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Kantor Group/Long Short Team: Time to Sweat the Small Things – Details Matter

Kantor Group/Long Short Team | June 2020

2020's roller coaster market performance serves as a stark reminder to investors that above average market returns with below average volatility are more likely to be cyclical rather than secular. After all, many are aware that the S&P 500 Index ("S&P 500") entered this year on a most remarkable run. Over the prior five years, the S&P 500 had delivered nearly 12% annualized returns with nearly 12% volatility[1]. To put that into context, over longer-term time horizons, the S&P 500's volatility typically runs approximately *double* its annualized return! Unfortunately for market participants, it only took but one dramatic quarter (i.e., Q1 2020) – punctuated by a 20% S&P 500 drop and a volatility metric of ~30% – to return the rolling historical five year period squarely back in line with its longer-term averages.

The reality is that today's backdrop is no ordinary environment – and is vastly different from the "risk on" environment in the years after the Great Financial Crisis. This environment is flush with a confluence of fiscal policy considerations, monetary policy stimulus, public health concerns, geopolitical uncertainty, commodity price volatility, election ambiguity and sequencing (i.e., restarting the economy) question marks. In fact, in only two months we have moved from the lowest U.S. unemployment rate in 50 years to the highest level of unemployment in nearly 80 years. Or what about how it took a mere 23 trading sessions for the equity markets to plunge 35% before ricocheting back up 35% in only 25 sessions? These are but two examples – one macroeconomic and one market-related – highlighting today's dynamic, uncertain and fast-paced backdrop. Unfortunately, while it took all but a few weeks to shut the U.S. economy down, we do expect it to take significantly longer to open it back up. Our longer-term optimism rests in an unrelenting confidence that the ongoing resilience, grit, ingenuity, and passion of the human spirit will no doubt allow us to emerge stronger on the other side of this pandemic.

So why is *now* the "time to sweat the small things"? Because fear is a terrible influence on rational action, and we believe one of the most important investment themes in 2020 and beyond will be *knowing the details* through a disciplined process. For instance, if we dig deeper into the aforementioned U.S. unemployment picture, it's noteworthy that some U.S. states have unemployment rates ranging from 30-40%, while others are less than 10%; and the 29% maximum differential between state unemployment rates is both meaningful and atypical (even in 2009, the max differential was ~10%)[2], and will ultimately impact the shape of individual state recoveries and businesses' health in those specific geographies. Consequently, we believe the events of the last few months will have major company-specific investment implications as we assess individual business models (e.g., customer demographics, geographies, supply chains, mission critical products and services, management expertise, etc.), business "moat" sustainability, market share shifts, economy-wide resource re-allocations, and optimal capital structure and capital allocation frameworks.

These factors are already wreaking significantly more havoc to publicly traded securities than the headline S&P 500 performance figure reveals. So for us as active managers, "sweating the small things" has arguably never been more important for portfolio construction – from the bottom to the top. Here is just a sampling of what we've been watching and analyzing to date:

[1] As measured by standard deviation of returns.

[2] Source: Deutsche Bank.

- **Company size matters.** Year-to-date through May 31st, the S&P 500 is down -4.9%. We believe the performance of this size-weighted index masks the true disruption that is occurring in today's economic landscape. For instance, the five largest companies – Microsoft, Apple, Amazon, Alphabet (Google) and Facebook – account for a record-setting level 21% of the S&P 500 Index, and about 14% of earnings; and on average, they are still expected to *grow* their 2020 sales by nearly double digits and earnings by mid-single digits. At the risk of stating the potentially obvious, the shutdown of the physical economy accelerated the push to the digital economy and benefitted well-resourced larger firms, particularly those in the technology and consumer-facing arenas. To further show the largest companies' disproportionate influence, the equal-weighted S&P 500 has posted a -12.1% performance year-to-date through May 31st. And moving down the cap spectrum further to medium (-10.7% YTD) and small cap (-15.9% YTD) publicly traded companies illustrates performance results that are relatively more in line with the hardships we are reading about on the front page of the newspapers each day.

