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EQUITIES

January Leadership Won't Last

By: Aaron Dunn, CFA | & Bradley Galko, CFA | February 13, 2023

Boston - The old Wall Street adage, "As goes January, so goes the year," gives us pause as we ponder that broad equity indexes like the Russell 1000 (6.7% total return) posted strong positive returns last month.

We believe the rally we have seen since October 2022 is not atypical. The S&P 500 bottomed in August 2002 and promptly rallied 15% over the following two months before simmering. That rally was led by excessively narrow market leaders heading into the bear market: tech stocks that bounced a full 43% over the same period, along with a bump from healthcare and consumer discretionary. Similarly sharp rallies have followed other bear markets through history.

Behavioral bias in investment decisions

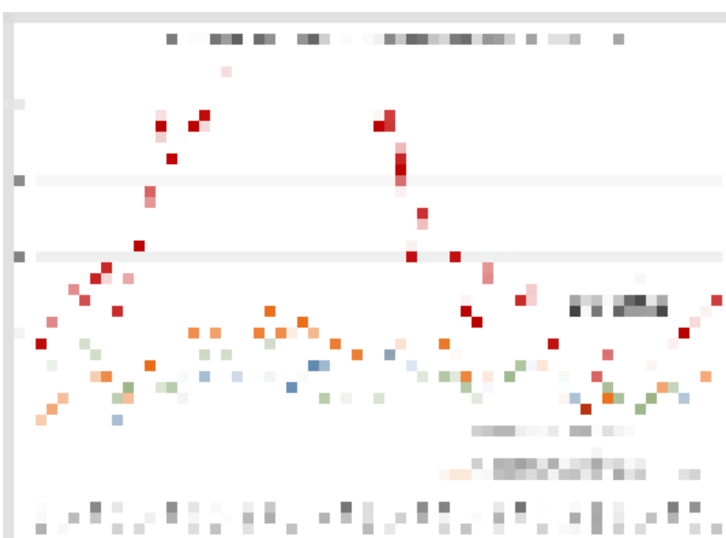
In our view, equity investors' quick return to the same former winners may be rooted in certain behavioral biases, which are highly prevalent in investment decisions. Both *anchoring* (the influence that a reference price can have on buyers' behavior) and *loss aversion* (the tendency to more strongly prefer avoiding losses than acquiring gains, relative to a reference point) come into play here.

Anchoring may irrationally impact an investor's decision making, such as feeling "safe" about the market's former winners. Daniel Kahneman, who won the 2002 Nobel Prize in Economic Sciences for integrating psychological insights into economics, suggests that losses are psychologically twice as powerful as gains (that is, someone who loses $100 will feel twice the pain versus the satisfaction of gaining $100).

It reminds us of the maxim that generals always "fight the last war," meaning that military strategy often centers around what happened before. History suggests that while this may work for a time, it's ultimately an unsuccessful strategy for the ensuing market upcycle.

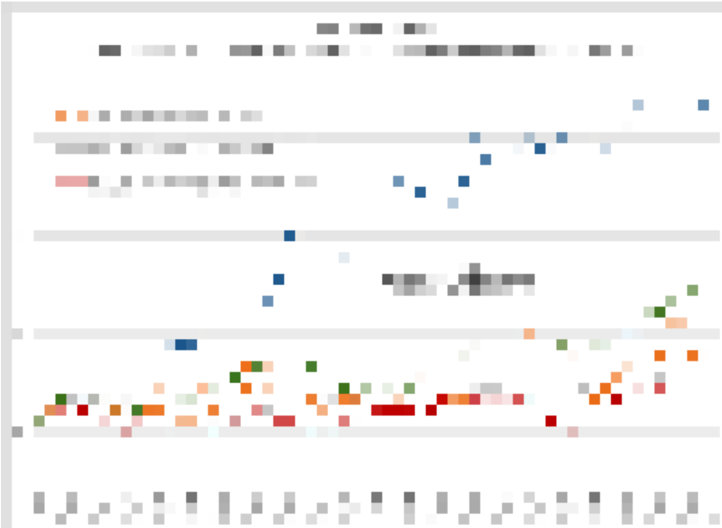
Change in leadership characteristic of bear markets

Returning to the post-dot-com bubble period from the start of 2004 through the middle of 2007, the S&P 500, was led by some laggards of the late-1990s bull market: energy, utilities, industrials, materials and real estate. Laggard groups were the prior cycle's leaders: tech and healthcare. A change in leadership is characteristic of bear markets, once the market is convinced that a new upcycle is afoot.



Source: S&P 500 and Bloomberg. **Past performance is no guarantee of future results.** An investor cannot invest directly in an index.

The current bear market is especially interesting. From March 2003, when the market had given back most gains of the rally off the bottom, and November 2003, the market generally moved higher. The leadership sectors were generally the same, but industrials and materials began to edge higher. Russell 1000 Value Index and Russell 1000 Growth Index traded leadership blows. In late 2003, as market participants became convinced that the economy was on a firmer footing, the leadership change flipped like a switch. A similar experience occurred in late 2009/early 2010.



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We published an Outlook for 2023 in mid-December 2022, noting that the first half of the year would include continued volatility and uncertainty, which we believe is happening with the current rally approaching an end and the expectation of a leadership change occurring. In our view, coming out of that period, the leadership will shift to quality cyclicals as we move into the second half of the year.

Bottom Line: We believe consistency and using an active approach are key amid uncertainty, and we continue to follow a proven investment philosophy and process to construct portfolios for clients with an emphasis on stock-by-stock decisions, based on an assessment of risk and reward. A relentless focus on acquiring leading companies when the market offers them at discounts to their intrinsic value is essential to adding value for clients over time.

S&P 500® Index is an unmanaged index of large cap stocks commonly used as a measure of U.S. stock market performance.

Russell 1000® Index is an unmanaged index of 1,000 U.S. large-cap stocks.

Russell 1000® Value Index is an unmanaged index of U.S. large cap value stocks.

Russell 1000® Growth Index is an unmanaged index of U.S. large cap growth stocks.

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