WHAT MAKES A STOCK A FORTRESS?

by Henry Pasts, Executive Vice President and Analyst, BTS Asset Management, Inc.

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In our view, what makes a stock a "Fortress" in the broad sense is its ability to leverage existing assets to drive earnings growth and maintain substantial cash reserves, minimizing reliance on external conditions. An equity called a "Fortress" in the broad sense considers only its Internal Growth Rate (IGR) compared to other stocks. Later on, we will discuss a sub-strategy of the BTS Enhanced Equity Income Portfolio called BTS Equity Fortress, which aims to further sophisticate this broad concept of a "Fortress" stock discussed throughout this paper.

Companies that do not depend on current credit conditions for investments hold a competitive edge, as credit and economic cycles can be unpredictable. By avoiding reliance on debt, these "Fortress" companies may be better positioned to remain competitive in varying economic climates.

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During periods of economic uncertainty, companies burdened by significant debt may face difficulties in fulfilling their financial obligations, potentially leading to heightened volatility in their stock prices. In contrast, we think companies equipped with substantial cash reserves have a distinct advantage. They are less dependent on external financing conditions, including credit cycles and market sentiment, and are not reliant on their own credit quality to fund business growth. This financial independence may allow them to navigate economic downturns more smoothly and maintain stable investment profiles over the long run.

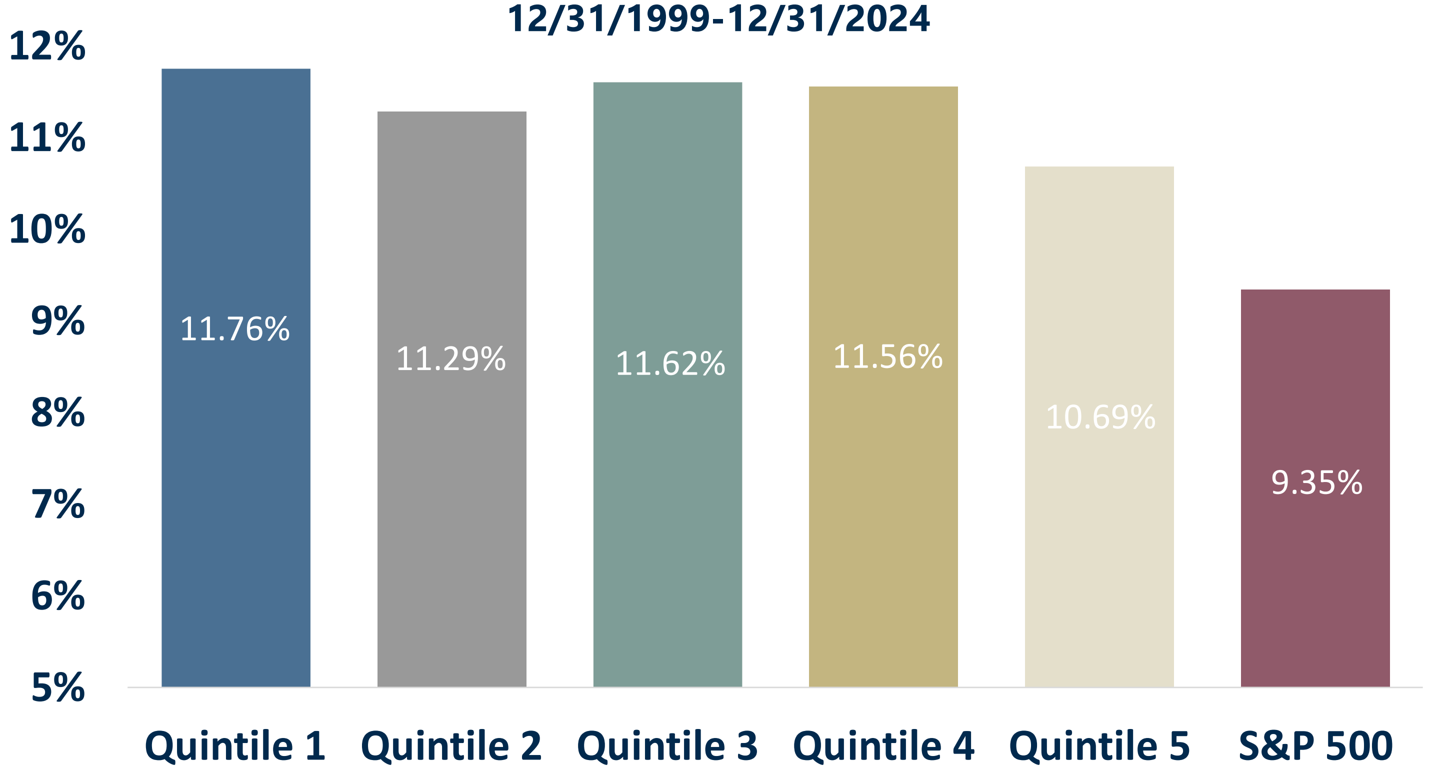
$$\textit{Internal Growth Rate (IGR)} = \frac{\textit{Return on Assets x Retention Ratio}}{\textit{1 - (Return on Assets x Retention Ratio)}}$$

BTS believes that a stock's Internal Growth Rate (IGR) can measure the extent to which a stock is a considered a "Fortress" in the broad sense.