- **Investment style matters.** The performance bifurcation between value and growth has been a hot button topic among investors for years. And with investors continuing to gravitate towards stability and visibility, the return differentials reached new levels this year with Growth up +3.5% and Value down -14.7% (year-to-date through May 31st). In fact, since 2007 Growth has outperformed Value by +5.6% on an annualized basis. For a *sustained* Value rally or major "catch up trade", we believe investors likely need greater confidence on global growth prospects that lift longer-term interest rates and commodity prices.

- **Sectors matter.** In 2020, the performance dispersion among sectors in the S&P 500 has been particularly harmful to portfolios that may not have diversified appropriately. From top (+7.4% YTD for Information Technology) to bottom (-33.9% YTD for Energy), there has been a dramatic 41% performance bifurcation. In fact, the top three sectors vs. the bottom three sectors saw a whopping spread of nearly 28%. Nonetheless, what we found particularly interesting in this last market drawdown was some significant sector outperformance and underperformance relative to their respective historical market sensitivities. For instance, the traditionally more defensive Utilities sector actually underperformed its beta-implied move. And even though the Energy and Industrial sectors underperformed, they were even weaker than would have been expected after being battered by macro-related factors, such as the precipitous drop in commodity prices that had both first and second derivative (e.g., lower energy-related capex) implications.

- **Geography matters**. Year-to-date through May 31st, the S&P 500's -4.9% performance has outpaced that of numerous global markets, including Emerging Markets (-15.9%), Europe (-14.5%), United Kingdom (-18.6%) and Japan (-6.6%). However, before investors re-allocate to different regions, it is imperative to understand the underlying composition of the various indices. For instance, while the S&P 500 has 27% exposure to Information Technology, Europe only has 7% and Japan only 12%. Meanwhile, Europe is dominated by Health Care (18%) and Consumer Staples (16%), while Japan is driven by Industrials (22%) and Consumer Discretionary (12%). These types of analyses help investors understand what types of companies they could be getting exposure to as they travel the world.

- **Fundamental market factors matter.** Today's equity market structure is considerably different than that of decades past. For instance, the vast majority of stock trades today are *not* done on a "single stock" basis; rather, individual stocks tend to find themselves as pieces of exchange traded funds, quantitative strategies or "baskets" (to name just a few). As a result, the various "characteristics" of an individual company's operations, financials or stock trading history are increasingly relevant. And in 2020 to date, companies leveraged to market factors such as Pure Growth, Pure Profitability, and Momentum had performance tailwinds, while companies exposed to market factors such as Pure Leverage and Pure Value have faced significant performance headwinds, given potential structural market shifts.

- **Companies matter.** We believe understanding businesses, balance sheets, management teams (and incentives) and business exposures (e.g., geographies, supply chains, end-market demand) has never been more important.

And, it is increasingly evident in returns by way of: (i) stock return dispersion jumping to the highest level since the 2008 financial crisis; and (ii) stock valuation dispersion remaining extremely elevated. Importantly, *depth* of analysis matters across sizes, styles and sectors. For instance, utility investing potentially shifts to greater scrutiny over power demand mix and previously agreed upon regulatory frameworks; media investing may take a closer look at subscription fee vs. advertising economics; consumer investing could increasingly revolve around "essential" vs. "non-essential" categorizations and the companies' pathways to their customers; and healthcare investing may assess everything from broader D.C. policy implications to vaccine solutions to nuances such as a company's exposure to elective surgeries.

