

A Tale of Two Markets

How well is the stock market doing this year? It depends on your yardstick.

As we approach mid-year, investors will begin reviewing their investment portfolio performance. Early in the year we saw a modest rally in equity markets followed by a severe decline in the wake of the outbreak of the Covid-19 pandemic. But in the past 3 months, the market has made steady progress in recouping much of that decline. As of Friday (06/12/20), the S&P 500 index was down 5.86% for the year. Although the S&P 500 is usually considered a reliable benchmark for portfolio performance, this year it is not accurately presenting the entire story. In fact, the divergence in performance of various segments of the equity markets is quite remarkable.

Let us take a look at some of the more popular equity benchmarks:

	One Year return	Year-to-Date Return
Dow Jones Industrial Average	-6.32%	-10.28%
S&P 500	5.61%	-5.86%
S&P Midcap 400	-7.46%	-14.69%
S&P Small Cap 600	-11.86%	-20.44%
Nasdaq Composite	23.05%	6.87%

As of June 12, 2020

In most years, equity indices tend to move more or less in sync. But the divergence between various sectors of the market has been apparent, both in magnitude and direction. There is a pronounced outperformance of large stocks over smaller stocks; The S&P 500 (large cap) index has been outperforming the Small Cap 600 index by over 16% in less than 6 months. Moreover, there is a marked divergence between the technology sector versus the rest of the market. The technology heavy Nasdaq Composite index (about 40% invested in technology stocks) has outperformed the S&P 500 index (about 22% invested in technology stocks) by nearly 13%. The gap with broader indices has been even greater.

What does this all mean for investors? First, broad industry diversification strategies have not worked well this year. Second, despite the strong rally these past few months, the recovery has not been as pronounced in smaller stocks. In fact, many stocks in a variety of sectors are still trading well below their 52-week highs. Some of those stocks are in sectors that have formidable operating challenges in a post-Covid-19 world. But other stocks are just out of favor and not keeping up with the averages.

In my view, this bifurcated market is creating long-term opportunities for equity investors. Valuations in many smaller capitalization stocks are quite compelling now, even after this rally. At the same time, many high-flying large capitalization technology stocks look to me as fully valued at best. Only time will tell. I do not believe, however, that this is the right time to abandon broad diversification strategies. If there is a big opportunity in this market, I would say - think small.