To illustrate the efficacy of IGR, consider breaking up the S&P 500 into quintiles at the end of each year based on highest IGR and calculating the average return over the next year for each security in each quintile. Then, average those yearly returns for each quintile. Below, we see that the top 80% of data has, on average, a higher yearly return than the bottom 20%. Compared to the market capitalization weighted S&P 500, the average yearly returns of each quintile are higher.

Average Next Year Return by Quintile based on Highest IGR vs S&P 500

12/31/1999-12/31/2024



For illustration and informational purposes only. The performance shown above is not a recreation of any BTS Portfolios or products, nor a recreation of any investable product. The S&P 500 constituents are divided into five quintiles based on their Internal Growth Rate (IGR). Quintile 1 includes the top 20% of companies with the highest IGR values, Quintile 2 includes the next 20% of companies, Quintile 3 includes the middle 20% of companies, Quintile 4 includes the next 20% of companies, and Quintile 5 includes the bottom 20% of companies with the lowest IGR values. Each year, the quintiles are calculated with market data as of 12/31 and the Average Next Year Returns for each security is calculated. Then, the average Next Year Return for each quintile across all years is calculated and is shown above. An investment cannot be made directly in an index.

Internal Analysis. Data Source: Morningstar and Bloomberg (yearly returns)

Analyzing IGR across all of the S&P 500 constituents may result in insights into the competitive advantages certain stocks may have due to their strong cash holdings and ability to increase net income through existing assets. Since the S&P 500 is market capitalization weighted, certain sectors or stocks that may have strong internal growth rates may not contribute to the returns of the index in a beneficial manner.

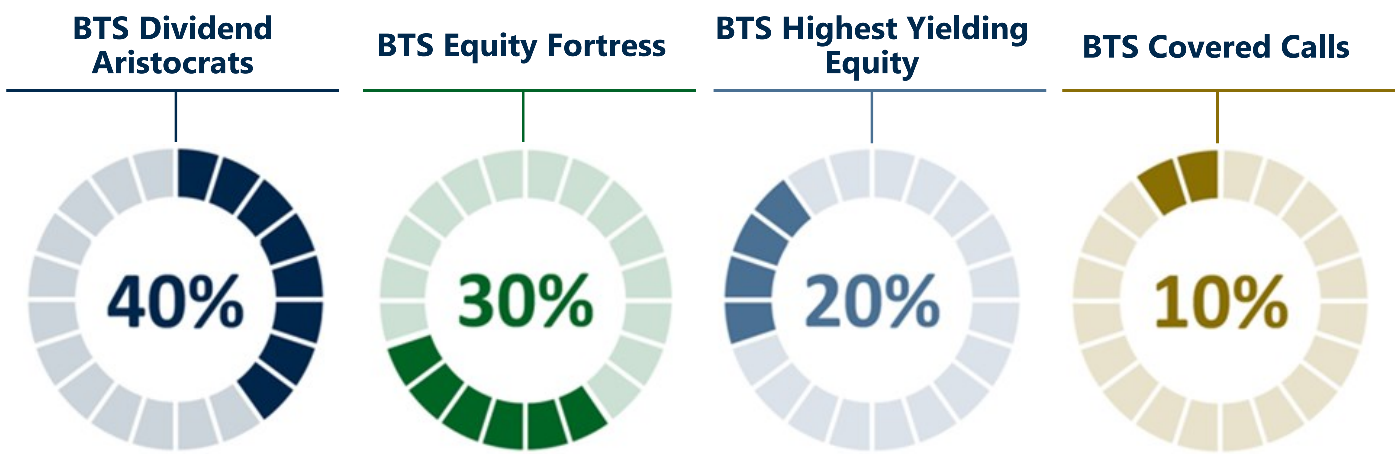
Examining stocks with higher IGR ratios during any given year may be a good place to start searching for stocks well positioned to weather various economic cycles, especially when the S&P 500 may be overly concentrated in certain sectors or specific stocks. Of course the search for strong companies doesn't stop at IGR, but may offer an initial filter that identifies stocks with earnings potentials that are not dependent on external factors, such as growth or cyclical stocks.

