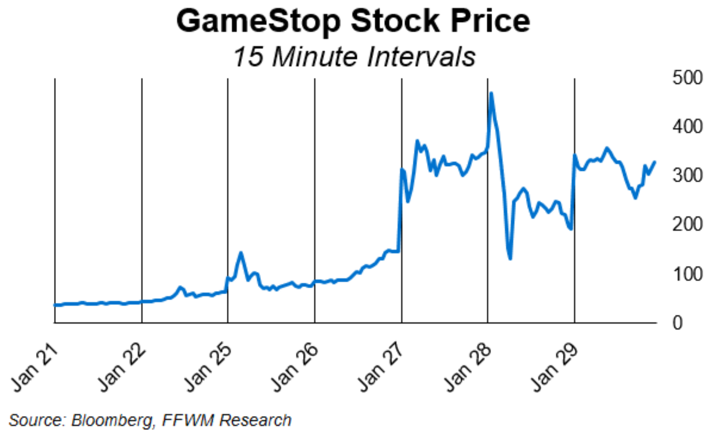
Avoiding The Worst Can Be The Best

"Only when the tide goes out do you discover who's been swimming naked."
- *Warren Buffett*

Watching financial news these days makes it seem like the whole country has caught trading fever. Companies whose real-world fortunes are sagging are experiencing stock performance that are making traders' fortunes. GameStop seems to be the most prominent example of a struggling company whose stock has caught the fancy of this new breed of "investor".

These traders are reportedly exacting revenge on Wall Street short-sellers (investors who profit when stock prices go down). Short-sellers borrow stock to sell, with the plan to buy the shares back later at a lower price.

Using social media platforms like Reddit, groups of traders (mainly using low-cost trading platforms, like Robinhood) are coordinating efforts to buy shares in some of the most heavily shorted stocks in the market. This buying pressure drives the price up, which can force the short-sellers to buy shares (or "cover" their shorts) in order to cut their losses. The higher the price goes, increased short covering drives it up even higher. That's part of the reason that GameStop stock has gone absolutely bonkers over the past several days. In fact, the stock has been so volatile that on January 28 alone, the stock opened at $360, shot up to $470, dropped down to $130, then went back up to $265 – all before noon!



With a focus on high quality stocks, we're happy watch from the sidelines as the traders and short-sellers duke it out. That's the beauty of being an active money manager – being able to avoid areas of the market that don't seem attractive.

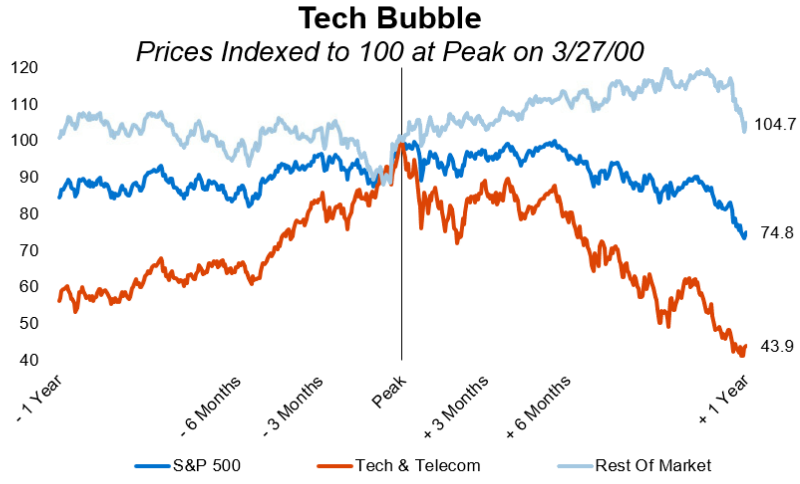
As a quick refresher, active money management means that an investor has constructed a portfolio to be different than the benchmark index against which their results are being compared. These differences can be expressed in a myriad of ways, but the two most common are via overweighting (or underweighting) various sectors and / or securities. Passive money management, on the other hand, looks to replicate the benchmark index as closely as possible.

