Bull Market? Really? Why Are My Stocks Down So Much? The Three D's: Diversification, Discount Rate, Duration

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November 21, 2023

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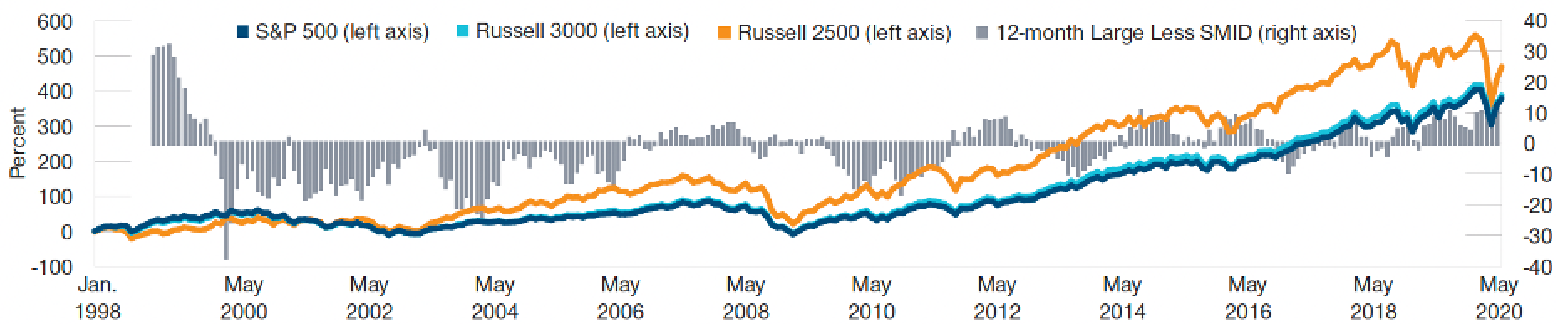
If you have a diversified portfolio, you will have exposure to small and mid-cap companies. As Jim Cramer on CNBC says, these small and mid-cap stocks have been "in the house of pain." We must address this at Seven Summits Capital because we have always maintained a meaningful allocation to small and mid-cap companies within our equity portfolios. We have done this because small and mid-cap company stocks have outperformed large-cap company stocks over long time horizons.

My tenure as a professional asset manager began in late 1997. At this point, I have been managing equities for over a quarter of a century. Over this period of time, my experience has informed me that adding a meaningful allocation to small and mid-cap equities to their larger cap brethren can provide meaningful incremental performance over time. This is no better illustrated than the T. Rowe Price illustration from 2020 below

Cumulative Total Return of the S&P 500, Russell 3000, and Russell 2500 Indices

(Fig. 1) A broader opportunity set can offer greater potential to generate alpha



Past performance is not a reliable indicator of future performance.
As of May 31, 2020.
Sources: Standard and Poor's S&P 500, FTSE/Russell, Russell 3000, and Russell 2500 (see Additional Disclosures); analysis by T. Rowe Price.
January 1998 through May 2020 monthly performance returns are in U.S. dollars. The 12-month large less SMID is the difference in total return between the S&P 500 and the Russell 2500 over a 12-month rolling period, calculated each month.

[1] Grinold, Richard, 1989. "The Fundamental Law of Active Management." Journal of Portfolio Management 15(3).

Thus, what we have seen as investors over the last several years is a stark reversal of the much longer relationship between the S&P 500 and the small and mid-cap Russell 2500. I have learned over time not to be a market trend-following investor, but instead, I rely upon time-tested fundamentals of companies and market asset classes.

