MAC Alpha Capital – The Need to Rebalance

We all know that we should rebalance our portfolios from time to time. At MAC Alpha, our belief is stronger than that – we believe rebalancing is an imperative; a critical component of a sound investment process.

Our focus is on consistent process – rebalancing is an inherent part of that. We do it with stocks within our portfolio and we suggest that one should do it with the asset allocation of their portfolio (think equities, bonds, alternatives, cash) as well as within equities (growth/value, large/small, domestic/international).

What happens in a portfolio if you own a stock at 50 and it rallies to 100? The one thing we know for certain is that you now have 2x as large a position[1] at 2x the price. Does it make sense that you should continue to hold that position? If you are comfortable with a position that is 2x larger at twice the price, then why wasn't the original position larger at 50? The only reason it should be 2x larger at 2x the price is that suddenly your research tells you that the Intrinsic Value[2] has more than doubled, so your expected return has increased as well. We think this rarely occurs with single stocks or with asset allocation. After a position has done exceptionally well, it most likely should be trimmed back to its prior weight, if not lower.

We have often seen this practice of holding onto stocks that have rallied, and we think it contains many psychological flaws such as **hubris** and **overconfidence bias**. It also includes various items from Charlie Munger's list of 39 Reasons for Misjudgments Explained by Psychology[3] such as **over-influence by the most recent evidence, as well as status quo bias and do-nothing syndrome.**

"Diversification is the only free lunch in investing." Harry Markowitz, 1990 Nobel Prize in Economics

Making the Correct Decision can be Difficult

Everyone knows they should rebalance, just as everyone knows they should exercise and eat healthily. It's not a lack of knowledge that separates success from failure but lack of will.

Why do people not rebalance? FOMO. Fear of Missing Out. It's not your fault, it is human nature. We are all wired that way – however, there is a significant cost to both your portfolio and your psyche of not rebalancing your assets. **It is more important to rebalance when expected returns (between your current allocation and where you should be) are more extreme.**

We always enjoy hearing what Oaktree's Howard Marks is thinking and while listening to one of his recent podcasts, a conversation with Annie Duke[4], an author and famous retired poker player, we were reminded of another piece he wrote shortly before the Covid-19 Pandemic. In his piece, "You Bet![5]", Howard likens investing to blackjack[6] in the following way: *"In my view, the active investing I'm*

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[1] In currency terms. Not quite mathematically true but close enough for the context of this paper, assuming the rest of your portfolio was unchanged the total value of your portfolio has gone up slightly as well so you actually have slightly under 2x the original position size in percentage terms.

[2] Intrinsic Value is what we believe fair value is for a security today

[3] Chapter 1 of Seeking Wisdom from Darwin to Munger by Peter Bevelin

[4] The Insight: Conversations – Special Episode with Annie Duke and Howard Marks – December 6, 2023. Oaktree Capital Management

[5] You Bet! – Howard Marks – January 13, 2020. Oaktree Capital Management

[6] We know that some do not like to link gambling and investing, and we do recognize the stigma associated with gambling, but in our desire to learn from all disciplines we do believe there is something to be learned from this example. A few well-known investors and authors have also talked about the value of playing and/or writing on games of chance - Edward O. Thorp, Bill

interested in – hopefully in markets that are less efficient – involves all three of the ingredients under discussion: hidden information, luck and skill. Thus it's most like poker and blackjack, not chess."

We think the analogy is relevant to asset allocation as well and believe the words "asset allocation" could be substituted for "blackjack" in the line: *"the key to further improving your probability of winning lies in the fact that, unlike most games of chance, in blackjack the outcomes of future hands aren't independent of the outcomes of past hands."*

What he is talking about is counting cards, a practice that leverages changes in the probability of success as you get more information about what cards have been played. The general premise is that when the concentration of 10s, face cards and aces remaining in the deck is high, the odds of the player winning increase. The higher the true count, the higher the optimal bet. It doesn't mean that you will win the next hand as there is still a high degree of randomness in the short run, but if you follow that model, an increased bet is the value maximizing decision.

