Matt's Minutes: Diversification is the enemy?
"Closed Captions"
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Hi there, this is Matt Curfman from the Richmond Brothers here with a November 2023 edition of Matt's Minutes. You saw my title, "Diversification is your enemy". You may wonder what in the world is Matt talking about? Well, that was actually basically a headline from notorious Jim Cramer who hosts the show Mad Money on CNBC, and I've heard comments from many of you over the last couple of years who do pay attention and follow him, so he's got a little bit of a celebrity status. But what does he mean when he says diversification is your enemy or diversification was not your friend in 2023?

What he really means is there's a heavy concentration in the overall market. And when we say market, what he means is the S&P 500. The S&P 500 is exactly what it sounds like. 500 companies make up that broad benchmark. And the S&P 500 is a cap weighted index. And when you think of what does that mean? A cap, a market cap, that means size. The bigger you are as a company, the more you matter. That's both good and bad. And the smaller you are, the less you matter. That's what happens in a cap weighted index. So, imagine you basically had 500 companies and the five or seven biggest companies accounted for nearly 25% of the entire market.

So, think about that, five companies out of 500. That's 1% of the constituents of the index account for one fourth of the entire market. That means the other 495 companies account for the remaining 75%. So, what's happening is we think this is creating more and more of the volatility in the most recent years, going back the last five years, if you've been watching Matt's Minutes, you'll note that in the last five years, five and a half years now, we've had three bear markets, which is a drop of 20% or more.

So, I want to give you some context and some historical perspective. The cap weighted index, everyone says, oh, it's doing great this year and on its own and in its own little narrow lens, that is true. However, that same benchmark lost 20% last year. The NASDAQ lost 33% and you may recall the bonds using Bloomberg U.S. aggregate lost 15%. It was a really tough year because the Federal Reserve so aggressively hiked rates last year. So, with that, I'm going to do a little screen share here and give you some perspective.

What I did here is I graphed from January of '22 all the way to January of '23, all the way through November 30th of '23. So, it's basically 23 months. What I did is you can see the bright colors on here. I'm like a kid. I like to have bright colors. There are a couple of different benchmarks. So, S&P level change, that's the cap weighted index, the dark purple. You can kind of see the trend lines here. You see it's coming back up. Now, S& P equal weight just says, what if we own all those pieces of the pie equally, all 500 companies equally, or all 11 sectors equally? That'll get you a very different outcome than owning a cap weighted index, even though you own the exact same thing, we just own it in different ways.

Bloomberg U.S. aggregate, those would be bonds -- U. S. bonds. And then the Dow Jones and the NASDAQ. So, what are the trends we're looking for? If you go back to 2022, you basically can see -- let me get my little drawer out. There's the trend. It was down. Those are some of the negatives I just mentioned. Now, if you go right here, this is basically January 1st of ‘23 to November 30th. In general, you see positive trends. Now, it's certainly not in a straight line. It kind of feels more like this. Right here is from the summer, July through the end of October, and the markets, basically all the benchmarks had roughly a 10% drop from their highs. If you were in Beacon in the Smoother Ride, you've had a little bit more transactions because remember, 10% downside is one of the safety thresholds where we want to have some defensive mechanisms in place.

Now in this case, markets starting to come back up again, but only in the month of November. The point of this is if you basically zoom out and look just in the 2022 and 2023 year, there's not a single broad benchmark that is still positive, despite the fact that trends are still positive this year. So, I wanted to basically give that perspective and just show you what we're seeing in the environment.

So, are we encouraged that things are going to get better? Should we be afraid heading into the 2024 election year? I have some data points on that too, but before I do, I want to just do a quick graph here of if you had two different pie charts, so to speak, and let me just draw some circles. My pies are not going to be perfect, but remember, I said that five of the S&P constituents account for 25% of the market. Here are those five, and then the rest are 495 spread over the other 75%. That is quite a concentrated market. So, when those five tech companies do well, it feels like the whole market's doing really well. It's not actually the case. When those five companies are doing really poor, it drags on the whole market.

What if you could basically have market exposure with more diversification, and this is not exact either, but let's say all of these slices are exactly equal. There's actually 11 sectors in the market and the S&P. But if we could own all 11 when we own, but have some safety nets in play, so that if the markets were to drop 10% roughly, we basically go defensive and then we wait it out a little bit before we get back to normal. This has been quite a roller coaster in the last year or two. So, I just wanted to share that and then perspective. So, should we still own markets? Should we still own equities going forward? And we think yes, the answer is yes. I also pulled some data, and this will be the last point and I'll, I'll check off here.

What have been the S&P 500 or index returns in past presidential election years? The S&P 500 has been around for quite a while. If you go back and say how many election years have there been since the S&P 500's existence, there have been 23 election years and basically 19 of the 23, which is 83% of the time, the market, the S&P 500 as a benchmark, had a positive return in a presidential election cycle, regardless of whether it was a Democrat or Republican being elected. So, I think that's noteworthy. This is data from Morningstar, from AMG, and from Ibbots & Associates, just for reference. The other thing is we're seeing inflation cool off a little bit from its highs. We're also seeing the Federal Reserve flatline. They're not continuing to increase the rates. We're seeing corporate earnings in the middle, kind of on a scale of one to five. One's awful, five's outstanding. I would say kind of okay, and then we're also seeing unemployment nationally under 4% still, and that tells us if you want to work, there is work available.

And so, you kind of look at all of the risky things out there, so Federal Reserve raising rates, high inflation, we had bank failures, big bank failures in March and April. We had the debt ceiling crisis over the summer, then you had the U.S. debt downgrade by the ratings agencies in August, and then you had more war breakout with Israel and the Gaza Strip. There's a lot of things going on in the world that can be scary. Economically, it feels like the sky isn't falling. We are encouraged by that and trying to cut through all the noise to let you know. So, we're still very comfortable with those of you who are using the Smoother Ride strategies.

You see a little bit more transactions because the market's been volatile, and the goal is to remove some of that and be a little more stable. Now there's a chance that we're never going to make exactly what a cap weighted index makes. But the long-term goal is to kind of have a broad-based approach, have some safety nets in place. And then if you also have some other safety nets, for example, money markets, CDs, fixed index annuities, those would be on the safer side, not really stock market investments that can keep your overall risk profile lower as we move through the volatility.

So, we are here to help guide you through no matter what the world throws in your or our path. My aim is to help educate, inform, and guide. And I hope this has been a helpful piece of information as we are kind of between holidays right now. Wishing you all the best as we move forward towards the holiday season. Peace, joy, happiness, and gratitude. We are thankful for having the opportunity to serve you. And I will check in again very soon. Thanks for tuning in.

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