Madison INVESTMENTS

Opposite Ends of Value:
The Hidden Risks in Value Indexing

Morningstar Style Box

Large Value	Large Blend	Large Growth
Mid Value	Mid Blend	Mid Growth
Small Value	Small Blend	Small Growth

Morningstar's push years ago to get our industry thinking in terms of the nine style boxes continues to provide a framework for differentiating investment options. However, if you dig a little deeper, it's far more complex than just the nine style boxes. Given the sheer number of public companies today, the constituents of a single style box can present vastly different investment prospects. For example, a mega cap can be seen as much different than a large cap, though they reside in the same box. Likewise, a micro cap will differ from a small cap despite being in the same style box. And so on.

Similarly, it's difficult to assume that we can simply break style into three categories: value, core, and growth. We contend that the style universe is much more complex. Not all value or growth companies are the same, and we often cannot make apples-to-apples comparisons of a single style box's constituents. Instead, we propose the following style spectrum:

Deep/Contrarian Value | Relative Value | Core | Traditional Growth | Aggressive/Momentum Growth

As an example, what is the difference between a Deep Value stock and a Relative Value stock?

Deep value stocks are generally companies that, for whatever reason, are trading at a discount to their market value in the mind of the portfolio manager.

There are many ways that "deep value" has been expressed within our industry: "it's like buying dollars for 50 cents," or others may say that "the company is misunderstood and the market isn't seeing its value." In the end, the assumption is based on price and not underlying quality or fundamentals. Some may say this very same stock "looks cheap" for a very good reason.

Deep Value

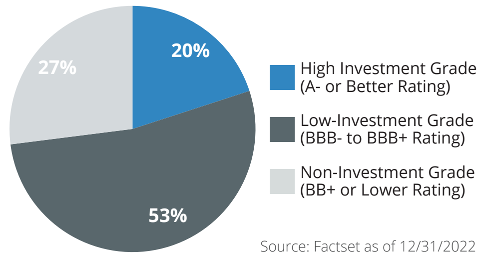
Stocks that trade extremely cheap, based on their valuation multiple.

Relative Value

Stocks that trade at lower valuations compared to companies in the same industry or sector.

For Large Cap Value, a mutual fund or Exchange Traded Fund (ETF) that tracks the Russell 1000 Value Index can be considered a traditional investment option. As an asset class, Large Cap Value historically receives a large % of an average investor's allocation versus other equity asset classes. However, the makeup of the index is what some might regard as overall low quality- low growth and higher debt but possibly trading at a value to underlying intrinsic value. As referenced in the pie chart, 80% of the index holdings' debt ratings are BBB or lower, including 27% of the index that would qualify as a junk-rated balance sheet. Quantitatively, the price-to-earnings multiple may be the definition of value, and comparing the discount of that asset to the overall market may lead an investor to think that a price appreciation to at least the market average is imminent.

Russell 1000 Value Credit Quality



Source: Factset as of 12/31/2022

Relative value stocks are companies that trade at a discount to their intrinsic value when compared to like assets within their specific peer group. This style tends to be on the right side of the value box. Other characteristics might include higher growth levels, other shareholder value sources like dividends and buybacks, and possibly a more market-like price-to-earnings multiple. An active investment manager may consider more forward-looking indicators to assess a company's growth potential and intrinsic value.

FINANCIAL HEALTH

Long-term Debt/Capital Ratio

Russell 1000 Value Index: 41.9
Madison Dividend Income: 41.0

Within the Russell 1000 Value Index are companies at all degrees of financial health, from healthy to over-levered. An active manager provides the opportunity to focus on companies with strong balance sheets.

EARNINGS GROWTH

5-Year Earnings Per Share (EPS) Growth

Russell 1000 Value Index: 13.2
Madison Dividend Income: 15.5

The index contains many companies with low or negative earnings growth. We believe this presents an opportunity for an active manager to be able to lean higher quality if so desired.

PROFITABILITY

Return on Equity (ROE)

Russell 1000 Value Index: 15.6
Madison Dividend Income: 22.6

Using ROE to measure profitability, the index contains a significant number of unprofitable companies. An active manager can avoid unprofitable companies or invest based on their assessment of future profit potential.

As of 2/28/2023
●Index Constituents

The shaded area on each chart reflects the portion of the Russell 1000 Value Index containing low Price-to-Book companies with strong financial health, positive earnings growth, and a positive level of profitability (respectively).

When deciding on the right allocation for the value portion of your portfolio, it's important to understand the hidden risks that may be lurking within the Russell 1000 Value Index. While this index may appear to be a traditional value investment option, the low-quality companies within its makeup can pose a significant risk to your portfolio.

KEY TAKEAWAYS:

1.

Be aware of low quality

Even though deep value and relative value fit into the same asset class, there can be a big difference in terms of quality characteristics and risk.

2.

Active management can overcome the deficiencies of the index

While large cap tends to be an efficient asset class, we believe the low-quality composition of the Large Cap Value Index makes a strong case for high-conviction and active management.

3.

Consider Madison Dividend Income

If you are open to using a dividend-focused strategy for your Large Cap Value allocation, take a look at the Madison Dividend Income strategy.

Madison Dividend Income Strategy

Led by 35-year veteran value portfolio manager John Brown, the Madison Dividend Income strategy embraces a relative value approach to build an all-weather portfolio of high-quality stocks with dividend yields greater than the S&P 500 Index.

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All investing involves risks including the possible loss of principal. There can be no assurance the portfolios will achieve their investment objectives. The portfolios may invest in equities which are subject to market volatility. Equity risk is the risk that securities held by the portfolio will fluctuate in value due to general market or economic conditions, perceptions regarding the industries in which the issuers of securities held by the portfolio participate, and the particular circumstances and performance of particular companies whose securities the portfolio holds. In addition, while broad market measures of common stocks have historically generated higher average returns than fixed income securities, common stocks have also experienced significantly more volatility in those returns.

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Price-to-Book Ratio: measures a company’s stock price in relation to its book value (the total amount raised if its assets were liquidated and paid back all its liabilities).

5-Year EPS Growth: the annual rate at which a company’s earnings have grown over the past five years.

Return on Equity (ROE): a profitability ratio that measures the amount of net income returned as a percentage of investors equity.

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The Morningstar Style Box™ was introduced in 1992 to help investors and advisors determine the investment style of a fund. The Equity Style Box is a nine-square grid that classifies securities by size along the vertical axis and by value and growth characteristics along the horizontal axis. Different investment styles often have different levels of risk and lead to differences in returns.