In **investing and asset allocation, one can substitute "outcome of past hands" with recent past or initial conditions.** The initial conditions for investing (such as current valuation, last year's performance, or the last 5 years' performance) **do** have a significant impact on future expected returns, and also extremely important, **RISK**.

We recognize that investing is less governed by the mathematical precision of blackjack, but whole-heartedly believe that understanding the past sheds light on which parts of the market are likely to outperform in the future. Looking at pockets of the equity market (US Growth, US Value, US Large, US Small, International Large, and International Small), we see that since the inception of the MSCI EAFE Small Cap index over half of the observations have seen US Growth or International Small Cap as the top performer and over half as the bottom performer.

Their ranking on the list tends to follow a cycle, with US Growth at the top 5 of the last 6 years. The last time US Growth was close to this dominant was in 1996-1999, when it was at the top 3 out of 4 years. Then, over the next 6 years, International Small Cap was the top performer in 4 and was in the top half of all 6 years, while US Growth was dead last in 4 of those 6 years and 5^{th} in the other 2 years. **We believe the initial conditions for International Small Cap Value investing have never been this attractive.**

"Buy when it's cheap – if not then, when?" James Montier[7]

Ranking of Annual Equity Market Returns by Category

2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023
Int Small	US Small	US Growth	Int Small	US Small	US Value	Int Small	US Small	Int Small	US Growth	US Growth	US Growth	US Growth	US Value	US Growth
US Growth	Int Small	US Large	Int Large	US Growth	US Large	US Growth	US Value	US Growth	US Large	US Large	US Large	US Large	Int Large	US Large
Int Large	US Growth	US Value	US Value	US Large	US Growth	US Large	US Large	Int Large	US Value	US Value	US Small	US Value	US Large	Int Large
US Large	US Large	US Small	US Large	US Value	US Small	Int Large	US Growth	US Large	US Small	US Small	Int Small	US Small	US Small	US Small
US Small	US Value	Int Large	US Small	Int Small	Int Large	US Value	Int Small	US Small	Int Large	Int Small	Int Large	Int Large	Int Small	Int Small
US Value	Int Large	Int Small	US Growth	Int Large	Int Small	US Small	Int Large	US Value	Int Small	Int Large	US Value	Int Small	US Growth	US Value

1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
Int Small	Int Small	US Value	US Growth	US Value	US Growth	US Growth	US Value	US Small	Int Small	Int Small	Int Small	Int Small	Int Large	US Growth	US Small
Int Large	Int Large	US Large	US Large	US Large	US Large	Int Large	US Small	US Value	US Value	US Small	Int Large	Int Large	US Value	Int Large	US Value
US Small	US Growth	US Growth	US Value	US Growth	Int Large	US Small	Int Small	Int Small	Int Large	Int Large	US Small	US Value	Int Small	US Large	US Large
US Value	US Large	US Small	US Small	US Small	US Value	US Large	US Large	US Large	US Small	US Value	US Value	US Large	US Small	Int Small	US Growth
US Large	US Small	Int Large	Int Large	Int Large	Int Small	Int Small	Int Large	US Growth	US Large	US Large	US Large	US Growth	US Large	US Value	Int Large
US Growth	US Value	Int Small	Int Small	Int Small	US Small	US Value	US Growth	Int Large	US Growth	US Growth	US Growth	US Small	US Growth	US Small	Int Small

Gross, David Einhorn, Peter Muller, Carl Icahn, Steve Cohen, Ken Griffin, Jim Simons, Boaz Weinstein, Warren Buffett, and Michael Mauboussin to name just a few.

[7] Value Investing James Montier

Is Large Cap Growth investing in the US likely to continue its unprecedented cycle of returns? We do not think so. The tables above tell us something about the frequency of one category of stocks to outperform another on a relative basis, but in investing[8], the probability of winning is not the only thing that matters. The magnitude of the gain or loss[9] matters as well. So, while US Growth looked promising after a period of very good performance in the late 1990s, what happened over the next 5-6 years is that Value and International Small did quite well.