With active management, there are two primary ways for an investment manager to beat their index. One way is to pick stocks that perform better than the index; the other is to avoid the worst areas of the market.

While we aim to always select good stocks, avoiding the worst parts of the market is where we'll likely deliver outperformance relative to our benchmarks over the long haul. What this strategy may lack in sizzle, history has shown it can deliver on the steak.

There are two prominent examples of how avoiding the worst parts of the market can generate outperformance. The first example is the Tech Bubble of the late 1990s and early 2000s. Back then, investors had no idea how to evaluate the business prospects for companies that were involved (or even claimed to be involved) with the internet. Not only were true "tech" stocks getting bid up by investors, so were the shares of telecommunications firms since all of the internet's awesome potential had to be transmitted around the world by cable supplied by the telecommunications companies. For a few years in the late 1990s, the price of any stock remotely associated with "tech" or "telecom" seemingly went straight up.

The chart at right illustrates the performance of the S&P 500 Index (blue line), just the Information Technology and Telecommunications sectors (orange line) and then the rest of the market excluding Tech and Telecom

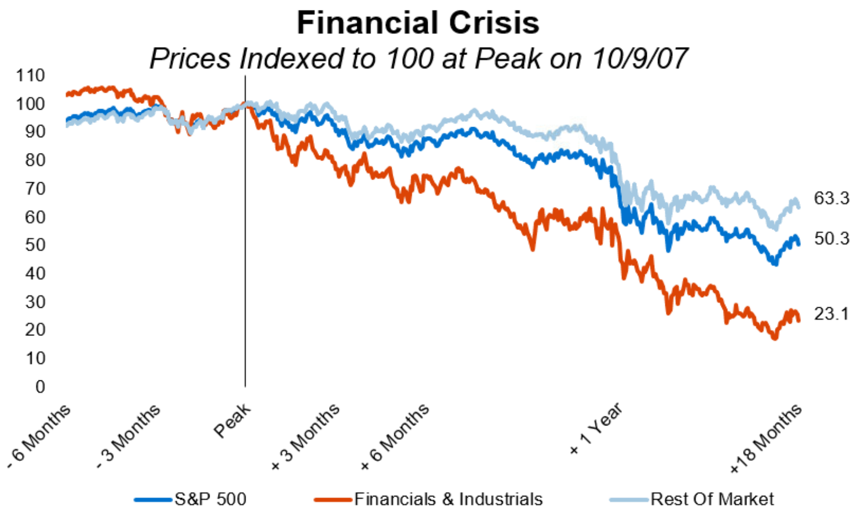


Source: Bloomberg, FFWM Research

(light blue line). In the year prior to the market peak on March 27, 2000, the price of the S&P 500 Index rose 16%, led by a combined 44% increase in the price of the Tech and Telecom sectors; the rest of the sectors in the S&P 500 Index actually lost 1% in value.

Then the bubble burst. In the months that followed, the performance of the Tech and Telecom sectors was abysmal. After twelve months, even the early "internet" investors were underwater after those two sectors lost over half of their value. The active investors that avoided the "bubbly" parts of the market significantly outperformed their counterparts that chased returns in what had been the hottest parts of the market.

The Financial Crisis is another example where avoiding the worst parts of the market resulted in significant outperformance. Unlike the Tech Bubble where stock valuations were detached from reality, the market's problems during the Financial Crisis weren't really due to overvaluation. Rather, the threat of the collapse of the entire financial system was to blame. This threat was a result of the irresponsible use of derivatives (largely, credit default swaps) and the damage caused by their overuse.



