STATERA
ASSET MANAGEMENT

Commentary: August 2018

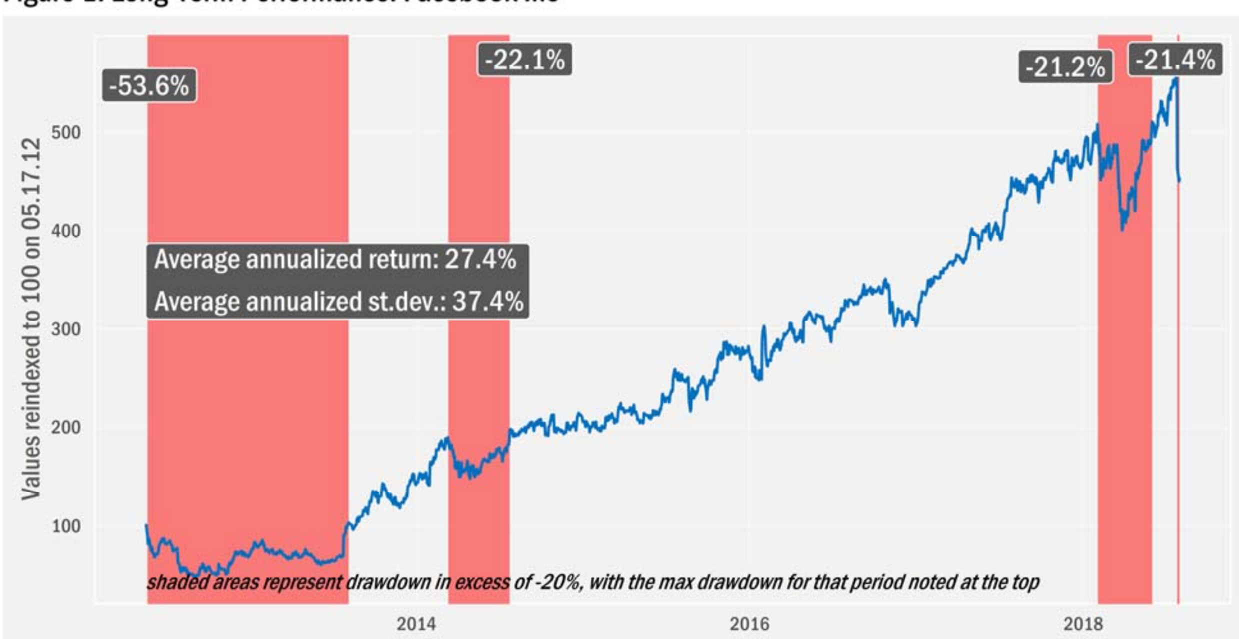
OK MISSING OUT

Fairly common to hear folks gabbing about how great a stock they own has performed. Common, too, having missed out on the run to the peak, the schadenfreude of those who avoided the downfall of former big winners. A recent example, we all might like to have seen our individual portfolios achieve gains like the shares in Facebook have seen since the company's IPO in 2012. But, with this latest swoon yet another example, there's been more than a bit of drama in the course the shares took to arrive at their current level. We think that's true for all individual stocks and find that portfolio diversification in all its forms, while offering no guarantees, helps to avoid such duress.

You've Heard (Some of) This Story

The latest plunge in Facebook shares was heavily covered in the media, not least for the stock's rather outsized impact on the market averages [even now, the stock is the fourth-largest member of the S&P 500, at 1.8% of the index, behind only Apple (AAPL), Microsoft (MSFT) and Amazon.com (AMZN)]. What seemed less talked about was the fact that this is the stock's second 20%+ drawdown this year. And the fourth since its initial public offering in 2012. While it's not proved the most volatile stock in the universe, it certainly has had its tumultuous moments.

