Tom Mullooly: I see these comments on social media where it's like this market's being held up by just a couple of names, and I'm thinking to myself we've seen this before, this has happened many times.

Brendan Mullooly: Wait, so you mean that small stocks and large stocks cyclically take turns leading the way? I just think that people get caught up, everybody turns into a technician seemingly when we go through this phase of the markets where large cap is working better than small cap, and they're all like well, breadth is very bad, and two or three other times this has led to some of the biggest crashes you'll remember.

Tom Mullooly: Oh my goodness.

Brendan Mullooly: What they neglect to tell you is that the other 50 times it didn't matter.

Tom Mullooly: It did not matter. That's right.

Brendan Mullooly: So I'm not saying ... Pay attention, of course, and that's neat that it did that that one time, but are you really willing to do anything drastic as a result of that?

Tom Mullooly: Yeah.

Brendan Mullooly: Preemptively, I don't think so.

Tom Mullooly: Crusty old guys like me will see references to the nifty 50 from the 1960s and into the 1970s, and invariably someone like Hamtil will raise the name Polaroid, and some of these Avon products and some of these other ones that were just the only things that were working. There's been lots of times, lots of times where you get a handful of stocks that generate all the return. All of it. And if you're not in those stocks, you're having a hard time making money.

Well, so but I think the people who get upset during these time periods are the ones that are obsessed with making sure that their portfolio is in what is working 100% of the time, which is impossible. Just to give you some context, since the second quarter of this year through today, small caps, the small cap 600 index is up 1% while the S&P is up 16%. So second quarter, third quarter, and now what we've seen. But from the beginning of the fourth quarter of 2020 through the end of the first quarter of this year, small caps were up 53% and the S&P was up 18%. And during that period of time, nobody was talking about there's only a handful of stocks leading the way, but we were just before that, and then you got half a year of 40% out performance from small stocks. And so if you weren't so worried before that about being all in on the ten stocks that were carrying the market and you remained exposed to the rest of the stocks and just waited for them to have their turn, which they did, you were fine.

Tom Mullooly: I think the bigger problem, and this probably ties in nicely with your video from this week is that if we were to go back in time to May or June, we would see headlines about how great small caps are.

Brendan Mullooly: Yeah.

Tom Mullooly: Right now. And people would pile in or overweight their accounts in small cap stocks and sit around and collect 1% while the S&P large cap stocks are taking off.

Brendan Mullooly: Right. So if you're trying to play the timing game between these two, I think you're going to have a bad time. That's my message.

Casey Mullooly: So I just want to refresh your guys' memory. In early September of this year, we had a discussion about how the S&P 500 hit an all time high in eight straight months, and it had only done that in one other year, which I think was 2017. But the message from that was like you said, breadth was bad, only a couple of big names leading the way, and then in September we got dun, dun, dun, a 5% dip in the S&P. Barely anything. It felt bad because the stock market seemingly hadn't gone down in forever, but yeah, we got a little 5% dip, and then the very next conversation we had was about the behavior gap because Morningstar put out that study about how the average investor under performs the funds they own by 1.7%, which is what I hit on in this week's video. I talked about ARC and how literally it shot the lights out last year, everyone piled in, and then this year it's down 25% when it's benchmark, the S&P is up 25%.

Brendan Mullooly: I will say one thing about small and large stock performance toggling is that at least to me it seems like the periods of time when small stocks are doing well, breadth is good in the market. It's usually the case, I guess, that large stocks are participating too, just not to the same degree. However, the reverse does not seem to be as true and it can feel bad to be especially a diversified investor or I suppose, a concentrated one like arc, if you're just in the wrong stuff.

Brendan Mullooly: Meaning like, if we're in one of these periods of time where large cap stocks are really leading the way and small caps have done nothing, the average might be that small cap stocks have made 1% over a six month period of time, but that doesn't speak to necessarily the individual names under the hood of that. And I think that especially this year, we've seen it with some popular names and things like what ARC invests in, hot stocks from last year that are smaller midcap names just getting absolutely eviscerated. So if you're in specifically those stocks then it's going to feel worse, and especially because large cap stocks are doing fine. So you look at the indexes and you say what the heck is going on?

Tom Mullooly: I think that is the conversation that advisors need to be prepared to have with clients because clients will be at home watching TV and they'll see the Dow is at or close to record highs, and then they rip open their statements and they see, "I'm losing money. I'm actually losing money. How could that be? My advisor is terrible." And that may not be the case.

Brendan Mullooly: It isn't the case.

Tom Mullooly: Yeah, so it really comes down to having a conversation between client and advisor about how this money ought to be invested and what to expect. That's such a big part of the relationship between advisor and client is knowing what to expect. So being in the right sector or the right side of the market every single time, like we started this conversation, 100% of the time, it's not possible.

Brendan Mullooly: I think what investors want is a smoother ride, and so sure, if you want to be at an all time high every time the market is at an all time high, then you can just own the S&P 500 and ride it out, but I don't think that virtually anybody is actually cut out for doing that. And so what you do instead is you diversify and you own some different things that are all going to return over time probably about the same ... Have about the same performance over time, but they're going to take different paths to get there. Meaning that if you own some small and large caps just at a super simple level, when the S&P goes nowhere for six months and small caps are up 50%, you're not going nowhere for six months.

Tom Mullooly: Right.

Brendan Mullooly: You're you're going somewhere.

Tom Mullooly: Yeah.

Brendan Mullooly: And on the other side of that, when the large caps are up and the small caps are lagging, you're going somewhere but you're not going there as fast as you might have been if you were only in the large cap. However, that's kind of the price you pay for a smoother ride. You're almost certainly always going to be ticked off at something in the portfolio because they can't all be in first place. And you're less likely to have a catastrophic loss as a result of doing it, which is another thing that most people like to avoid with their investments.