"Geographic diversification can help mitigate volatility in a portfolio. But in the current environment, we also view it as a good opportunity for U.S. investors to achieve higher relative returns, as the drivers of U.S. stock outperformance over the last decade have likely sown the seeds for their underperformance over the coming one." Ian Kresnak, CFA, Vanguard Investment Strategy Analyst[10]

Similarly, we also believe that there is value in international diversification as do top practitioners such as AQR[11]. They also have a viewpoint on implicit assumptions being made to extrapolate a continuation of similar returns over the next decade in Driving-with-the-Rear-View-Mirror.

Next, we will look at the returns to gain a deeper understanding of the true impact of these cyclical changes.

Current Parallels to Late 1990s and Early 2000s

In the first 3 years of this century, from 2000-2002, Jean-Marie Eveillard, legendary global small cap value investor, friend, and mentor to our CIO, outperformed the NASDAQ 100 (a good proxy for US Growth) by over **45% per year** in a long only strategy. **If one had remained in the NASDAQ, they would have lost 73% of their initial capital**. For every $1 invested with Jean-Marie instead of the NADASQ 100, **you ended with nearly 5x more money in just 3 years**. We think that was quite a respectable outcome[12], especially when it came with much lower volatility and no real drawdowns on initial allocation.

What if we choose a less favorable period and go from the beginning of 2000 to the end of 2006 and compare Russell 1000 Growth (R1G) with International Small Caps (ISC)? Staying with R1G vs. moving to ISC would have resulted in losses of 30% vs. a gain of 145**% or a relative loss of 175%, not 175 bps but 17,500 bps, for failing to act!**

Now what if we switched just 2% of our portfolio? That little 2% change would have resulted in a gain on one's portfolio of 3.5% relative to staying the course in Russell 1000 Growth. Said differently, every 1 unit change in a portfolio weight between those two categories resulted in an extra 1.75x terminal wealth in just 7 years, so a 10% change would have added 17.5% to the portfolio value – again with much less risk.

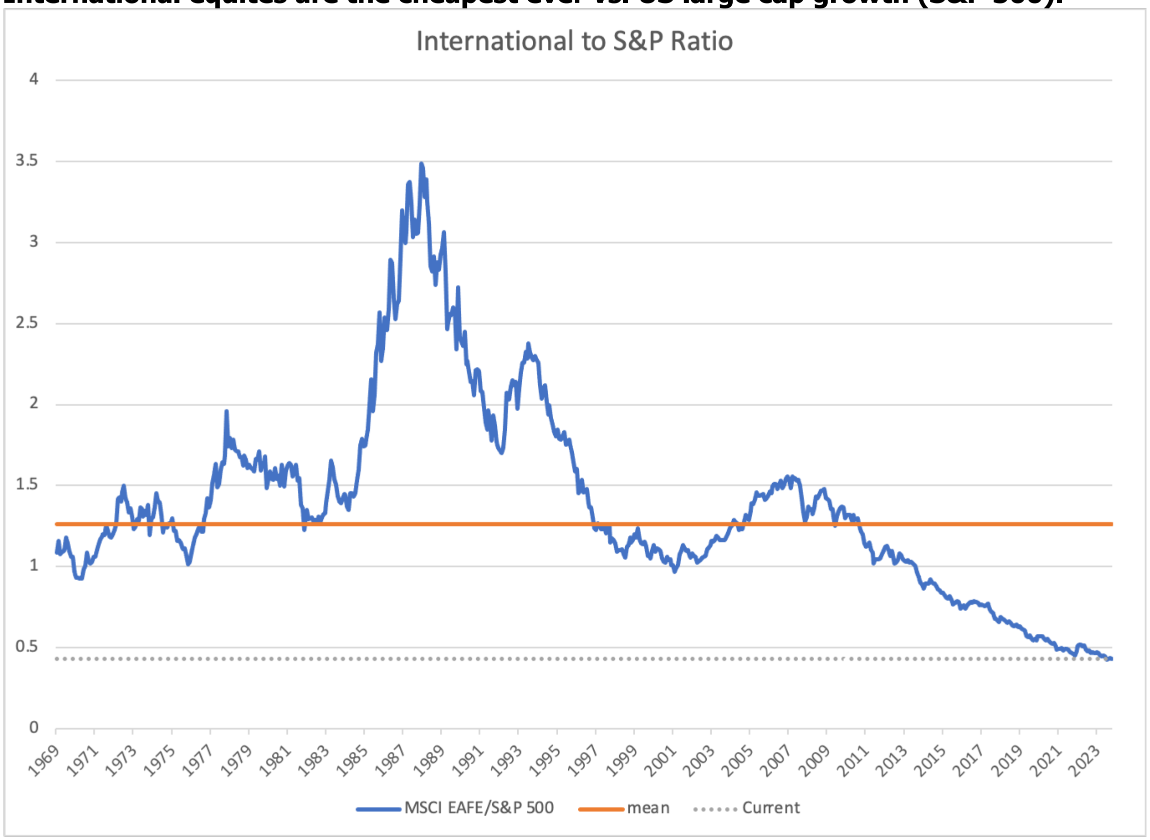
"What the wise doing in the beginning, fools do in the end." Warren Buffett

