DUPONT CAPITAL

EQUITY STRATEGY REVIEW
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## US Small Cap, Structured Equities

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Inflation. A word that until recently only existed in my parent's vocabulary. At first, it was labelled "transitory". But more and more factors are pointing to inflation being a more permanent fixture within the investment landscape going forward.

Labor issues are plentiful. Just as the GFC saw a postponing of retirement, Covid seems to have accelerated retirement for the Baby Boomers. Couple this with the advent of TikTok fame and bull market day trading profits, Gen Z's are skipping the workforce in record numbers. This has culminated in the lowest number of unemployed workers per job openings in 70 years.

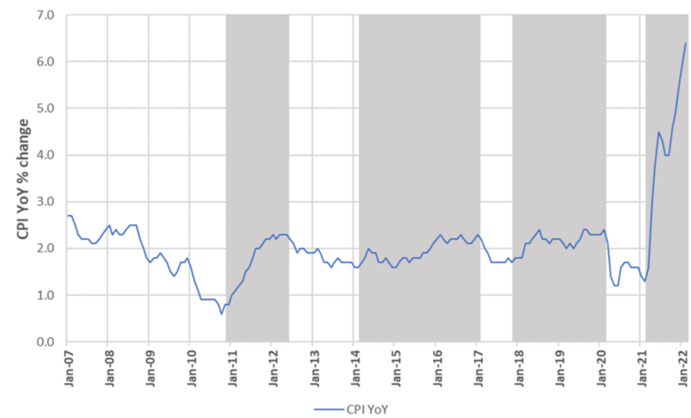
Then there are all the supply issues. First it was computer chips during Covid, which morphed into just about any part or component. Then the transportation bottlenecks started to bite. Ports were having trouble offloading ships, storing containers, and clearing containers, both domestic and abroad. The truck driver shortage only became more acute as vaccine mandates forced unvaccinated truckers off the road. Borders were shut down. Transportation costs, both on sea and land, have reached multi-year highs. Then the West leveled crippling sanctions on one of the world's largest commodity exporters, Russia, in retaliation for its invasion of Ukraine. This has caused widespread Nationalism across the globe as several countries banned exports of commodities to ensure domestic supply while global commodity prices have seen their strongest start in 20+ years.

The result? Inflation expectations are starting to become ingrained in the system. In the latest University of Michigan inflation survey, one-year forward consumer inflation expectations just hit 5.4%, the highest reading in the last 40 years. Inflation clauses in contracts are not only being triggered, but written into new contracts, embedding inflation in the system for years to come. This has all led to probably the most profound investment regime change we have seen in decades.

To get a handle on the potential implications of this regime shift, we studied the historical impact inflation had on our factor universe. We began our study by running the correlations between all the factors in our factor universe and month over month change in headline CPI, lagged for two months (to account for reporting delays). We also delineated history between periods of rising inflation (defined as general upward trend in year-over-year change in headline CPI as depicted in the grey shaded areas of exhibit 1).

Exhibit 2 shows the results at the factor family level. Overall, Value showed the strongest correlation with inflation at 18%, with Growth coming in second. Interestingly, correlations largely doubled across the board during periods of rising inflation, like what we are experiencing today, and fell during falling inflationary periods.

Exhibit 1: YoY Change in CPI (with rising inflation shaded in grey)




Source: DuPont Capital, Barra

Exhibit 2: Factor correlations to inflation 2007-2021

| | Value | Growth | Sentiment | Quality |
|---|---|---|---|---|
| Inflation (all periods) | 18% | 11% | -2% | 5% |
| Periods of Rising Inflation | 30% | 23% | 16% | 7% |
| Periods of Falling Inflation | 13% | 4% | -24% | 3% |

Source: DuPont Capital, Barra

Exhibit 3: Factor ranks in a rising inflation environment

| Top 5 | Bottom 5 |
|---|---|
| 1. Growth Adjusted Earnings to Price | 20. Momentum |
| 2. Cashflow Return Composite | 21. Earnings Revisions |
| 3. Cashflow to Price | 22. Margin Composite |
| 3. EBITDA to Enterprise Value | 23. Dividend Change |
| 3. Share Buyback Yield | 24. Low PPE Growth |

Source: DuPont Capital, Barra

To corroborate this, we also calculated inflation betas for each factor and combined them with the correlations, on a ranking basis, to arrive at a more inclusive measure of inflation's impact on factor performance. Exhibit 3 shows the top and bottom five ranked factors in a rising inflation environment. As expected, Value figured heavily, with four of the top five. Intuitively, this makes sense as we would expect rising inflation to give cover for companies to grow their top line faster. Value companies typically carry higher operating or balance sheet leverage. Both will magnify top line growth at the net profit line, thus boosting the earnings and profitability-based metrics.

We have written a lot lately about maintaining an elevated exposure to Value within our multifactor investment framework and how we transitioned from asset based Value factors to more earnings and cashflow based Value factors. With what looks like the onset of a more permanent inflationary investing environment, we are gaining increasing comfort with our current positioning.

## About our firm:

DuPont Capital Management is an SEC registered investment advisor based in Wilmington, Delaware. Since the firm's establishment in 1993, we've had a long history of developing global investment opportunities in both traditional and alternative strategies across equity, fixed income and alternative investments. Our investment team structure gives us the ability to be flexible and adapt to changing market conditions. DuPont Capital's focus is delivering consistent investment management results for our clients. Our history of institutional asset management is rooted back to 1942 when our former parent company, DuPont, established a pension plan for its employees. Corteva Inc. succeeded DuPont as sponsor of the DuPont Pension Plan in 2019. DuPont Capital is a wholly owned subsidiary of Corteva and continues to manage the legacy DuPont Pension Plan.

DuPont Capital's President and CEO, Valerie Sill believes in education and diversity of experience as represented in our investment teams which are comprised of PhDs, engineers, medical doctors, and scientists. We believe their global expertise creates a portfolio implementation edge that benefits our clients.

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