Casey Mullooly: Yeah, I think that's a good point too because I was thinking another conversation that I think we have regularly, especially when we have headlines like this where it's just the ten biggest names are pulling the market. We get calls that are like, "Well, why don't we just own those names? I want to put my money into those names." And I think it's important as advisors that we communicate that you do own those names. You own them through the funds like for the S&P 500. You own the biggest names that are out there. You own the biggest companies.

Casey Mullooly: I think I saw a statistic this past week about how Vanguard's total stock market index, which is like the biggest index fund in the world is about ... I think it was like $1.9 trillion in assets, which accounted for like just under 3% of the entire market. That's just an extreme example, but it's like you own Apple, Amazon, et cetera through your index funds so you are getting exposure to those names.

Brendan Mullooly: It also probably behooves you to look at what the biggest stocks leading the way have done historically in terms of moving forward from there, like the ones that are there today weren't there five years ago, ten years ago. These names have changed, and so if you want to pile into all those names individually, you also have to be prepared to pull the plug when the time is right, and if you do that via you have something like a mutual fund or an ETF instead, it's taken care of for you. Because I think pulling the plug on darling stocks like that is easier said than done.

Brendan Mullooly: So having it done for you via an index fund or an ETF is just going to be a lot easier than trying to pile in and then make the right call on the way out. Because you can look at these stocks individually, if you want to go along for the ride with the biggest winners over time, you're also going to have to sit through 50 plus percent draw downs on the way to get there, and I just don't think that the average investor is going to do that.

Casey Mullooly: Yeah.

Brendan Mullooly: Nor do they need to.

Casey Mullooly: I think we ... Again, we did a podcast on how the names in the S&P 500, the top ten names in the S&P 500 changed over the last 50 years, and I think it was in 2005, AIG was like the fifth biggest company in the S&P 500, and fifteen years later, it's ...

Brendan Mullooly: It's not.

Tom Mullooly: It's gone.

Tom Mullooly: Twenty years ago, the number seven company in the S&P 500, the seventh largest company in the S&P 500 was Enron, which I mean was ... That was like Labor Day, and it was gone by Christmas.

Brendan Mullooly: Or you look at GE, another example. Do you think there's something to the idea that we get caught up more in the periods of time when large cap stocks are ... So large cap stocks are leading, right? And we're talking about the ten biggest names or the five biggest names that are propping the market up or whatever, but that's how market capitalization indexes like the S&P 500 work.

Tom Mullooly: Yeah.

Brendan Mullooly: And so do you think that we get caught up in those periods of time because it's so tangible, because you can point to market cap weighted names that are in the large cap space that are just behemoths that we all recognize? It's very easy to identify these companies, we're all familiar with them. But when small caps are leading, it's just like oh, it's just small caps. There's no names to latch onto. What's the hottest name in the S&P 600 index? You might be able to name like ten stocks from that 600 list if you're a regular person.

Tom Mullooly: Technically, at one point all of these companies were small caps.

Brendan Mullooly: Yeah, yeah.

Tom Mullooly: And then they became large cap.

Brendan Mullooly: Right.

Tom Mullooly: I mean, think about what did we do before 1986, before Microsoft went public? I mean, we must have been like the cave people. We had nothing to go on and now look at it. I'm being sarcastic but growth was described differently in each decade going back. In the nineties, growth was described differently. That was a lot of cable, internet, telephony. A lot of all of those things were going crazy. In the 1980s, it was biotech and mergers. In the seventies, we had the Nifty 50, these were industrial companies and other direct to consumer type companies, [inaudible 00:12:42], Kodak, Avon, things like that. So in every decade we have a different, I don't want to call it a theme, but it just seems like there's different drivers and the economy changes all the time.

Brendan Mullooly: I don't know that I necessarily buy that they're the driver. I get that that's the story that we're all being pitched on, I just think it's a real easy one to digest and we're all very willing to accept it, but you can look through history and small and large cap stocks have both done well. Actually, if you look over history, you've been more rewarded for investing in small cap stocks because they're more volatile.

Brendan Mullooly: And so I just think we get really caught up in these periods where it's just ... There's no headline to write that just says, "Hey, guess what? Small and large cap stocks are cyclical, and they're going to ebb and flow over time in terms of what you would prefer to own, if you want to be in the best one." That's not a headline, but it is a headline to be like if you're not in these five stocks, you're not making any money, and it gets people all riled up and we don't need to be riled up. It's just normal market activity.

Casey Mullooly: I think there's some element too of, like you said, the story that we're being pitched about these companies. There's somehow an element of how it shouldn't be this way, that the top five or ten names are the ones that are "pulling the market". Like that's somehow wrong because I think with investing there's this belief that it should be hard and that you should have to dig through the weeds and pull out small cap company names that are going to ...

Tom Mullooly: Uncover hidden gems.

Casey Mullooly: Right. Yeah. But it's just like yeah, so what if this is what's happening and what's performing best. It's like okay.

Brendan Mullooly: The so what though is that people will say that it seems fragile that only ... That our fate is basically in the hands of five or ten companies is the message that's being pushed here. I'm not saying I believe it. So I think this is what people are being led to believe is that this is fragile and that a couple times you look back through history and this has been the harbinger of all of your favorite market crashes, if you want to go through the highlight reel of circle this, circle that, circle this.

Casey Mullooly: Yeah.

Brendan Mullooly: Do you know what those three circles are? It's 2008, 2000.

Casey Mullooly:
Yeah. But I think that ...

Brendan Mullooly: 1972.

Casey Mullooly: ... the whole point of people saying that is to make themselves sound smart.