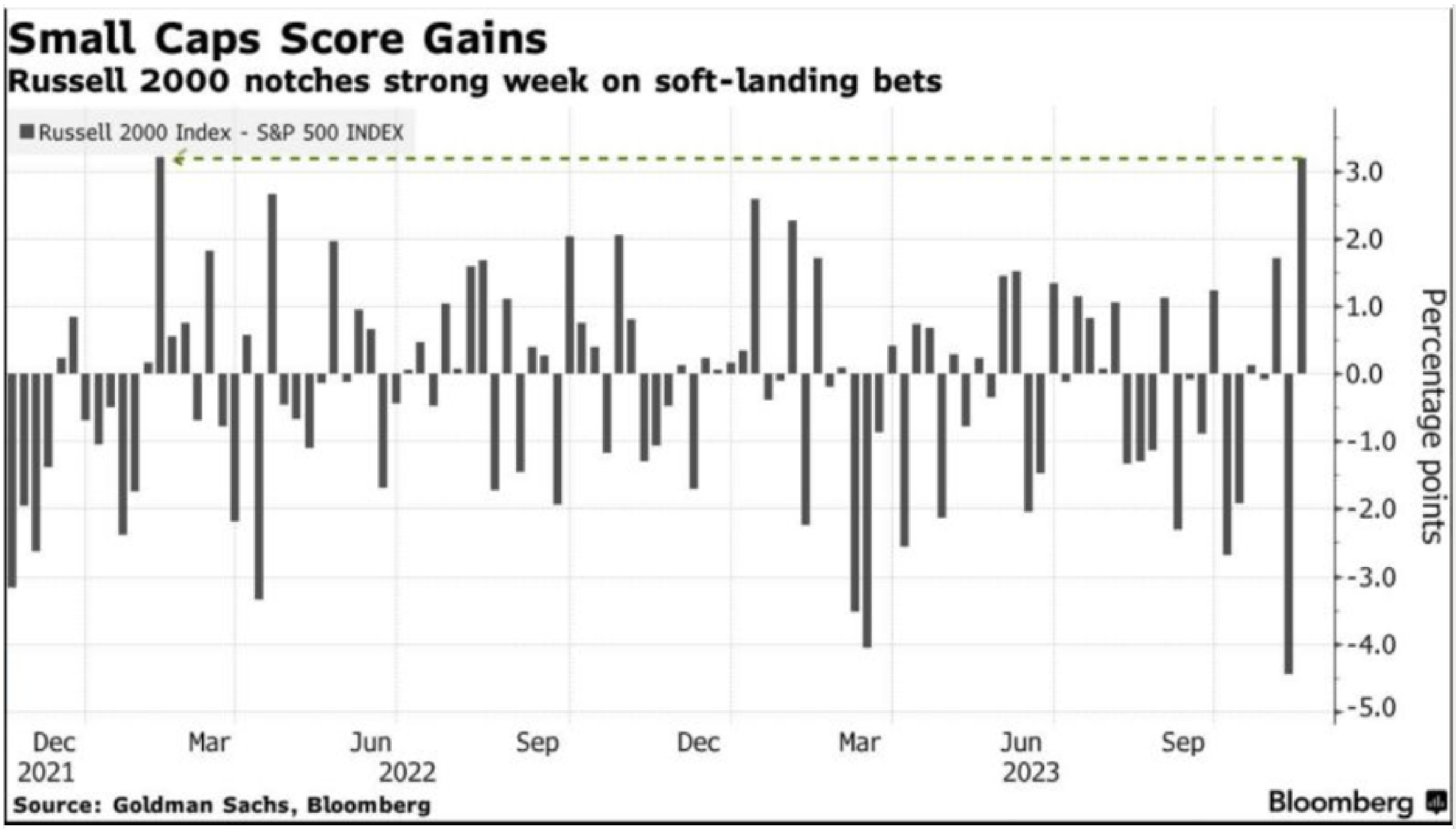
Because of the break of multi-decade trends between small, mid, and large-cap equity performance that we have seen of late, I am seeing market pricing that significantly diverges from company fundamentals. How do stocks end up having prices that significantly diverge from fundamentals? Stock prices go down a lot. It is not pleasant if you own these stocks before they hit bottom. When will the bottom occur? No one ever knows. The only knowable thing is that prices are materially diverged from valuation metrics.

When price and fundamentals significantly diverge, an investor has three choices: 1. Sell the securities that have declined in value and chase the rising securities, 2. Give up on actively managing individual securities and buy ETFs and mutual funds, or 3. Add cash to the portfolio or create cash by selling shares of securities with the strongest relative performance and add shares in the securities that have declined enough to create a compelling variance between price and intrinsic value.

Bringing this comparison forward to the market's most recent period, Liz Ann Sonders of Charles Schwab posted the following to her LinkedIn followers on November 10, 2023:

From 2009 through 2012, the discount rate used to calculate the present value of future cash flow assumption had fallen due to the Federal Reserve cutting rates to combat the recession and help heal the wounds created by the financial crisis. This current period of Federal Reserve tightening in response to a spike in inflation following the first global pandemic in over 100 years occurred during a period of above-average economic growth and no financial crises. Thus, we experienced a rare concurrent stock and bond Bear Market in 2022 without an accompanying recession. This lack of recession enabled the Federal Reserve to push its Federal Funds Rate up by more than 5% in a very short period of time. This significant rise in interest rates directly pushes up the discount rate used to value future profits and cash flows regarding the present value of stocks. The stock prices most severely hit by this higher discount rate were younger and smaller companies, sometimes called "long duration equities," whose value is disproportionately leveraged to growing future cash flows and high dividend-paying equities such as real estate investment trusts (REITs) and regulated utility companies. The present value of the expected stream of future dividends significantly influences REITs and Utility stock prices, making those prices very sensitive to changes in the discount rate.

