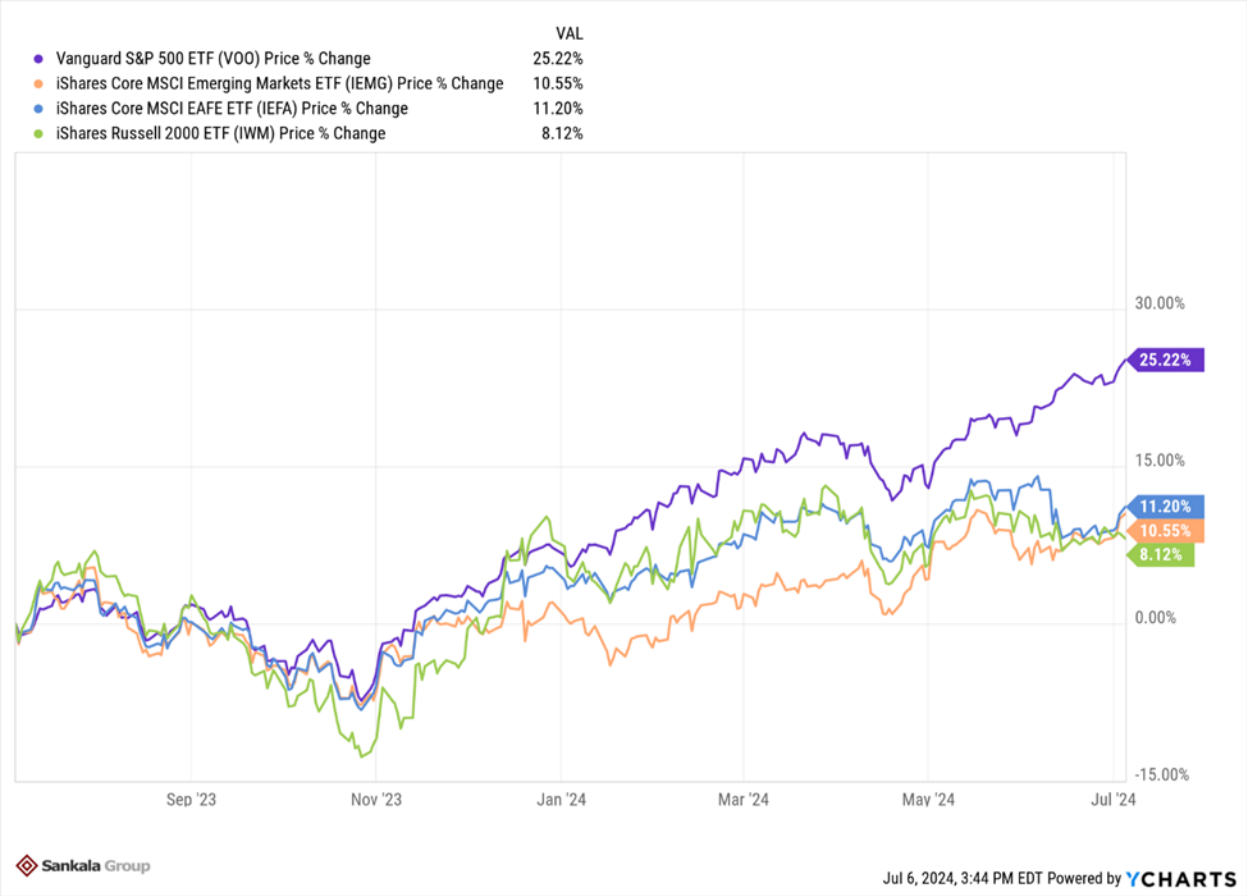
Sankala Group

Model, Meet Reality

Harold Hallstein

In our business, sometimes making clients money is not enough. While typically we avoid focusing on short-term financial trends in our letters, after some challenging internal discussion, we concluded it was necessary to address a couple of them and take some accountability for the recent shortcomings in our research on the interplay between interest rates and stock prices.

To start, you need to be aware of a remarkable divergence in performance between the world's largest firms, as represented by the S&P 500, and smaller companies both in the United States and globally. The chart below compares the returns of the S&P 500 to U.S. smaller capitalization companies (Russell 2000), and also developed and emerging market international stock indices.



A few things are worthy of note:

- S&P 500 firms (purple), led by the largest technology companies, have trounced all other types of stocks in the last 12 months.
- Other types of stocks performed fairly tightly together over the period.
- The divergence started in earnest around the turn of this year, at which time smaller firms (green) had been leading the markets.

We did not anticipate this remarkable and somewhat historic shift around the New Year because we had been doing well in prior quarters based on the specific research we laid out in Q3 2020 and Q3 2022, about how falling and rising interest rates impact stock prices.

