Market Commentary
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English Version

Exercise Discipline and Stick to the Process

Get guidance on investments, and the major structural factors behind your clients' portfolios.

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Exercise Discipline and Stick to the Process

Investing is both a science and an art. We tend to make decisions based on a combination of time-tested principles, along with assumptions based on our own experiences. Yet we live in a dynamic investment world, where rigid principles can be affected by market dislocations, and assumptions tainted by our own behavioral biases. Given this backdrop, how can we attempt to successfully navigate markets? In reality, there are no magic bullets or fool-proof formulas. Only the adherence to disciplined, yet flexible investment processes, as well as the recognition of our own biases and limitations. For example, I have accepted the fact that the probability that I will successfully call the tops and bottoms in the markets on a consistent basis is low. Truth be told, the same can be said for everybody else, though not everyone will admit it. Sometimes we do get it right, sometimes by skill, sometimes by luck. We've heard the saying "sometimes lucky is better than good". This is true, but as we know, hope and luck are not investment strategies. What we strive for is a strategy based on a disciplined, repeatable, process guided by logic and experience. Such a process has a high probability of success. Going back to the example of market timing, we have a much better chance of successfully generating returns on a consistent basis if we target not the top or the bottom of the market, but instead the "meat" in the middle.

In the last Weekly Market Musings from April 27th, titled "Don't Get Sucked In" we made the argument that with the S&P 500 closing in on the 4150 level, a near-term pull back in the U.S. markets is very probable. As such, we are of the opinion that staying neutral or taking profits off the table is a better strategy than getting sucked into the current rally. The index could conceivably go to 4200 or even higher before it turns lower, and if it did, the conviction in our view that taking profits

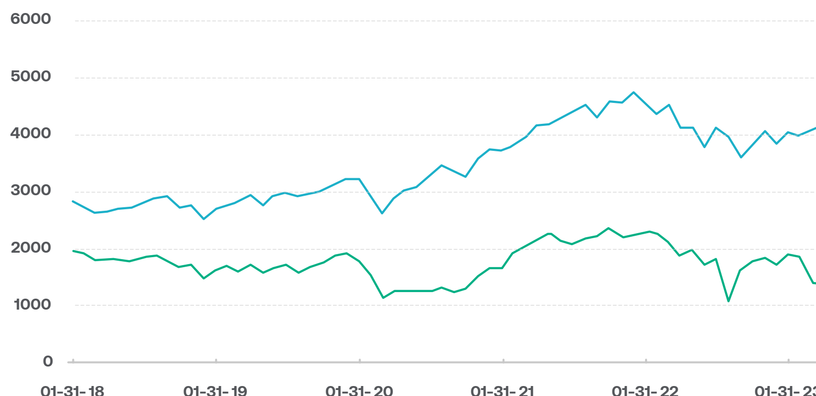
is the right strategy would grow even stronger. Not because we are betting the bank that a top at 4150 is set in stone, nothing in the market is, but because we believe that given the data surrounding current market conditions, the "meat" in the middle of this rally has already been picked off the bone, so there is more downside than upside potential in keeping our chips on the table.

As we stated in our last opinion piece, there are several market data parameters pointing to the high probability of a near-term pullback, including narrow market breadth, as well as the fact that small caps and financials tend to lead a bull-market higher, not lower. Let's delve into this last point in more detail. Market data has shown that the KBW Bank index has been a good leading indicator of general market performance. The logic is that a move in this index tends to reflect prospects of financial conditions in the economy. In the graph below, we can see a chart of the S&P 500 index (SPX) compared to the KBW Bank index (BKX). For display purposes, only the last five years of data are shown, but this correlation goes back over twenty years. It can be argued that both indexes are virtually mirror-images of each other, with the BKX slightly leading the SPX. However, let's look at the most recent portion of the curve. We can see that for the better part of this year, the BKX experienced a steep drop, while the SPX trended higher. We all know that the collapse in a number of regional banks created chaos for the banking sector, while Big Cap Tech has propelled the S&P 500 higher. There's always the argument that "this time is different", and it could be, but given the 20-year track record in correlations between both indexes, the probability is that the S&P 500 will follow suit sooner or later. History might not always sound the same, but it does tend to rhyme.

Shifting gears, let's delve deeper into the current rally's historically narrow breadth. Through the end of the first quarter of this year, the S&P 500 was up approximately 8.3%. However, 6% of that 8.3% was generated by 9 stocks. In other words, over 70% of the market's return stemmed from a mere 2% of its constituents. As J.P. Morgan explained in a recent report, this is the narrowest breadth in any market since the 1990s. On a market-cap basis, the top 10 largest companies in the index represent almost a third of its size. In fact, the top 4, Apple, Microsoft, Amazon, and Alphabet combined represent over 20% of the index. As Dubravko Lajos-Burkas, Global Head of Equity Macro Research for J.P. Morgan recently wrote: "The market cap of the largest 10 stocks relative to the S&P 500 is at the 96th percentile relative to history, and the weight of the two largest stocks (Apple and Microsoft) as a percent of the S&P 500 index is at new highs