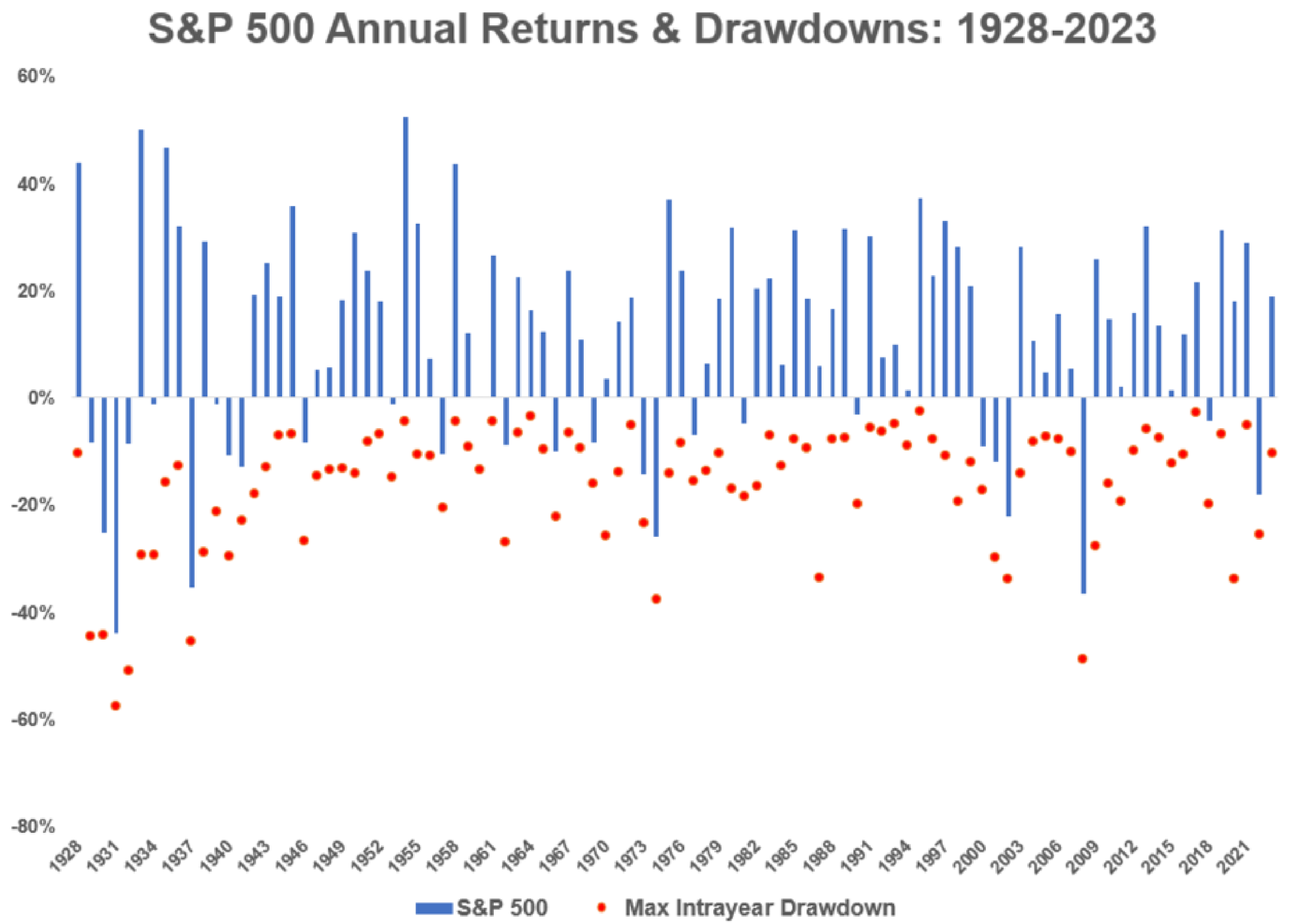
This could all change very quickly, and just this month, we have seen evidence that such a reversal is underfoot. The yield on the U.S. 10-Year Treasury Note recently peaked at over 5%, but in November, thus far, that yield has fallen abruptly to under 4.50%. Valérie Noël of Syz Bank in Switzerland posted on LinkedIn on Sunday, November 19th "Small Caps Are Back!! Russell 2000 scores its best week relative to the S&P 500 in almost 2 years" and paired this observational comment with the chart below:



