July 2023 Investor Letter

**Is successfully managing an investment portfolio a skill, or just dumb luck?**

Since my clients have entrusted me with the privilege of partnering with them to grow their family's wealth, I would like to think that it is because of the skill I have achieved during my 37 years on Wall Street. But I am also a little bit lucky with regards to being able to read the tea leaves and understand the trends that appear to repeat themselves throughout market cycles. Sometimes I'd rather be lucky than smart.

In 1973, a Princeton University economist named Burton Malkiel came up with a new portfolio theory called "the efficient markets theory." In his popular investing book, A Random Walk Down Wall Street, Mr. Malkiel argued that if the market is truly efficient and stock prices reflect all factors immediately as soon as they're made public, then a blindfolded monkey throwing darts at a newspaper stock listing should do as well as any investment professional.

And as a matter of fact, this theory was put to the test in 1999 when a chimpanzee named Raven threw darts at the Wall Street Journal's stock pages and selected a "portfolio" of stocks. Raven's portfolio returned 213% that year, more than four times the return of the Dow Jones Industrial Average and better than 6,000 investment professionals in the study!

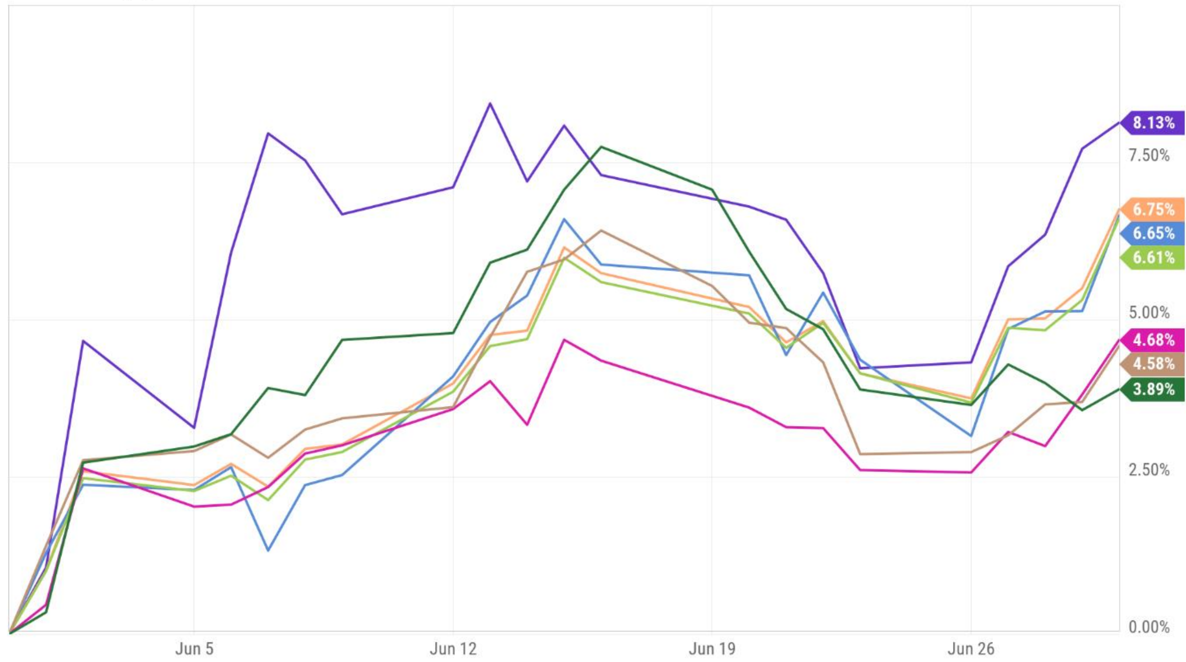
How was a monkey able to outperform the markets? One would immediately guess "luck," but there is more to it than just luck. In a universe of several thousand companies listed on the exchanges and reported daily in the Wall Street Journal, the vast majority of these listings are for smaller companies, not just the "Big Six" mega-caps that we explained in last month's investor letter. As a reminder, a portfolio's returns are a combination of βeta (return explained by just the market), market capitalization (size of the company listed), and the "value" of the underlying earnings stream of said company. The level of these three items in a portfolio gives the portfolio a unique risk profile and return characteristic. The Fama and French Three-Factor Model is an asset pricing model developed in 1992 that expands on the traditional capital asset pricing model

(CAPM) of the present value of the future earnings in relation to the market by adding size risk and value risk factors. This model considers the fact that “value” stocks and small-cap stocks outperform markets on a regular basis. By including these two additional factors, the model adjusts for this outperforming tendency, which is thought to make it a better tool for evaluating investment performance.

The small-cap premium is widely recognized in academia as the extra return expected for taking risk by investing in smaller companies mainly because these smaller companies may not be well known, may not be global, may not be well capitalized, may only have a few products, and may not have large distribution networks for their products. In addition, smaller companies may have to pay more than large companies when borrowing money to operate, so it’s logical that equity investors would expect to earn greater returns relative to larger companies.

So, when a blindfolded monkey is randomly throwing darts at the WSJ stock listings, more often than not he will hit small-cap value companies, and a lot of these smaller companies when building out his “portfolio.” And over time these smaller companies with their increased premia have proven to outperform the overall market.

This is just one of the many reasons why we have recently increased our exposure to small-cap value focused ETFs in our portfolios. I am not going to be caught trading like a monkey and throwing darts at the WSJ to pick individual stock names for our portfolios, but rather owning liquid ETFs that track the Russell 2000 which create a portfolio of these small-cap value stocks to better participate in this sector’s historical outperformance. As the chart below shows, June 2023 seems to be the start of this outperformance.



As always, thank you for partnering with me and Double Eagle Partners. If you have any comments, questions, or concerns, please do not hesitate to give me a call.

Regards,

Jim Claire