[8] Or in baseball - batting average; and in insurance - frequency
[9] Or in baseball - slugging percentage; and insurance - severity
[10] Making-case-international-equity-allocations Vanguard, May 2023
[11] International-Diversification-Still-Not-Crazy-after-All-These-Years AQR Insights, May 2023
[12] That's a huge understatement, especially since he was making double digit compounded positive returns while other indices were losing significant amounts annually with a long only portfolio.

What is different today? What follows is a graph showing international stocks relative to the S&P 500. What is most interesting here is that international stocks are **much** cheaper today than they were in the beginning of 2000. **It will take an extra doubling (or about 15% per year over 5 years) just to get back to the starting point.** So those **exceptional returns that Jean-Marie or the index were able to achieve started during a period where international was not nearly as favorable as today**. If a similar scenario were to play out of the next 3-7 years (as per the two examples above), then there is a potential extra 100% return that could come to ISC this time around. Obviously, this would just add to the outperformance of international small cap value vs. US large growth.

We believe that the small cap and value factors are about as cheap as they have been historically and will also contribute to the performance of the space over the coming years[13].

International equites are the cheapest ever vs. US large cap growth (S&P 500).

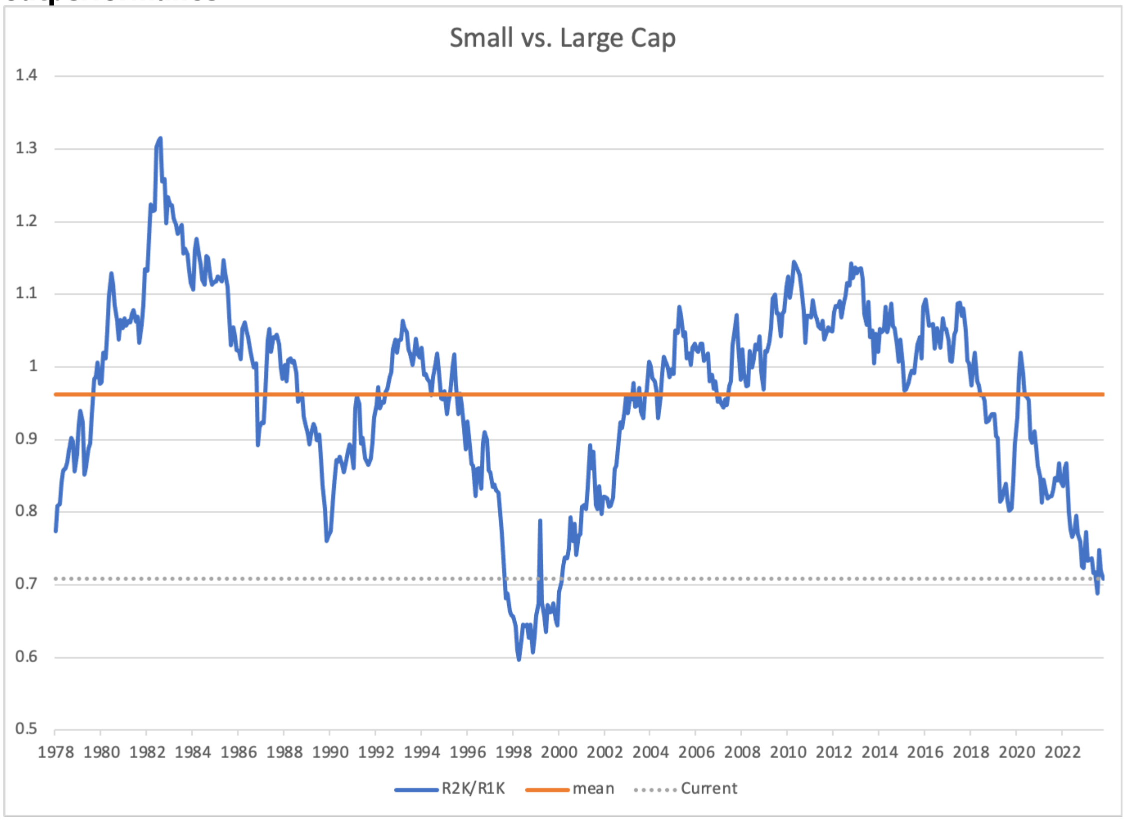


