

Overview

- ❖ The market is playing favorites
- ❖ Is now the time to become more flexible? What Ted Williams had to say

July 24, 2020

Dear Starvine Capital Client:

The first half of 2020 witnessed moves in equities that will stand out in market history. It was a period marked by enough uncertainty such that Warren Buffett – for the first time in his career – did not take advantage of a market crash despite holding ample cash. The second quarter saw a strong rebound after a miserable Q1 that was marked by a pandemic induced sell-off; fully invested accounts in the Starvine Flagship Strategy increased 26.4% to 26.5%, while fully-invested accounts in the Mid-Large Cap Strategy increased 24.0% to 24.1%.

This ‘bounce’ in Q2 however fell short of recovering the paper losses suffered in Q1. For the half year ended June 30, fully invested accounts in the Starvine Flagship Strategy decreased 13.5% to 13.6%, while fully-invested accounts in the Mid-Large Cap Strategy decreased 12.9% to 13.3%. During the period, the S&P TSX Total Return Index¹ decreased 7.5% and the S&P 500 Total Return Index increased 1.5% in Canadian dollars (-3.1% in USD). The movement in the exchange rate over the first half is estimated to have positively affected performance by 2.9% to 1.6% as U.S. listed equities comprise 63% and 34% of the Flagship and Mid-Large Cap strategies, respectively, while the U.S. dollar appreciated 4.7% over the period.

The heat map below is not the most aesthetically pleasing but provides a sense of just how difficult it would have been for one to keep up with the S&P 500 on a year-to-date basis without big-cap technology names.



The benchmarks cited by Starvine are standards against which the performance of the strategies can be measured. However, the Starvine strategies approach portfolio construction with a bottom-up approach and thus do not refer to the composition of any index as a reference from which to select securities. Performance of the strategies may differ significantly relative to benchmarks of any time period.

Nearly 25% of the market value of the S&P 500 is now represented by just six companies known as ‘FAANGM’ (Facebook, Amazon, Apple, Netflix, Google, and Microsoft). This small selection of companies contributed disproportionately to the index’s rise over the past few years. It is not without merit that these stocks have enjoyed multiple expansion – they are excellent businesses with deep moats and high organic growth. However, their valuations have also benefited from continued fund inflows into passive investing strategies. Since these strategies seek to replicate index returns, which are market weighted, the inflows naturally find their way into the names with the largest market capitalizations.

While it is not inevitable that this trend will ever reverse, the current state of the S&P does not appear (in my opinion) to provide a good ‘set-up’ for index investing. A key question in the near-term is what the implications are for small- and mid-cap companies in a market correction, given many in this group still trade at beaten-up valuations. Will the gravity of a reversal in mega-cap tech stock performance pull everything else down, at least on a temporary basis? It is a possible scenario but still unknowable.

The fact that we own publicly traded securities grants ultimate ease and flexibility in terms of buying and selling. It is that very privilege that can be used opportunistically to one’s advantage, yet it contradicts what a long-term investor should *mostly* be trying to achieve: gaining from the growth in the intrinsic value of companies as measured by their ability to reinvest earnings at a decent rate or return. One hypothetical example would be a prosperous local pharmacy. Should the owner sell it and run for shelter because FAANGM might crash? Of course that would be ridiculous – the pharmacy doesn’t even have a stock price. But the absence of price fluctuations should not affect how the owner thinks about the pharmacy as an asset any differently than the owner of shares in a small cap company – whose shares may gyrate immensely, and year-round in a public auction. The investor still owns a fractional interest in the company, no matter how insignificant or the lack of influence on how the business is operated. Held long enough, the returns of either the pharmacy or shares will be dictated mostly by the growth or decline in the earnings power of the underlying business.

In *The Science of Hitting*, Ted Williams stated that his first rule of hitting was to get a good ball to hit. He divided the strike zone into 77 cells and assigned percentages to each cell that represented the probability of success. Having extreme plate discipline was no doubt a large contributor to his achievement of a .344 career batting average. However, the most impactful insight from the book in my view was that a batter increases the pitcher’s target by 37% when swinging at pitches just two inches out of the zone. Such a minor relaxation of selectivity can make the difference between a .300 and a .250 hitter. Investing is no different in these uncertain times. It always makes sense to improve one’s decision making process, but not to relax one’s standards and swing based on trends that may in hindsight prove to be large distortions in the market.

Sincerely,

Steven Ko
Portfolio Manager

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