In short, in 2020, we made the case that drastic Federal Reserve cuts in interest rates due to the pandemic were likely to drive stocks higher despite *falling* corporate earnings at that time – and we saw that as a fact of the math which drives discounted cash flow models used to value stocks. That observation worked for us, and we were bullish during a period of time when many

investors were panicked, and certainly very few could imagine the S&P 500 reaching new highs only six months after lockdowns began.

Our initial work then led us to continued research on the topic of interest rates and asset prices, which we published in 2022. That work essentially presented a more nuanced observation, and differentiated between how rising rates should impact growth companies (high duration equities) versus value companies (low duration equities). The conclusion was clear: rising rates, based on the math of discounted cash flow models, should impact growth companies more than they should impact value companies, especially when the rising rates start from a low nominal base (0 to 1%).

That conclusion also worked for us: when interest rates rose sharply during 2022, higher dividend value firms saw a small gain and small cap value firms lost around 10%, while the S&P 500 sank a very serious 18% and large cap growth index funds lost nearly 30%.

Given this COVID-era work, you can see how we became "attached" to some of our ideas about how changing interest rates would impact various corners of the equity markets.

Well, leave it to the stock market to shatter the analytical confidence you might have built. In early 2023, when the current large capitalization, A.I. fueled growth regime really began, the interest rate on the 10-year Treasury was ~3.5%. It is now ~4.3%, in mid-2024, having climbed meaningfully higher. Based on our equity duration research, this increase in rates should have kept higher valuation growth stocks contained in pricing, and on balance should have benefited firms with higher current earnings and cash-flow. Essentially, it was a continuation of the very conditions which did exactly that in 2022.

That is why we took little action to upshift our equity allocations into growthier large firms. Why would we, given what we had seen work so well for us through the COVID era?

That was the wrong choice. I did not respect enough that artificial intelligence appears not to be a buzzword rally like the "*meta-verse*" had been, nor did I see how the cash-rich balance sheets of the very largest technology firms would let them avoid fears of refinancing risk in the new higher interest rate environment. They simply don't borrow money for operations, so they don't have that risk, and that overpowered the relationship of how interest rates and discounted cash flow models work. Hence, you have Microsoft trading at 40x its annual earnings, a level rarely seen since the Dot-Com bubble.

So how do I take some accountability for this? Well, I can start by saying it was not through lack of attention, or serious/dedicated in-house research. In retrospect, the only way we could have avoided lagging during such an enormous performance spread was to have concentrated an uncomfortably large amount of capital in these larger firms - a very significant risk in its own right. The model that had been working very well for us was showing that such an approach would have been betting on low historical probabilities.

We also perhaps placed too much credence in a philosophy most professional investors ascribe to in some way, shape, or form. Warren Buffett once said, “size itself is the enemy of large returns.” Most professionals believe that. They think it is more likely to see a company worth 100m grow to 200m, than it is to see a company grow from one trillion to two trillion. This is why you read much more often about venture capitalists, entrepreneurs, and hedge funds owning esoteric stocks than you do about the pension fund managers that own big positions in the world's most established companies.