Each time international stocks have rebounded from low valuations since the 1970s, they have overshot the mean and risen at least 1.5x the value of the S&P 500 (which would be a tripling[14] from current levels). Also worthy of note, in the 2 of the 3 of the previous examples the rally from low to peak valuation took 3 years or less. Post the 2000 dot com bubble crash the timeframe from trough to peak was about 6 years.

[13] We would also refer you our 4Q 2022 and 2Q 2023 letters for more details on the history of what happened and likely implications for many years to come.

[14] Which would be nearly 38% per year of outperformance for 5 years.

For international to rebound to its long-term average, international needs to grow nearly 2.75x current levels (assuming the S&P 500 stays flat). **Over five years that would be over 22% per year of outperformance.**



US small[15] caps are close to the cheapest ever relative to large cap. We do think the data is distorted relative to the past (implying that small is actually cheaper than it first appears), due to the following: we believe there are nearly 2x as many stocks trading at > 10x sales, even though there are only about ½ as many public equities today[16] (this is an indicator of wanton speculation prevalent in the market). **Small must outperform large by nearly 5% per year for the next five years to get back to its long-term average.**

[15] We used the US in this example because we do not have data series that extend back 40-50 years in international small cap. We believe the conclusion would be directionally very similar if we were able to have that international time series.

[16] This is for the US market. We see about 410 companies today vs. 225 in early 2000, trading at above 10x EV/Sales. There are about 3,000 US public equities today vs. over 6,000 in 2000.

