MAINSTAY CAPITAL MANAGEMENT LLC

The Case for Increased Exposure in Small Cap Stocks
(June 17, 2018)

On February 9th we sent a communication providing some perspective on the stock market's pullback. If you remember at the time, the stock market had just completed a 10.1% correction from January 26th through February 8th. In fact, it was the 10% correction that we were quoted on calling for in January on Bloomberg TV.

In this February 9th communication we stated that the pullback was a "normal and overdue correction, not the start of a new bear market for stocks." That the "underlying fundamentals for stocks as described are just too compelling and positive for a significant downturn in stocks right now." We continued to re-iterate through February and March that it was a "correction and only a correction" in an ongoing bull market, even as the doomsayers came out of their bear dens to proclaim this was the start of a much more severe 30% or 40% decline for stocks.

It's now mid-June, and the stock market did not decline any further than the initial 10.1%. Indeed, it recovered and NASDAQ Composite and Russell 2000, among other indexes have already moved on to setting new highs. So much for market calls made by the doomsayers back in February and March.

One area of particular interest that I would like to point out at this time, though, are the opportunities that we have realized in small cap stocks in our client portfolios this year. We have significantly increased exposure to small company stocks in client portfolios in 2018. We saw the opportunity in small cap stocks as two-fold.

First, we knew that tax reform would be a tail wind for company earnings and correspondingly stock prices in 2018. The companies that stood to benefit the most however, were small companies, as their tax burden would be reduced an average of 35% through tax reform. A savings in corporate tax is a savings that flows right through to bottom line "after-tax" earnings.

Second, was the onset of tariffs and potential global trade wars in 2018. Large company, multi-national conglomerates are sure to lose, on average, with tariffs and trade wars. Small companies, however, tend to be more domestically oriented, both for their supply chain and sales. Therefore, in this tariff and trade war climate the win goes to small versus large cap stocks.

Indeed, since the first announcement of tariffs, small cap positions held in our GM, Ford, and other company retirement savings plan managed accounts, as well as those held in our IRA and non-retirement accounts have performed nicely compared to the S&P 500, Dow Jones Industrial Average, and other large cap stock indexes. For example, the small/mid cap index funds in GM, Ford, and other 401(k) plans have gained 8% since tariffs were first announced in mid-February. FIAM Small Cap Core, held in GM accounts, has gained 9%. Our anchor holding for small cap exposure in IRA and non-retirement accounts, Virtus KAR Small Cap Growth Fund, has gained 18% over this period. The S&P 500 Index by comparison has gained only 2% since mid-February when tariffs were first announced and the Dow Jones Industrial Average has declined. Please review the chart of various fund performance over this period.

Small caps started 2018 with valuations at their lowest level relative to large cap stocks since 2009. Strong fundamentals and attractive valuations made small caps an opportunity not to be passed up. And, we think the strength in small cap stocks continues. In May, U.S. small business optimism hit a 34-year high!

This report is another example of our tactical asset allocation process in practice. And, this tactical move to an increased exposure in small cap stocks has paid off nicely for our client portfolios.