



THOUGHT FOR THE WEEK

Hitting Home Runs

SYNOPSIS

- Several stocks experience catastrophic losses at some point, and many never recover.
- Despite so many stocks delivering investors such bad losses, the overall equity market is up dramatically since 1980.
- Diversification is the only way to reap the rewards from “home run” stocks without owning all of the risk.

STRIKING OUT

I recently read a rather intriguing report on the history of equity returns published by Michael Cembalest, Chairman of Market and Investment Strategy at J.P. Morgan. He conducted an extensive analysis on the Russell 3000 index to determine the frequency of catastrophic losses.

The Russell 3000 Index measures the performance of the largest 3,000 US companies representing approximately 98% of the investable US equity market. Whereas the S&P 500 only represents large companies, the Russell 3000 is a mix of large, medium, and smaller stocks. It is reconstituted annually to ensure that new and growing companies are reflected.

Three very startling conclusions came from comparing his work to the historical returns of the index that are worth noting:

1. **Huge Gains:** The Russell 3000 increased over 1,800% from 1980 to 2014, which is a strong return over a 35-year time period.
2. **Catastrophic Losses:** Over the same time periods, roughly 40% of all stocks suffered a permanent 70%+ decline from their peak value.
3. **More Losers Than Winners:** Two-thirds of all stocks underperformed the Russell 3000, and the median return since inception relative to the index is -54%.

Even the savviest investor is wrong way more often than right.

Upon first glance, these conclusions may appear to contradict one another. How can an index of stocks do so well when most of the individual components performed so poorly?

The answer lies in this somewhat complicated chart below, which shows how frequently stocks either outperformed or underperformed the Russell 3000 index.

Distribution of excess lifetime returns on individual stocks vs. Russell 3000, 1980-2014



Source: FactSet, J.P. Morgan Asset Management.

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The red-dotted line indicates the median return, which is currently to the left of the -50% bar on the chart. This red line is effectively confirming the third conclusion above that states that most stocks have performed rather poorly when compared to the broader market.

However, the reason why the index has surged has to do with the green-dotted line. The stock returns to the right of the green line are the home runs that we all dream of owning, but they only account for around 7% of the stocks in the sample.

It's mind boggling to think that such a tiny subset of stocks can perform well enough to drive the equity market up so high until we start to think about the math behind winners and losers.

A stock has a limit to how much money it can lose because its loss is capped at 100 percent. On the other hand, a home run can theoretically rise forever. Since there is no cap on the upside, these select few stocks have been the driver for such powerful performance for U.S. equities over the past three decades.

Simply put, for every Apple or Google, there have been way more companies that have failed, but in the end, the returns on the home runs have more than offset the losers.

IMPLICATIONS FOR INVESTORS

Wouldn't it be great to put together a portfolio that only consists of future home runs and avoids the other 93% of stocks? In fact, we could even take it a step further and bet against the stocks that we don't want to own so that we amplify our returns even higher.

In a nutshell, that's pretty much what the entire hedge fund industry attempts to accomplish each and every year. These money management firms are

filled with billionaires, PhDs, and some of the most brilliant academic minds to ever live, and they work hundred-hour work weeks and spend millions every year for access to information to try to find that 7% of stocks.

The problem is that not even this cohort can pull it off because such a herculean task is impossible. Even the most successful investor will only find a handful of home runs over the span of a lifetime, so what separates the best from the rest is recognizing this reality and managing the risk along the way so that a catastrophic loss on a single holding does not take the entire ship down.

NOTE: *The best way to manage such risk is to avoid concentrated holdings at all times. Numbers don't lie, and if any given stock has a 40% chance of experiencing a permanent loss of 70% or greater from their peak value, then no one position should ever dominate a portfolio.*

But not all hope is lost because the beauty of disciplined investing is that there is no reason to even try to only pick home runs. Owning a lot of losers is perfectly fine because the catastrophic losses won't matter as long as we follow three important rules:

1. **Remain Diversified:** Owing a diversified portfolio of stocks can give an investor exposure to a few home runs and dramatically reduce concentration risk.
2. **Ignore The Pawns:** Don't lose faith when some of the stocks in your portfolio blow up. These are merely the pawns that must exist for you to achieve success, so focus on total portfolio returns rather than individual holdings.
3. **Swallow Your Pride:** Successful investors would much rather be rich than right, and the only way to be rich is to learn to become comfortable with being wrong a lot. Even the savviest investor is wrong way more often than right.

The bottom line is that the investors should focus on the overall portfolio performance rather than the individual components because the only way that catastrophic losses can derail your financial future is if you break the rules of diversification.

Sincerely,



Mike Sorrentino, CFA

Chief Strategist,
Aviance Capital Management
mikeonmarkets.com

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