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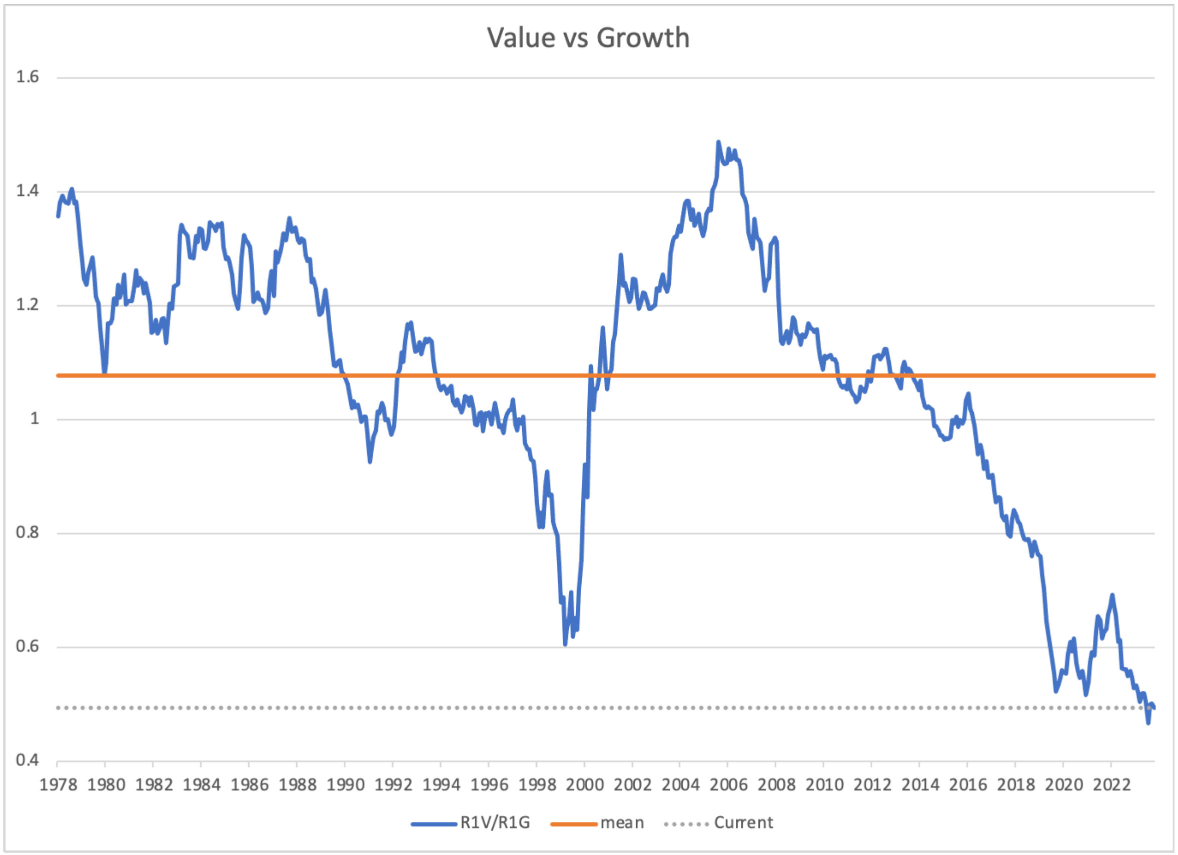

Value remains at unprecedented lows relative to growth over the past 45 years. When the rebound occurred post 2000 peak, it was quick– it took less than 3 years for value to double relative to growth, or a 25% per year compounded alpha. Today, **value would have to compound over 15% per year for five years for value to get back to its long-term average.**

Why Else Might International Small Cap Value Stocks Work Now?

- Relative underperformance cycle is 2nd longest in history dating back to pre-1929.
- When things have been bad over prior 5 years the next 1-5 years typically do well.
- US Small caps are less than 4% of the total market, lowest levels since 1930s.
    - Historical weight nearly 2x larger
    - We are hearing about large allocations coming – flows do matter in small caps
    - The weight nearly doubled from 1999 to 2004 and helped to drive positive returns
- Concentration among mega caps is the greatest ever for R1G for top 10; similar for SPX and NASDAQ 100 – both of which are another risk for large cap growth indices.
- **M&A** – still a large amount of cash on corporate balance sheets, while the number of public companies is down nearly 50% from an all-time high near peak of 2000 bubble.
- **Private Equity** – has trillions of cash too, and they are much more present in international markets than ever before. They recognize the improved opportunities here as well.
- If **USD continues to weaken, it helps international and value.**
- If the **US enters a recession, value tends to do better.**
- **Small caps do better when the Federal Reserve is cutting rates.**
- **Small caps tend to do well in election years.**
- We think that many more global small cap management teams are focused on proper capital allocation than they were in 2000 – another opportunity for value creation.

