

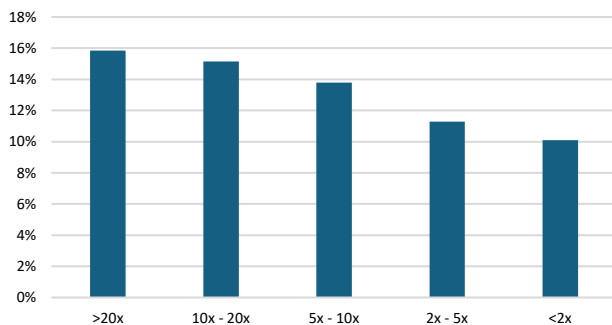
Equity Beat: Stranger Things

By Eric Gordon, CFA



It's been a very mysterious year for "quality" investing thus far. The search for discovering stocks that compound over time often leads us to businesses that require limited capital investment with strong profit margins and high levels of free cash flow. Often, these businesses establish and maintain a competitive moat from ownership of proprietary data, regulatory advantages and/or innovation that leads to product/service superiority. Put simply, they rarely need to reinvest heavily to grow, which often leads to clean balance sheets and shareholder-friendly uses of cash, including buybacks, dividends and opportunistic acquisitions. While broad in economic scope, the stocks of these companies tend to perform well over the long-run, and especially at times when capital is scarce and discipline is rewarded.

CHART 1: MEDIAN 10-YR ANNUAL RETURN (2015-2025) OF S&P 500® INDEX CONSTITUENTS GROUPED BY CAPITAL EFFICIENCY RATIO COHORT



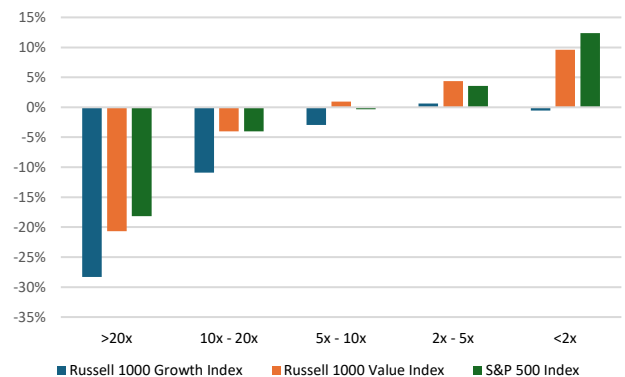
Source: FactSet. Data as of April 10, 2026.

Note: Capital Efficiency ratio is defined as cash flow from operations divided by capital expenditures.

Over the trailing decade, we've seen the most capital efficient companies outperform others. A simple measure of capital efficiency is cash flow from operations divided by capital expenditures (the "CE ratio"). Over a decade, this ratio based on the cumulative cash inflows and outflows is a telling gauge of a company's capital efficiency. While companies are rewarded in equity markets for more than solely an efficient use of capital – perceived longevity of competitive moat and growth drivers are also essential – from 2015 through 2025, this metric led the way. Among current constituents of the S&P 500 Index, the median ten-year annual stock return for a company with a CE ratio above 20x was nearly 600 basis points better than a company with a CE ratio below 2x. Compounded over ten years, that differential in performance is a mile wide. To quantify, that's a cumulative return of 335% versus 162%.

For fans of the Netflix show from which the title of this write-up originated, many quality-oriented investors feel as though they've been living in the "Upside Down" through early April. In fact, the cold, dreadful, dystopian version of the fictional town of Hawkins, Indiana might be an upgrade to the stock market environment through which they've been navigating. Demogorgons have viciously attacked the perceived long-term prospects of many asset-light businesses in the name of artificial intelligence (AI) disintermediation. It's as if Vecna himself has convinced equity market participants to fear asset light business models, and instead, take comfort in asset-intensive businesses where obsolescence risk is low (the "HALO" (Heavy Assets, Low Obsolescence) effect of 2026).

CHART 2: YTD MEDIAN PERFORMANCE OF STOCKS IN RUSSELL 1000® GROWTH INDEX, RUSSELL 1000® VALUE INDEX AND S&P 500 INDEX BY CE RATIO COHORT



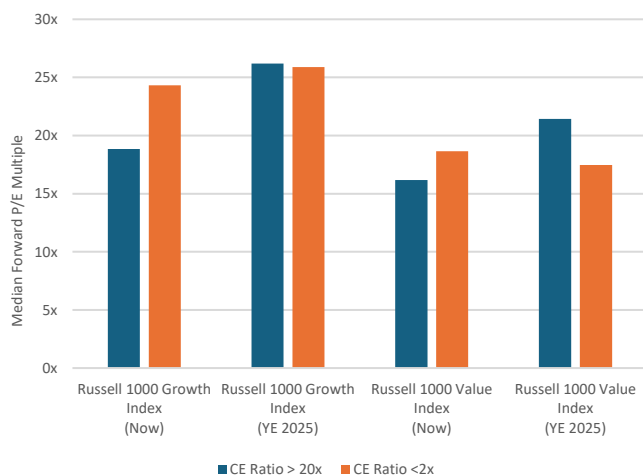
Source: FactSet. Data as of April 10, 2026.

