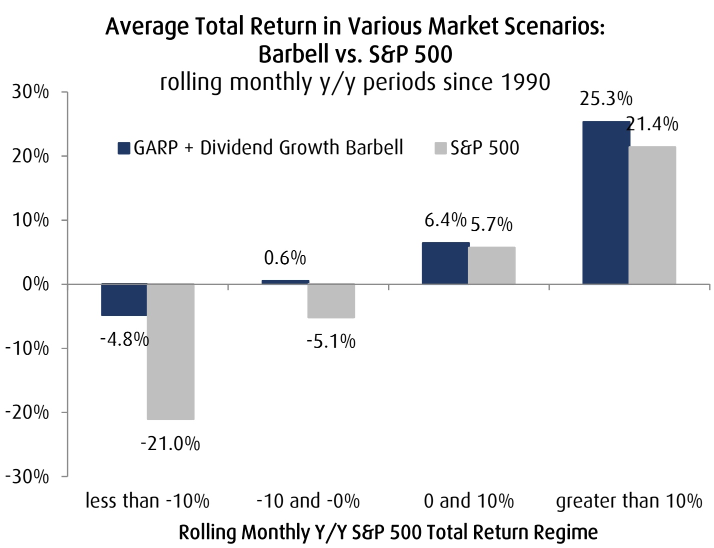



Source: BMO Capital Markets Investment Strategy Group, FactSet, IBES.

## GARP + Dividend Growth Barbell Can Combat Volatility and Limit Downside During Market Declines, Yet Also Posts Solid Gains During Market Strength

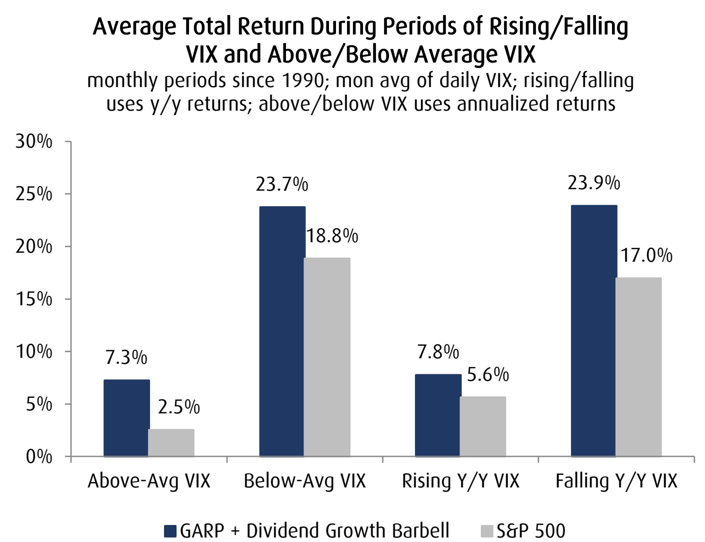
One of the most attractive attributes of a barbell strategy, from a historical performance perspective, is the ability to limit losses during market declines, yet also participate in the price upside during periods of market strength. We analyzed all rolling monthly one-year holding periods' returns since 1990 and divided S&P 500 returns into ranges. According to our analysis (Exhibit 13), a barbell approach (i.e., 50% GARP, 50% dividend growth and yield) significantly limited losses relative to the broader market when the S&P 500 shed 10% or more on a y/y basis (-4.8% vs -21%) and managed a 0.6% average gain when the index fell between 0% and 10% versus the 5.1% average loss recorded by the S&P 500 (Exhibit 8). That being said, a GARP + dividend growth barbell can also outperform as the broader market moves higher. Indeed, our barbell strategy eclipsed the S&P 500 by 70bps (6.4% vs 5.7%), on average, when the index posted y/y returns between 0% and 10% and outperformed by about four percentage points (25.3% vs 21.4%) when the S&P 500 logged gains in excess of 10%. In addition, a GARP + dividend growth barbell can also combat periods of volatility and uncertainty as measured by average daily VIX levels. For instance, we analyzed all rolling monthly periods since 1990 and found that a barbell strategy produced a 7.3% average annualized total return during above-average VIX readings, and a 7.8% average one-year return when VIX was rising y/y, compared to S&P 500 average returns of 2.5% and 5.6%, respectively (Exhibit 14).

**Exhibit 13: GARP + Div Growth Barbell Can Limit Losses During Market Declines, but Also Performs Well During Periods of Market Strength**




Source: BMO Capital Markets Investment Strategy Group, FactSet, IBES.

**Exhibit 14: Barbell Approach Has Outperformed the Broader Market, on Average, in Volatile Times**




Source: BMO Capital Markets Investment Strategy Group, CBOE, FactSet, IBES.