universe of small and mid-cap stocks is where fundamental stock selection is paramount. Still, it is also an area of the market that can be left out in the cold for periods of time when other factors are paramount in the minds of investors, such as interest rates, geopolitical concerns, and other macro-economic factors. The last two years have been one of those periods when markets were consumed by worries about an inflationary repeat of the 1970s, rising interest rates that have caused consumers to experience borrowing rates not seen in over 15 years, persistent worries about an impending recession, and a powder keg war in Ukraine that could draw NATO into a direct confrontation with Russia. Hamas terrorists have recently exacerbated geopolitical concerns by mounting an unexpected brutal attack on Israeli civilians and Israel's justifiable retaliation on the Hamas stronghold of Gaza City. However, from a market perspective, interest rates appear to have peaked here and in many other countries worldwide; the fear of recession seems to have finally waned after a U.S. third-quarter GDP growth rate of 4.90% and recent better-than-expected inflation reports.

Our base case remains that we avoid a meaningful recession in 2024, the initiation by the Federal Reserve of cuts to the Federal Funds Rate by May, and a meaningful outperformance over the next six to eight months of small and mid-cap equities versus the S&P 500. Such a period of outperformance could be much more extended, as it was between 2003 and 2012, illustrated in the chart at the beginning of this commentary. The structural advantage of large-cap growth equities, particularly the mega-cap tech and communications services companies such as GOOGL, META, MSFT, AMZN, AAPL, NFLX, and NVDA, is very formidable. However, these dominant companies' stocks cannot, in my experience, outpace the rest of the equity market indefinitely. This does not mean that they are in bubble-like technology stocks in the year 2000, which will lead to an inevitable crash. Still, these stocks certainly could stall out and move sideways in a relatively narrow trading range for a period measured in years while the rest of the market catches up.

The following chart produced by Ben Carlson is a powerful reminder for investors of how the stock market regularly induces fear and anxiety through downward volatility in prices, which, when viewed over longer periods of time, turn out to be false alarms. Carlson posted this chart on November 20th in his Wealth of Commonsense investment blog:



The chart shows that over the last 95 years, the broad equity market has experienced just 26 down periods, with only 16 down years since the end of WWII. The pre-WWII period is not particularly informative, given that the regulatory environment governed by the Securities and Exchange Commission took effect with the passing of the Securities Act of 1940.

The red dots mark the intra-year maximum sell-off percentage of the S&P 500, which inevitably scares many investors. That fear triggers many investors to react to attempts to avoid temporary price declines in their investments. The fact is that no one knows for sure if experiencing one of those red dot sell-offs will turn into one of the rarer down years in the market. Logic dictates that if, roughly 70% of the time, the "red dot" sell-offs occur during what will turn out to be an up year in the stock market, the investor should not do anything to try to sidestep such declines. For active investors, such selloffs should be viewed as an opportunity to acquire shares of long-term investments at temporarily lower prices.

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Disclosure:

Advisory services are offered through CS Planning Corp., an SEC-registered investment advisor.

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Exchange-traded funds (ETFs) are sold by prospectus. Please consider the investment objectives, risk, charges and expenses carefully before investing. The prospectus provides a balanced analysis of the investment risks and benefits. Read it carefully before you invest.

- The Standard & Poor's 500, or simply the S&P 500, is a stock market index tracking the performance of 500 large companies listed on stock exchanges in the United States. It represents the stock market's performance by reporting the risks and returns of the biggest companies. Investors use it as the benchmark of the overall market, to which all other investments are compared.
- The NASDAQ Composite Index is a large market-cap-weighted index of more than 2,500 stocks, American depositary receipts (ADRs), and real estate investment trusts (REITs), among others. Along with the Dow Jones Average and S&P 500, it is one of the three most-followed indices in US stock

markets. The composition of the NASDAQ Composite is heavily weighted towards information technology companies.

- The Dow Jones Industrial Average (DJIA), also known as the Dow 30, is a stock market index that tracks 30 large, publicly-owned blue-chip companies trading on the New York Stock Exchange (NYSE) and the Nasdaq.
- The Russell 2000 index is an index measuring the performance of approximately 2,000 small-cap companies in the Russell 3000 Index, which is made up of 3,000 of the biggest US stocks. The Russell 2000 serves as a benchmark for small-cap stocks in the United States.
- The Russell 2500 Index measures the performance of the 2,500 smallest companies in the Russell 3000 Index, with a weighted average market capitalization of approximately $4.3 billion, median capitalization of $1.2 billion, and market capitalization of the largest company of $18.7 billion.

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