Sometimes Smaller is Better

October 2023 **Letter No. 123**

Fall colors have arrived in force this week, and one can't help notice the remarkable change. It's a visible reminder that it is time to transition from a season of warmth to a season of cold, but of course, here in northern Wisconsin, we are always hopeful that warmth stays longer! Seasonal weather changes are akin to seasonal market changes. Many may not even think about this, but there are distinct seasons to the markets, too. Although no two markets look exactly alike, they can often rhyme. However, as one season comes and another goes, the longer-term cumulative effects that each market season contributes to the overall economy can result in significant valuation changes to different assets at different times. Successful investing requires one to be mindful of how these year-in and year-out short-term seasonal changes pile up and weigh in on the longer-term net outcomes, some which might be beneficial and others quite disruptive, depending upon how one is positioned ahead of time.

Historically, the first quarter of every year is the market season where relatively large amounts of "new money" flow inward from year-end bonuses as well as pension and profit-sharing plans. Upward bursts in the markets in early

January are pretty common. As this first season ends, the tax filing season begins (March – April), and that can often lead to a reversal of some of those earlier money flows as tax payments must be made. Another market season arrives in the fall as some of the big institutional market participants (hedge funds, mutual funds, foundations, large pension funds) often shore up their portfolios right around September 30 (the end date of the third quarter), perhaps selling out of some losing positions. It is preparation for the final season of the year, late November – early December. This is a time wherein the proceeds from those earlier sales can be redeployed into potentially more attractive positions <u>right in front of the New Year</u> because, as noted above, the expectation is that a lot of new money will be flowing inward soon thereafter (January again!). It only makes good business sense to have your positions lined up ahead of time! So it goes, year in and year out. In between each of the seasons, anything can happen.

My favorite tree!

Two important influences for investors are the changes that occur within our giant economy and the relative valuations in securities that are sensitive to those ongoing economic mutations. Changes to these two data sets are often slow and cumbersome, and it can be difficult in real time to determine how a change in one variable (such as a big change in interest rates) can have an effect on another variable (such as the amount of interest offered by bonds compared to the potential earnings power of stocks, or vice-versa). As the incoming data impacts the markets, they react with their adjustments, but it is quite rare when big changes occur in an abrupt fashion. Changes are generally quite gradual (perhaps barely noticeable), but every once in a while, the adjustment to past data happens all at once, both on the upside and downside. This might explain how there can be unexpected frenzied rallies in some markets and complete panic attacks in others. At one extreme, we get one relentless new high after another; at the other extreme, we get a crash.

"So what?" you might say. ***"What does all of this have to do with me??"*** Great question. Some market strategists who take a longer view of things have been noticing two recent phenomena: *how long* and *how out of favor* small company stocks seem to have been. These strategists might be warming up to the idea that perhaps some of the more short-term seasonal patterns we've just gone through have been too favorable to large company stocks (among the most well-known names) **at the expense of much smaller companies with little to no investor familiarity.** Looking ahead, as it is their job to do, perhaps small company stocks are where the better future opportunity exists. I do not disagree with that thinking.

Here in the first half of 2023, we witnessed a frenzied rally in one narrow corner of the stock market – "Artificial Intelligence" (AI). But while all eyes were focused on AI, there has been a slew of small companies that have continued to go about their daily business trying to grow and build long-term value for their shareholders, too. Perhaps this overlooked corner of the market is deserving of more attention, and the time is now for more scrutiny. I believe there is exceptional opportunity to be found somewhere in the small company stock space.

Every year in the fall season, I go through an exhaustive exercise focused on finding new opportunities among stocks using their stock charts as the starting point. I will view a thousand or more stock charts in search of a specific historical trading pattern. The majority of charts won't match my criteria, but of those that do, I will then drill down further by looking at the fundamental financials of the remaining candidates. The end goal is to find a few "needles" with rare potential out of a "haystack" of stocks. I have been doing this every year for decades, and I am excited to see what is in store for 2023. **I am well aware that there are literally hundreds of small company stocks that got crushed in the bear market of 2022 with losses of 75% and more,** and for most there has been no meaningful recovery to date. Even the most ardent of bears would reason that they can't all be bad, so the search is on!

In the meantime, I believe that for those who rely on mutual funds, ETFs, or variable annuities for their large retirement accounts (or other long-term investments), the time may be right for layering in a bit more allocation toward small cap stock assets that are available to you. For example, if you've only had 2% to 4% allocated to small company funds up to now, the time may be right to increase that by another 1% or 2%. Once I work my way through all of the stock charts contained within the Russell 2000 Index this year (Russell 2000 includes a lot of small caps), I will reassess the exposure level. In the meantime, I am not really considering any other asset allocation changes from what has been advocated for most of this year. At this stage, it is only baby steps. As always, we are here to have these kinds of conversations with each of you individually. You can reach us at (715) 362-1719, or by e-mail: holperind@stifel.com.

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Asset allocation does not ensure a profit or protect against loss. Past performance is no guarantee of future results.

The Russell 2000 Index measures the performance of the 2,000 smallest companies in the broader Russell 3000 Index, which measures the performance of the 3,000 largest U.S. companies based on total market capitalization. The average market capitalization is approximately $490 million, and the median market capitalization is approximately $395 million. Small company stocks are typically more volatile and carry additional risks, since smaller companies generally are not as well established as larger companies.