Figure 1: Long-Term Performance: Facebook Inc



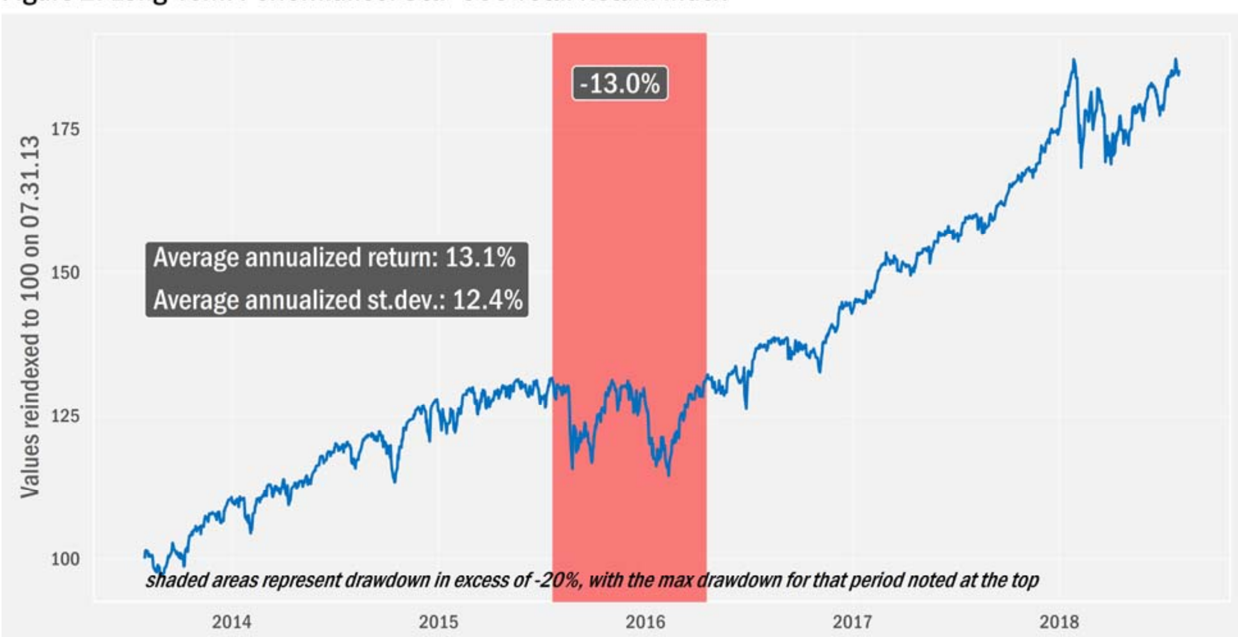
From 05.17.12 to 07.31.18. Past performance is not indicative of future results. Investing in securities involves risk, including risk of losing some or all the invested capital. There is no guarantee that any investment or investment strategy will achieve its objective. Drawdown may be measured as the maximum loss from a prior peak value and/or the length of time the portfolio requires to return to breakeven after a prior peak. SOURCE: SRCM using data from Bloomberg

Odds Are...

That's the truth for most stocks, actually: individual stocks tend to be more volatile than the market average. All sorts of news and events can be impactful for individual stocks and groups of stocks, but not so impactful for the rest. Some stocks may zig while others may zag. Aggregating all those movements, indexes tend to be less volatile than most individual securities. Thinking about that usual difference, because we often come across accounts in which just a few individual stocks comprise a large portion, this month we asked ourselves to determine what level of loss one would have had to endure across a bunch of stocks over the last five years, versus what we might have experienced owning an index composed of those stocks. We then put those relative losses in the context of 5-year total returns. What we found is that, while the S&P 500 performed better than its constituents, on average, nearly all individual stocks experienced a larger interim drawdown.

Over the past five years, of the 500 stocks that comprised the S&P 500 at the time[1], all but a handful saw an interim maximum drawdown greater than the S&P's 13.0% drop (Figure 2). Of course, many stocks saw multiple drawdowns in excess of 13%. Most recovered from those drawdowns, as all but about 15% of them saw gains through the entire period. But, the S&P's total return over the past five years outpaced more than three-fifths of its constituents. We put that relative outcome in perspective in Figure 3. Granted, it's only one time period, and the results might have been dissimilar had we looked at all such historical 5-year time periods, we nonetheless find this sample indicative of the potential benefits of diversification.

