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Second Quarter 2024 Commentary

Dear Clients,

Please find enclosed your Second Quarter 2024 Investment Reports.

U.S. Large Cap Stocks produced another strong quarter, up 5.8%. However, U.S. Mid Cap Stocks (-2.7%) and U.S. Small Cap Stocks (-4.1%) both declined for the quarter. International stocks also produced a mixed experience, with Developed International Stocks returning a -0.4%, while Emerging Market Stocks produced a strong 5.0%. U.S. Bonds were essentially flat for the quarter, while a continued strengthening of the U.S. Dollar against global currencies pushed global bonds to a -1.1% for the quarter.

Benchmark Returns

	Last Quarter	Last Twelve Months	Last Five Years (annualized)
U.S. Large Cap Stocks	5.8%	27.7%	16.1%
U.S. Mid Cap Stocks	-2.7%	11.8%	9.4%
U.S. Small Cap Stocks	-4.1%	11.4%	8.4%
Developed International Stocks	-0.4%	11.5%	6.5%
Emerging Market Stocks	5.0%	12.5%	3.1%
U.S. Bonds	0.1%	2.6%	-0.2%
Global Bonds	-1.1%	0.9%	-2.0%

Data source: YCharts (get.ycharts.com/disclosure/). Past performance does not guarantee future results. It is not possible to invest directly in an index. Last five years data is annualized. Indexes in table are:
US Large Cap Stocks: CRSP US Mega Cap TR
US Mid Cap Stocks: CRSP US Mid Cap TR
US Small Cap Stocks: CRSP US Small Cap TR
Developed International Stocks: MSCI EAFE NTR
Emerging Market Stocks: MSCI Emerging Markets NTR
US Bonds: Bloomberg US Aggregate TR
Global Bonds: Bloomberg Global Aggregate TR

The season of U.S. elections is upon us, a bit earlier than usual with a pre-July Presidential debate. Democratic elections by their nature allow for multiple future paths, and because markets ordinarily do not like uncertainty, we would not be surprised to see a rise in market volatility as we head from here to November. However, we would remind clients not to overly conflate political results with portfolio results. The forces that drive market outcomes are multifactorial and there is no well-established statistical link between short-term market performance and U.S. election outcomes.

An example of an economic factor that does drive markets is inflation. However, inflation's place as the top financial news headline has been slipping. The June annual inflation rate was recently reported as 3%, still above the Federal Reserve's target of 2%, but well below the staggering 8%+ annualized rate of two years ago that captured the market's attention and resulted in the multi-year poor performance of longer-term bonds.

In inflation's place, top financial news headlines have been recently dominated by the performance of Nvidia, the chip manufacturer that has benefited from the boom in investment in Artificial Intelligence ("AI"). During the second quarter, Nvidia briefly became the largest company in the world by market capitalization (which is measured as the aggregate value of all outstanding shares of its stock), surpassing both Apple and Microsoft this June. We do not want to use this newsletter to add more ink to the debate about Nvidia's valuation. However, we do want to use the topic of this stock's ascendancy to prompt a broader thought exercise.

If you laid out a chart (histogram) that stacked dots on the y-axis for each U.S. stock that was ever listed on a major stock exchange, and located that dot on an x-axis based on the lifetime return of that stock, what would that chart look like?

Would it surprise you to learn that the majority of U.S. stocks would be located to the left of money market fund

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performance on the x-axis? The chart would have a bell-shaped lump (i.e., lots of dots) in the middle of the x-axis that is centered slightly below the average return of money market funds. Yet there would also be a "tail" of dots that extends far to the right (a right "skew" to the distribution in statistical terms). This positive skew exists because companies like Nvidia, Microsoft, and Apple have produced outsized returns. In other words, in the United States stock market data at least, there are a few companies that generate fabulous returns, whereas many produce middling returns. This result likely matches your personal intuition.

However, we all know of a historically successful company that eventually closed its doors, replaced by an upstart appealing to new tastes or deploying new technology. In fact, if you only invested in the largest 10% of stocks in the 1920s (the then far-right "successful" dots on the x-axis), and repeatedly rebalanced to the largest 10% of stocks each June thereafter, you would have about 40% less money today than if you had simply bought all stocks. *Only* buying the current economic winners has historically been a shaky long-term strategy.

The economist Joseph Schumpeter famously wrote about this "changing of the guard" phenomenon in his 1942 book titled *Capitalism, Socialism, and Democracy*. His book covers a range of topics than we do not have time for in this letter, but in it, he popularized the term "creative destruction." He wrote "Capitalism … by nature … incessantly revolutionizes the economic structure from within, incessantly destroying the old one, incessantly creating a new one. This process of creative destruction is the essential fact about capitalism." Indeed, one could argue that Americans have culturally embraced creative destruction as an economic process more than most (in other words, American consumers have been accepting of that fact that new companies will replace old ones). Evidence of creative destruction also exists in the timeline of the stock market; a few new companies become stars, often at the expense of yesterday's winners.

So why not just pick the next great winners? Well, like picking the next great rock star, restaurant, or clothing trend, it is a daunting task among so many new entrants, all eager to make their mark. This is where diversification comes into the conversation. If there is a high bar to predict which stock will become tomorrow's leader, and you know most will not, it makes instinctive sense not to put all your eggs in one basket. The curious thing about such a cautionary truism is that most of us will quickly nod with acceptance upon hearing it and move on. However, with an extra moment of reflection, we can more deeply appreciate that the egg idiom teaches us that diversification does not create additional upside; rather diversification's benefit is in protecting downside. If you put your eggs in two baskets, and your foolhardy friend puts all their eggs in one basket, the best you can do is show up at your destination with the same number of eggs as your undiversified friend.

Diversification is tough medicine because as humans, we cannot help but compare ourselves to the rare single egg basket traveler who completes their journey without dropping their single basket. Envy of the concentrated risk taker who reaches their journey's end unscathed is equivalent to saying, after the journey, that you wished you had only put your eggs into the baskets that were not dropped. Who has such clairvoyance? The diversified traveler must accept before the journey that they will always have a basket they wished they had filled with more eggs, and a basket they wished they had not carried.

Recall that earlier we said that the distribution of *each* stock's performance put most stocks (more than half) below the performance of money market funds. That is a lot of dropped eggs. However, we can also ask: what is the distribution of *all* stocks combined? The performance of this diversified outcome is decidedly positive, easily outpacing money market funds and all but a very few, very lucky single basket travelers.

As always, we remain grateful for your trust.

Leavell Investment Management, Inc.