Growth, value, and core indices have all experienced an Upside Down moment year-to-date, with roughly a 30% (3,000 basis points) level of outperformance of the least capital efficient companies compared with the best. Companies with low CE ratios are typically those in the Utilities sector, combined with old economy businesses within Materials, Industrials, and Energy sectors. Many companies in these sectors are price takers most, if not all, of the time, own depleting assets, and must endure cyclical peaks and troughs based on unpredictable economic and geopolitical scenarios, all of which makes capital allocation, to put it mildly, challenging. For the Russell 1000 Growth Index, companies at the low end of the capital efficiency spectrum for this year (those with a CE ratio below 2x) include bellwethers Amazon (AMZN), Alphabet (GOOG), Walmart Inc (WMT), and Meta Platforms Inc (META).

Future free cash flow generation remains a question mark for these hyperscalers, which continue to accelerate data center related investment. WMT, which currently trades at a forward P/E above 40x and hasn't been this expensive since the Clinton administration, is viewed as a haven away from the toxic, spore-filled parallel dimension also known as capital-light investing.

Sticking to valuation, across both the growth and value indexes, we are now seeing the least capital efficient companies strangely trading at meaningful valuation premiums to those with the highest CE ratios. Within the Russell 1000 Value Index, Utilities, Energy, and Materials stocks are trading at P/E ratios above asset-light Technology, Health Care and Communication stocks. In the Russell 1000 Growth Index, software and asset-light Financials and Industrials companies are broadly trading at a discount to energy pipelines, fast-service restaurants and airlines. These gaps in P/E valuation are other-worldly, as companies with CE ratios above 20x are trading, on average, at a 5.5x and 2.5x discount to those companies with CE ratios under 2x in the Russell 1000 Growth Index and Russell 1000 Value Index, respectively. Only a few months ago, at year-end 2025, the highest-CE-ratio companies traded at a premium to the lowest-CE-ratio companies for both Indexes as shown in the chart below.

CHART 3: MEDIAN P/E FOR RUSSELL 1000 GROWTH INDEX AND RUSSELL 1000 VALUE INDEX CONSTITUENTS GROUPED BY CE RATIO COHORT, CURRENT VS YE 2025



Source: FactSet. Data as of April 10, 2026.

There are points in an economic cycle when capital intensive stocks do tend to outperform. Heavy-asset businesses typically benefit from significant operating leverage due to their collective large fixed-cost bases. Early in an economic recovery, rising utilization can spread fixed costs across a broader volume base, and incremental profit and margin levels are often substantially higher than baseline levels. This is usually the “Goldilocks” environment for low-CE-ratio companies and stocks. That is not the environment in which we find ourselves. Thus, their outperformance year-to-date has been nothing short of stunning.

One could conclude, that after just three months of the year, quality-oriented equity investors are already “Running Up That Hill” of relative performance to catch up to their benchmarks (just couldn't pass up that reference).

It remains to be seen how investors choose to define “quality” in the future, but I suspect it won't change drastically from today. Competitively advantaged companies defined by moat longevity, growth trajectory and capital efficiency, will likely remain at the forefront of the description. The question of whether advancements in generative AI will interrupt those companies advantaged today is a reality. The market's exceptional response to that question year-to-date feels surreal, bordering on supernatural.

Thanks for reading, and remember to never skip a Beat

- Eric

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Forward P/E Ratio is determined by dividing the price of the stock by the company's forecasted earnings per share.

Free cash flow (FCF) represents the cash a company generates after cash outflows to support operations and maintain its capital assets. Unlike earnings or net income, free cash flow is a measure of profitability that excludes the non-cash expenses of the income statement and includes spending on equipment and assets as well as changes in working capital.

CapEx, or capital expenditures, are funds used by a company to acquire, upgrade, and maintain physical assets such as property, plants, buildings, technology, or equipment.

A Capital Expenditures (CapEx) Ratio measures how much a company reinvests in itself by purchasing fixed assets (property, plant, equipment) relative to its cash flow or revenue.