Mean Reversion

History is ripe with examples of hubris leading to catastrophic outcomes – ask the Romans about Teutoberg Forest, the French about Napoleon's invasion of Russia, and the Americans about the disaster at Little Bighorn.

After 15-year bull market we believe some investors have come away with extreme levels of hubris, having never been tested by adversity. **Lack of experience through cycles has convinced them that their process does not need to consider alternatives.** Recency bias – "extended period of recent" – might lead one to question rebalancing decisions today. Here is where being contrarian can really pay off.

Art of Contrary Thinking

Being contrary just for the sake of doing so is not the way we suggest one operate. We are optimistic at the end of the day. We suggest being contrary for another reason – to achieve success where others do not. We know that its "safe and warmer inside the herd."[17] **You can hide there but that is not the way to superior performance.**

We understand that conventional wisdom is that small caps are a risky asset class. Conventional wisdom isn't always right; in fact, it is always wrong at the turns. Just ask investors who opted to invest in nifty fifty stocks in the 1970s and lost nearly everything[18] (see another Howard Mark's piece we referred to in a previous letter). **Our experience is that exceptional performance is often created by taking a less traveled path – you must be both contrarian and right. You do not get differentiated returns by doing what everyone else does. The bonus of this approach is that you will likely get better returns with LESS risk.**

Arguably the most successful allocator of our time knew that better than anyone. Former Yale CIO, David Swensen's big bet wasn't successful only because private equity returns will always beat public equities – they most certainly will not[19]. **He was also willing to go against the grain and allocate significantly to an asset class poised for long-term outperformance**. Most investors who copied him did much worse. Why? Because they didn't do it until much later and they tiptoed in. By then, competition was greater in the space and there was huge dispersion among managers. **It's important to be early and invest with the best managers (he also did that).**

We believe that the international small cap value space is poised for both exceptional risk adjusted returns and outstanding absolute returns.

Conclusion

[17] Legendary global investor, true gentleman, MAC Alpha Capital Board of Advisors member, and friend, Jean-Marie Eveillard
[18] Actual loss was about 90%. See our December 2022 letter.
[19] Clearly, we believe that this is no longer the case today. His success was aided by a steadily declining rate environment that allowed PE's leverage to amplify returns.

"You should remember that good ideas are rare. When the odds are greatly in your favor, bet heavily." Charlie Munger

We are not suggesting that rebalancing is a binary decision – all or nothing. **It should be more of a continual process; however, given the extremes between the historical returns and expected future returns, an urgency currently exists.** We are saying that if you had an x% exposure to US Large Cap Growth at the beginning of 2023 and were happy with that level of exposure, at a minimum, take some of your gains and rebalance away from what has worked so well – as history suggests that is the way to achieve better returns with less risk. Even better would be to underweight the upside outlier while concurrently overweighting a recent downside outlier with a history of strong long-term returns. Finally, this should be done before everyone else attempts to do the same thing.

Portfolio rebalancing has always been the right decision. To extend Nobel Prize winner Harry Markowitz's comment (from page 1), **REBALANCING ONE'S PORTFOLIO ALLOCATION IS THE SECOND FREE LUNCH IN INVESTING. Rebalancing is even more necessary today** given the magnitude of relative returns we have seen over the past 6 years or so. **Is the potential cost of inaction worth the risk?**

Bibliography & Suggested Reading

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How We Know What Isn't So: The Fallibility of Human Reason in Everyday Life, T. Gilovich
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Judgment Under Uncertainty: Heuristics and Biases, D. Kahneman and A. Tversky
The Most Important Thing Illuminated, H. Marks
More Than You Know, M. Mauboussin
The Success Equation, M. Mauboussin
Think Twice, M. Mauboussin
Value Investing, J. Montier
The Art of Contrary Thinking, H. Neill
Extraordinary Popular delusions and the Madness of Crowds, C. Mackay

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