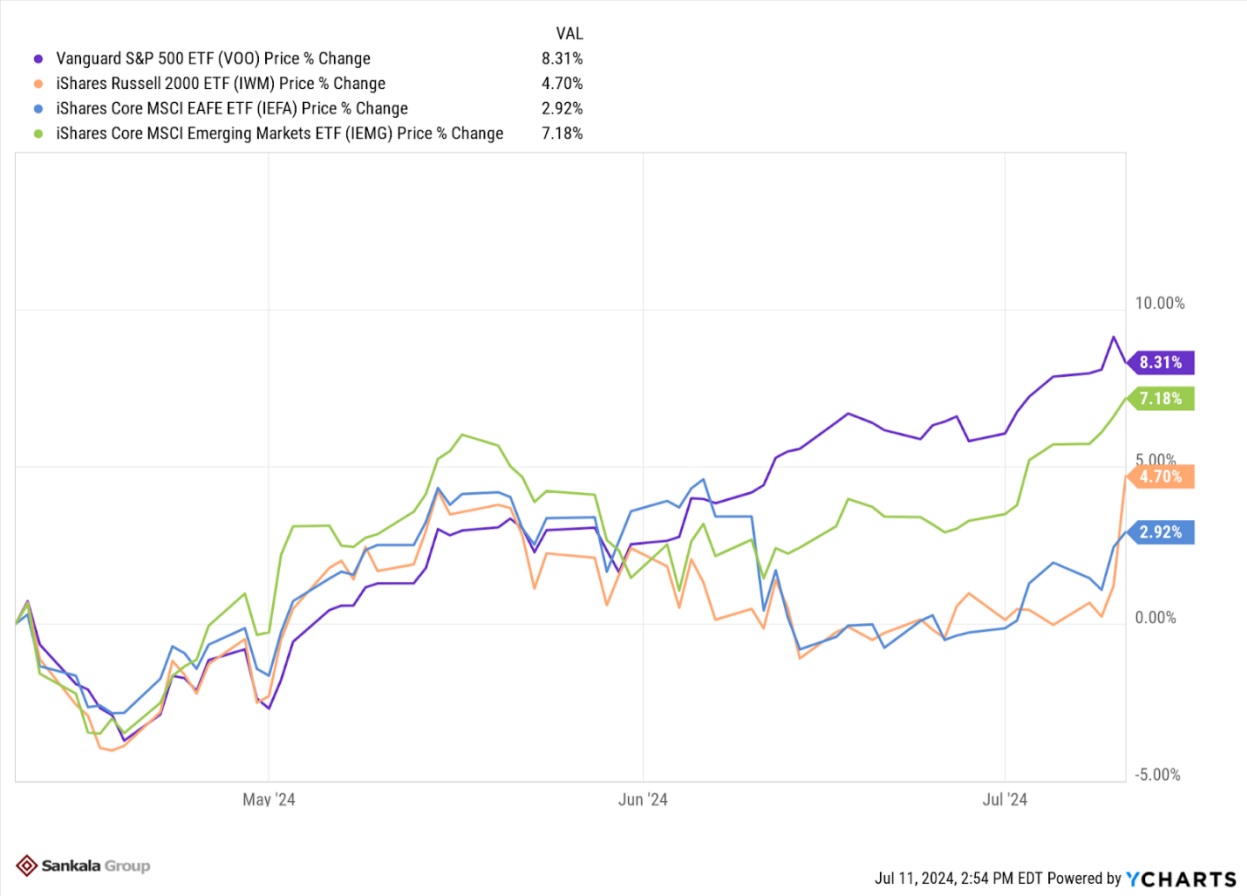
Thomas wisely reminds me that we need to be careful to not let our thinking (or rationalizations) become a warm blanket to take shelter under. He is completely right - the correct way to address this problem is not to point fingers at valuations in the world’s biggest companies. Instead, we must keep pushing our research forward, and we are currently exploring the durability/longevity of higher profit margins in history, something many of these largest firms have in common. In industry speak, this style of investing is called the “quality” factor, which suggests the combination of a strong balance sheet and high margins tends to endure in terms of performance over time. We plan to increase our exposure to this factor after we have completed our deep in-house study of how it works and why.

Another critical observation is that artificial intelligence does not appear likely to be regulated soon. Despite that what I see being called “AI” is often large firms jumbling up other people’s copyrighted creative/research work, and then re-presenting that mashup as their own (...or somehow some artificial being’s own, unconnected to the firm that owns the software which produced it), regulation seems unlikely because these firms already have such incredible lobbying clout, and the 118th Congress is at a point of historic inactivity, passing the least legislation in generations.

Lastly, making our life even more complex, given the fairly reliable periodic mean-reversions in markets, we are considering our options as far as timing any strategic shift. When you look at the chart that opened this letter, there is some fundamental irrationality when you see a group of investments which tend to be highly correlated, to buy the anomalously high one and sell the conformities trading more cheaply. That kind of action has gotten many investors in trouble over the decades, and has led to magnificent overpayments for certain popular investments.

Today, 7/11/24, I’m reviewing the paragraph above, prior to publishing our letter. The observation about mean reversion is asserting itself *very* strongly. In fact, the S&P 500 large capitalization stocks *declined* today by almost -1%. The Russell 2000 has *risen* +3.5%. That is a stunning 4.5% reduction in the performance spread between the two in under 24 hours. This occurred shortly after the Federal Reserve observed less inflation than anticipated, and markets think interest rate cuts are likely later this year.

You can see the remarkable turn today in the updated chart of the last 3 months below. The Russell 2000 is the (orange) line:



Despite this major change, we are not out of the woods yet. Part of what we learned during this period was that our modeling of interest rates and stock prices, while powerful, did not account for a critical variable. Our quantitative work did not take into account that fast-changing interest rates create refinancing risk for companies with significant debt outstanding, and companies that have large cash balances do not have that risk, and actually get to collect higher short-term interest rates on their corporate treasury. These considerations can overpower the mathematical relationship found in the cash-flow models that our work is built on.

So, we need to update our work to consider how leverage ratios (debt levels) can be adjusted for in this context. That will be difficult to sort out as companies of both types can be found in all major indices, but we can at least adjust based on the aggregate debt levels in each index, and certainly utilize it in our single-stock selection work.

We hope you appreciate our desire to be as direct, transparent, and analytical as possible in our communication with you. We want you to understand what is happening, how we are making choices, and why. It is our passion to understand the market, so we are excited to learn from our mistakes and push our research to the next level.

Best,

Harold Hallstein
Sankala Group LLC
T: (720) 310-0605

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