Key Takeaways

The period above, 12/31/1999 to 12/31/2023, experienced extreme volatility through economic and credit events such as the Dot Com Bubble, The Financial Crisis and Great Recession of 2008, as well as the Global Pandemic beginning in 2020. Higher IGR values may have higher returns, but further analysis with other financial ratios may help further distinguish stocks with strong underlying fundamentals. This approach may allow an investor to consider equities with strong underlying fundamentals to weather unpredictable economic conditions and participate in return streams of such companies that an investor may not participate in due to the market capitalization weighted nature of the S&P 500.

A More Sophisticated Solution

Up until now, we have looked at "Fortresses" in the broad sense, which considers only the Internal Growth Rate ratio. BTS took the simple concept of IGR illustrated above and amplified it by adding a proprietary set of optimal fundamental ratios and quantitative metrics to further vet companies, while optimizing for less risk across the 11 GICS Sectors and comparing selections against historical trends in their respective sectors to make over and under weight decisions. In the Enhanced Equity Income Portfolio, the BTS Equity Fortress sub-strategy consists of 30% of the portfolio.



Disclosure

Past performance is no guarantee of future results.

Important Risks

Diversification does not ensure a profit or guarantee against loss.

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Definitions

Fortress and Fortresses are broad terms used to denote stocks with high Internal Growth Grates (IGR) relative to other stocks. The particular commentary considers stocks within the S&P 500 Index. The term "Fortress" should not be viewed as synonymous to the BTS Equity Fortress sub-strategy of the BTS Enhanced Equity Income Fund, nor should the performance of the IGR illustration on page 3 be viewed as indicative of the performance of the BTS Equity Fortress sub-strategy.

Annualized Return is the equivalent needed to obtain the same total return over the period.

Internal Growth Rate (IGR) is the highest level achievable for a business without obtaining outside financing. It is calculated as the most recently available Return on Assets metric multiplied by the trailing 12-month Retention Ratio, divided by 1 minus the same multiplication of Return on Assets and the 12-month Retention Ratio.

Return on Assets is an indicator of profitability and measures the trailing 12-month Net Income, or net profit, as a percentage of average assets over the past 12 months as reported on a stock's balance sheet.

Retention Ratio is 1 minus the trailing 12-month dividend payout ratio, where the 12-month dividend payout ratio is the trailing 12-month total common dividends divided by the trailing 12-month income.

Price To Earnings (P/E) Ratio is a ratio for valuing a company that measures its current share price relative to its earnings per share (EPS).

Internal Growth Rate w Lowest PE is the average rank of the highest IGR and the lowest Price to Earnings data available on 12/31 of each year. The top quartile of the average rank was used to display the returns of the stocks over the next year.

Sharpe Ratio measures risk-adjusted return, highlighting the average return earned in excess of the risk-free rate per unit of total risk. 2% is used as a proxy for the risk-free rate of return.

Market Capitalization refers to the total dollar market value of a company's outstanding shares of stock.

The S&P 500 is an index that includes 500 leading companies in leading industries of the U.S. economy and is a proxy for the total stock market. Returns shown are total returns with dividends reinvested.

The Global Industry Classification Standard (GICS) is an industry taxonomy developed in 1999 by MSCI and Standard & Poor's (S&P) for use by the global financial community. The GICS structure consists of 11 sectors, 25 industry groups, 74 industries and 163 sub-industries into which S&P has categorized all major public companies.

BTS Enhanced Equity Income is BTS strategy currently available at Axos Advisor Services and various UMA/SMA platforms. It consists of 4 strategies, Dividend Aristocrats, Equity Fortress, Highest Yielding Equity, and Covered Calls.

Covered Call refers to a financial transactional in which the investor selling call options owns an equivalent amount of the underlying security. To execute this, an investor who holds a long position in an asset then writes (sells) call options on the same asset to generate an income stream. The investor's long position in the asset is the cover because it means the seller can deliver the shares if the buyer of the call option chooses to exercise.

BTS Dividend Aristocrats Equities are considered based on their ability to have increased year-over-year dividend payments for the past 10-15 years or longer.

BTS Equity Fortress Equities are considered based on the ability to finance internal revenue and asset growth without taking on excess debt as determined by the Adviser's proprietary model.

BTS Highest Yielding Equity Equities are considered based on having the highest dividend yield in their respective sector.

BTS Covered Calls Invests in exchange traded funds (ETFs) that pursue a covered call strategy. Covered call ETFs invest in a portfolio of equity securities and also write, or sell, call options on their equity exposure in order to generate income from the premiums received from writing call options.

All returns are calculated using data from Morningstar Direct and Bloomberg starting on 12/31/1999.

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