S&P 500 Index
vs KBW Bank Index

— S&P 500 Index
— KBW Bank Index



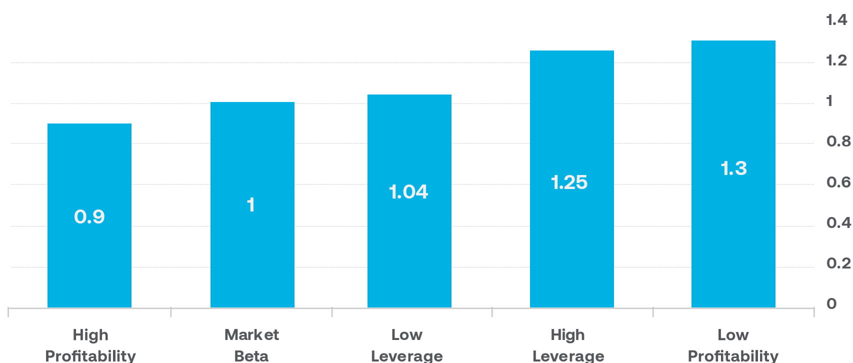
Source: Insigneo, Bloomberg. As of 5/5/23

(14%)....The largest 11-50 stocks within the S&P 500 are at the 24th percentile... and trade 7X turns cheaper than the largest 10 Mega-Caps" (J.P. Morgan, 4/25/23). From a valuation perspective, the Information Technology sector currently trades at a 20% premium to its own historical valuation on a current P/E basis, and close to a 38% premium to the index's current valuation.

Given our views regarding the high probability of a market pullback in the near term, a logical question is "what can we do about it?". To be honest, the answer depends on each individual investor's willingness and ability to tolerate volatility. An investor with a low tolerance or a pressing need for liquidity could consider the relative safety of Treasury Bills, especially given the high yields these are currently providing. To be clear, we are not advocating that investors sell out of the market and run to cash. We are just saying that this could be a potential strategy for a very particular type of investor. Most investors want to retain a certain degree of exposure to U.S. markets. For these investors, we would recommend seeking exposure to companies with strong quality factors.

Quality is a broad term that tends to be subjective. We define quality mainly by two general parameters: sustained profitability and strong financial positions. We measure profitability in terms of a company's Return on Equity (ROE), as well as its Return on Invested Capital (ROIC). A strong financial position could be measured by a company's relative level of leverage, or indebtedness. This can be generally assessed by studying a company's Debt/Market Cap or Debt/Equity ratios. Historically, quality factors tend to do better in down markets, providing investors with an alternative to weather market turmoil. The chart below breaks down two quality and two non-quality factors in terms of market beta. As a refresher, beta compares how an asset moves in relation to the overall market, in this case the S&P 500. A beta of 1, implies that the asset behaves the same way as the market. A beta higher or lower than 1 implies that the asset moves more or less than the market. As we can see from the chart, the betas for the quality factors of low leverage and high profitability have been fairly in line with the market. In fact, the beta for the factor of high profitability is slightly less than one, meaning that assets with this factor should move less than the overall market. On the other hand, the non-quality factors of low profitability and high leverage exhibit betas that have been higher than the market, specifically 1.3 and 1.25, respectively. What this means is that, historically, assets with these factors have moved between 25% and 30% more than the market. This is a positive trait when markets are expected to move higher, but not when they are expected to retreat.

Historical Beta of Quality and Non-Quality Factors (relative to the S&P 500 index)



Source: Insigneo, Bloomberg. As of 5/23

To be fair, quality tends to be more company-specific than sector-specific. To this point, quality attributes can be found in companies stretching across multiple sectors, including well known areas of the market like Information Technology, Consumer Staples, and Healthcare, as well as sectors that are lesser known for this attribute, like Consumer Discretionary, Energy and Materials. Sifting for quality does entail digging deep into individual companies, which is why most investors tend to take a broader approach and gain exposure to this attribute through mutual funds or ETFs. The Information Technology sector has many companies that fit the parameters of high quality. Companies like Microsoft and Apple are highly profitable and sit on large levels of cash relative to their levels of debt. This year's steady rise in this sector could pose some resistance to the relative outperformance of quality during a market pullback. This is why diversification plays an important role. Retaining exposure to quality factors across multiple sectors is key.

— "adhering to a **disciplined, yet flexible investment process** guided by logic and experience, has a higher probability of generating consistent returns over time."

Considering the market data parameters discussed above, coupled with various financial risks such as the potential for significant credit contraction, the possibility of lower-than-expected earnings, and a weaker economic outlook, we continue to believe that there is a high probability of a market pullback in the near term. In such an environment, a strategy that favors a diversified group of stocks with high quality and profitable growth characteristics and reduces exposure to lower quality holdings has a high probability of outperforming the overall market. As we said before, adhering to a disciplined, yet flexible investment process guided by logic and experience, has a higher probability of generating consistent returns over time. The "meat" in the middle of the current rally is likely already off the bone. Let's exercise discipline and stick to the process. ■

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House Views Matrix

	TACTICAL (UP TO 3 MONTHS)	CYCLICAL (UP TO 12 MONTHS)
US Equities[1]	UNDERWEIGHT	UNDERWEIGHT
European Equities	OVERWEIGHT	OVERWEIGHT
Japanese Equities	OVERWEIGHT	OVERWEIGHT
Emerging Market Equities	OVERWEIGHT	OVERWEIGHT
Chinese Equities	OVERWEIGHT	OVERWEIGHT
US Treasuries[2]	NEUTRAL	NEUTRAL
Investment Grade Fixed Income	NEUTRAL	NEUTRAL
High Yield Fixed Income	NEUTRAL	NEUTRAL
Emerging Market Sovereign	OVERWEIGHT	OVERWEIGHT
US Dollar	UNDERWEIGHT	UNDERWEIGHT
Energy[3]	OVERWEIGHT	NEUTRAL
Precious Metals	NEUTRAL	NEUTRAL
Cash	NEUTRAL	OVERWEIGHT

[1] Relative to global equities in USD
[2] Relative to aggregate fixed income markets in USD
[3] Relative to an overall commodity allocation

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