- **And yes, earnings *always* matter.** As we look at Q1'20 earnings results, about 46% of S&P 500 companies posted positive EPS growth; meanwhile, approximately 20% of S&P 500 companies saw EPS contraction of greater than 25% and another ~8% posted an EPS loss[3]. And the greatest "certainty" from Q1 earnings calls may have been how much uncertainty exists today, which was further evidenced by about 200 companies withdrawing financial guidance, 85 companies suspending stock buybacks, and over 30 companies suspending or omitting dividends. Looking ahead to Q2, the range of outcomes look even wider. Specifically, fundamentals are expected to deteriorate further, with only ~23% of S&P 500 companies positing positive growth, 34% expected to see EPS declines in excess of 25%, and 13% expected to post an EPS loss. Generally, during times of stress, there are numerous instances when individual stock prices may disconnect from fundamentals. And the earnings results from Q1'20 were no different, as we believe there are company-level opportunities where stock price moves ran out-of-synch with EPS revisions (i.e., negative price changes against positive EPS revisions) or where the magnitude of moves did not accurately capture the change in its fundamental positioning.

In closing, we believe the extraordinary fear, volatility and dispersion bring forward the power of a disciplined fundamental process, experience, risk management and active portfolio management. So what are we doing? Analyzing company fundamentals, monitoring the credit markets, and testing and re-testing individual investment theses. The small things matter, and now more than ever, we believe "knowing your companies" should be combined with stringent risk management in the pursuit of attractive long-term risk-adjusted returns.

Please reach out with any questions/thoughts/concerns.

[3] Source: Credit Suisse.

behavior. Information on historical observations about asset or sub-asset classes is not intended to represent or predict future events. Historical trends do not imply, forecast or guarantee future results. Information is based on current views and market conditions, which will fluctuate and may be superseded by subsequent market events or for other reasons.

For more information on COVID-19, please refer to the Center for Disease Control and Prevention at cdc.gov

The S&P 500 Index consists of 500 stocks chosen for market size, liquidity, and industry group representation. It is a market value weighted index (stock price times number of shares outstanding), with each stock's weight in the Index proportionate to its market value. The "500" is one of the most widely used benchmarks of U.S. equity performance. As of September 16, 2005, S&P switched to a float-adjusted format, which weights only those shares that are available to investors, not all of a company's outstanding shares. The value of the index now reflects the value available in the public markets.

Emerging Markets are represented by the MSCI Emerging Markets Index, Europe is represented by the STOXX Europe 600 Index, UK is represented by the FTSE 100 Index and Japan is represented by the Nikkei-225 Stock Index.

The MSCI Emerging Markets (Net) Index is a free float-adjusted market capitalization-weighted index that is designed to measure the equity market performance of emerging markets. The index consists of the following 26 emerging market country indexes: Argentina, Brazil, Chile, China, Colombia, Czech Republic, Egypt, Greece, Hungary, India, Indonesia, Korea, Malaysia, Mexico, Pakistan, Peru, the Philippines, Poland, Qatar, Russia, Saudi Arabia, South Africa, Taiwan, Thailand, Turkey, and the UAE. Net total return indexes reinvest dividends after the deduction of withholding taxes, using (for international indexes) a tax rate applicable to non-resident institutional investors who do not benefit from double taxation treaties. In June 2016, the benchmark was changed from the MSCI Emerging Markets (Gross) Index to the MSCI Emerging Markets (Net) Index. The benchmark was changed to better reflect how account returns are calculated.

The STOXX Europe 600 Index is derived from the STOXX Europe Total Market Index (TMI) and is a subset of the STOXX Global 1800 Index. With a fixed number of 600 components, the STOXX Europe 600 Index represents large, mid and small capitalization companies across 17 countries of the European region: Austria, Belgium, Denmark, Finland, France, Germany, Ireland, Italy, Luxembourg, the Netherlands, Norway, Poland, Portugal, Spain, Sweden, Switzerland and the United Kingdom.

The Nikkei-225 Stock Index is a price-weighted index composed of Japan's top 225 blue-chip companies traded on the Tokyo Stock Exchange.

The Financial Times Stock Exchange 100 Index, also called the FTSE 100 Index, FTSE 100, or FTSE, is a share index of the 100 companies listed on the London Stock Exchange with the highest market capitalization.

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