## BMO Outperform-Rated Stocks That Fit the Theme

**Exhibit 15: BMO OP Rated Stocks Passing the GARP Screen**

| Ticker | Company | Price | BMO Rating* |
|---|---|---|---|
| BKR | Baker Hughes Company Class A | $32.67 | OP |
| CPAY | Corpay, Inc. | $307.42 | OP |
| DLTR | Dollar Tree, Inc. | $122.39 | OP |
| EXPE | Expedia Group, Inc. | $135.80 | OP |
| FI | Fiserv, Inc. | $152.25 | OP |
| MRK | Merck & Co., Inc. | $127.00 | OP |
| MS | Morgan Stanley | $93.85 | OP |
| NEM | Newmont Corporation | $38.60 | OP |
| PPG | PPG Industries, Inc. | $130.52 | OP |
| SLB | SLB | $49.11 | OP |
| SYY | Sysco Corporation | $77.29 | OP |
| TRV | Travelers Companies, Inc. | $213.43 | OP |

Source: BMO Capital Markets Investment Strategy. Prices as of 4/24/24. *Rating Key, according to BMO Capital Markets Equity Research: OP: Outperform, Mkt: Market Perform, Und: Underperform, NR: Not rated by BMO Capital Markets. Some stocks in the table above may be covered by our Canadian affiliate BMO Nesbitt Burns Inc. Click here for disclosures on those stocks: https://researchglobal0.bmocapitalmarkets.com/public-disclosure/

**Exhibit 16: BMO OP Rated Stocks Passing the Dividend Growth and Yield Screen**

| Ticker | Company | Price | BMO Rating* |
|---|---|---|---|
| AIG | American International Group, Inc. | $74.97 | OP |
| CINF | Cincinnati Financial Corporation | $119.92 | OP |
| MOS | Mosaic Company | $30.49 | OP |
| MPC | Marathon Petroleum Corporation | $199.14 | OP |
| PSX | Phillips 66 | $157.79 | OP |
| TRV | Travelers Companies, Inc. | $213.43 | OP |

Source: BMO Capital Markets Investment Strategy. Prices as of 4/24/24. *Rating Key, according to BMO Capital Markets Equity Research: OP: Outperform, Mkt: Market Perform, Und: Underperform, NR: Not rated by BMO Capital Markets. Some stocks in the table above may be covered by our Canadian affiliate BMO Nesbitt Burns Inc. Click here for disclosures on those stocks: https://researchglobal0.bmocapitalmarkets.com/public-disclosure/

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| Date | Title |
|---|---|
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| 3/26/2024 | US Strategy Comment:  Small and Mid-Cap Check Up |
| 3/21/2024 | US Strategy Comment: Revisiting Our Style Recommendations |
| 3/13/2024 | US Strategy Comment: Navigating the Range |
| 2/27/2024 | US Strategy Comment:  S&P 500 Target Update, Holding Steady |
| 2/15/2024 | US Strategy Comment:  YARP Primed for a Turnaround |
| 2/6/2024 | US Strategy Comment:  Market Concentration Worries May Be Overstated |
| 1/18/2024 | US Strategy Comment: 2024 Off to a Wobbly Start |
| 1/9/2024 | US Strategy Comment:  Technology Remains a Top Sector Pick |
| 12/13/2023 | US Strategy Comment: How to Own Both Growth and Value for 2024 |
| 11/15/2023 | US Strategy Comment:  Three Observations to Help Climb the Wall of Worry |
| 10/26/2023 | US Strategy Comment:  High Dividend Yield Weakness Likely Overdone |
| 10/18/2023 | US Strategy Comment: Happy Birthday Bull Market |
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| 4/3/2024 | US Strategy: US Multi-Factor Profiles – April 2024 |
| | **Investment Strategy Snapshots and Special Reports** |
| 11/27/2023 | 2024 Market Outlook - The Year Ahead for the U.S. and Canada |

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### Distribution of Ratings (April 24, 2024)

| Rating category | BMO rating | BMOCM US Universe* | BMOCM US IB Clients** | BMOCM US IB Clients*** | BMOCM Universe**** | BMOCM IB Clients***** | StarMine Universe~ |
|---|---|---|---|---|---|---|---|
| Buy | Outperform | 49.6 % | 19.6 % | 48.4 % | 55.8 % | 58.4 % | 57.7% |
| Hold | Market Perform | 48.1 % | 20.6 % | 49.5 % | 42.7 % | 40.8 % | 37.5% |
| Sell | Underperform | 2.4 % | 18.2 % | 2.2 % | 1.4 % | 0.9 % | 4.8% |

* Reflects rating distribution of all companies covered by BMO Capital Markets Corp. equity research analysts.

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~ As of April 1, 2019.

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Mkt = Market Perform - Forecast to perform roughly in line with the analyst's coverage universe on a total return basis;
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(S) = Speculative investment;
Spd = Suspended - Coverage and rating suspended until coverage is reinstated;
NR = No Rated - No rating at this time; and
R = Restricted - Dissemination of research is currently restricted.

The total return potential, target price and the associated time horizon is 12 months unless otherwise stated in each report. BMO Capital Markets' seven Top 15 lists guide investors to our best ideas according to different objectives (CDN Large Cap, CDN Small Cap, US Large Cap, US Small Cap, Income, CDN Quant, and US Quant have replaced the Top Pick rating).

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**(April 2013 - October 2016)**
http://researchglobal.bmocapitalmarkets.com/documents/2013/rating_key_2013_to_2016.pdf

**(January 2010 - April 2013)**
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