Source: Bloomberg, FFWM Research

The chart at right illustrates the equity market before and after the October 9, 2007 peak. The blue line is the S&P 500 Index, the orange line is just the Financial and Industrial sectors, and the light blue line is the rest of the S&P 500 Index, excluding Financials and Industrials. Now while none of the performance is anything to write home about, Financials & Industrials lost over 75% of their value while the rest of the market lost nearly 40%. On a relative basis, the managers that were able to avoid the most problematic sectors of the market significantly outperformed. By seeing that Financials and Industrials were in bad shape (which wasn't terribly difficult to do at the time), active investment managers could have avoided those sectors and therefore protected their clients' capital to the downside.

As investment managers, we won't chase the hottest areas of the market just to keep pace with benchmark returns. We will remain focused on our commitment to "quality" and keep a keen eye on valuation. History has shown that those who chase returns on the way up are often caught offside when the trend changes. Or, as Warren Buffett said, "Only when the tide goes out do you discover who's been swimming naked."

Aside from avoiding Sherwood Forest (where the Robinhood traders dwell), we have been underweight the large "growth" stocks that have dominated market performance for the past several years. To an extent, this outperformance was justified in that during the low growth, low interest rate environment of the past few years, durable earnings growth has been hard to come by. Thus, investors have bid up shares of companies that could deliver this growth.

The pandemic lockdown served to exacerbate this trend, as those "growth" stocks that had been leading the way up (Facebook, Amazon, Google, Netflix, Microsoft, Apple, etc.) continued to deliver growth during the new "COVID economy." This precious earnings growth not only drove their share prices higher, but also pushed their valuations to sky-high levels.

With the calendar turning to 2021, earnings growth should be easier to come by as companies lap the trough earnings of the first half of 2020. As investors search for earnings growth, they are now finding that there are cheaper alternatives to the previous market leaders.

Price always matters in the long-run, and we believe that investors will be compelled to turn to more cyclical "value" stocks that can deliver solid earnings growth while trading at fairly significant discounts to the previous market leaders. If this shift persists – and there are signs over the past few months that it will – it won't take much for the struggles of these large growth stocks to hold back the broader market.

The table at right illustrates two examples of how this can play out. If the "Big Growth" stocks mentioned earlier fell 10% and the rest of the market returns 5%, then the S&P 500 Index would return just 1.7%. However, an active manager avoiding that struggling area could add significant value relative to the benchmark. In the other scenario, if the Tech and Consumer Discretionary sectors (which account for 40% of the S&P 500 Index) fall just 10% and the rest of the market was up 5%, the returns for the stock market would be negative 1%.

A TOP-HEAVY MARKET CAN HELP THE ACTIVE MANAGER

	"Big Growth"	Rest of Market		Tech & Discretionary	Rest of Market
% Index	22.0%	78.0%	% Index	40.0%	60.0%
Return	-10.0%	5.0%	Return	-10.0%	5.0%
Contribution	-2.2%	3.9%	Contribution	-4.0%	3.0%
	Index Return	**1.7%**		**Index Return**	**-1.0%**

Source: FFWM Research

Such a disparity of returns would drive home the idea that 2021 could be a year of "a market of stocks, not a stock market." If the "growthier" areas of the market struggle – even a little – and the shift towards those more cyclical "value" stocks plays out, active management could provide relative outperformance even if the broader index doesn't do much of anything.

Regarding our client portfolios, we believe the time has come to prepare for a change in market leadership by adding more exposure to cyclical areas of the market. Within equities, we've recently increased our clients' exposure to larger, more developed international markets. We've also made moves to increase exposure to smaller companies in the US and have added targeted exposure to more cyclical areas of the US large cap space. In the fixed income area, we remain focused on more credit-sensitive securities (with less exposure to the more cyclical areas of the market) with shorter maturities as a hedge against potentially rising interest rates. We have focused our exposures in the alternative market segments to hedge against potential market volatility and rising inflation, and remain less exposed to real estate.

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Are not deposits	Are Not FDIC Insured	Have No Bank or Federal Government Guarantee	May Lose Value