Figure 2: Long-Term Performance: S&P 500 Total Return Index



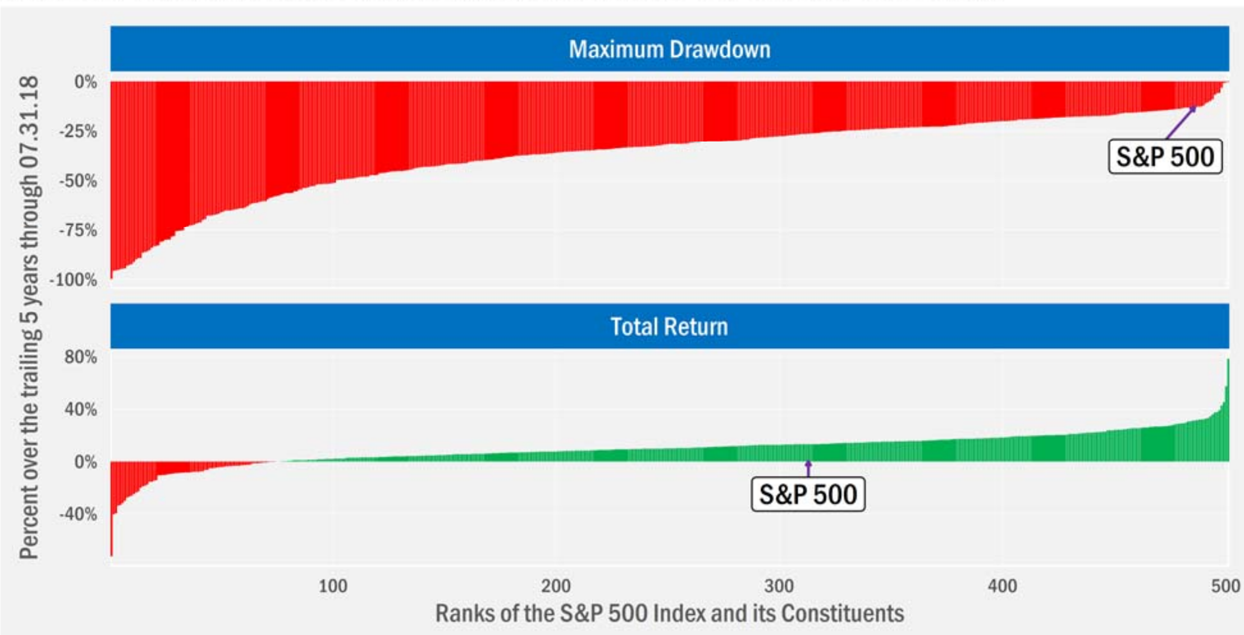
From 07.31.13 to 07.31.18. Past performance is not indicative of future results. Investing in securities involves risk, including risk of losing some or all the invested capital. There is no guarantee that any investment or investment strategy will achieve its objective. Drawdown may be measured as the maximum loss from a prior peak value and/or the length of time the portfolio requires to return to breakeven after a prior peak. SOURCE: SRCM using data from Bloomberg

[1] For this study, we used the holdings of an ETF, the SPDR S&P 500 ETF Trust (SPY), that seeks to track the performance of that index, five-year-ago (07.31.2013) details for which we retrieved via Bloomberg.

Diversify the Drama

While the potential for outsized returns via individual stock investing is clearly there, we think the potential risks far outweigh that potential reward. The more, the merrier, we say, even as we approach stock investing with a mindset similar to that which many stock pickers pursue. We seek incremental return over the market but maintain an eye toward reducing the risk that can come with a focus on a narrower set of stocks. While we expect that our tilts toward smaller, less expensive and higher quality stocks may lead to relative outperformance over the long term, we understand that these tilts may lead to underperformance over any time frame. Same can be said of individual stocks, even a handful of stocks, but the magnitudes of such shifts and potential losses can be larger, the narrower the diversification of the portfolio. So, we think the odds stack in our favor by incorporating a wide diversity of exposures with our portfolios.

Figure 3: 5-Year Max Drawdown and Trailing Total Return of S&P 500 and Constituents



From 07.31.13 to 07.31.18. Constituents as of 07.31.13 using the holdings of the holdings of an ETF, the SPDR S&P 500 ETF Trust (SPY) as a proxy. Past performance is not indicative of future results. Investing in securities involves risk, including risk of losing some or all the invested capital. There is no guarantee that any investment or investment strategy will achieve its objective. Drawdown may be measured as the maximum loss from a prior peak value and/or the length of time the portfolio requires to return to breakeven after a prior peak. SOURCE: SRCM using data from Bloomberg

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