Playing Catch Up?

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An unlimited number of strategies can be used for investing in the stock market. Some choose a strategy that consists of several stocks that are grouped based on similar characteristics such as market capitalization or style. The history of the stock market going back to 1926 provides many examples of groups of stocks and how they perform over time. The groups with the longest time horizon include different market capitalizations of stocks. Such basic groupings include large-, mid- and small-capitalization stocks. Then there are groupings by style such as growth, value, and blend in addition to sectors such as industrials and utilities and so on. For long-term investors, the trends of these groups of stocks can have an important impact on the design, management, and potential return on those portfolios.

The volatility of returns of these strategies is the greatest over the short term. For a variety of reasons, this volatility cannot be accurately anticipated so decisions based on brief periods can result in underperformance. For those who understand the potential of these short-term periods of volatility, an important principle that investors have relied on to keep their portfolios on track is a concept known as "return to the mean." This theory implies that various broad market strategies that have established a record of long-term returns have a mean or average return. When there is a wide divergence between the mean and the recent price performance of that strategy, believers in the return to the mean theory have confidence in the likelihood that the price movement of that strategy will move the strategy's value back to the long-term mean return.

For investors who believe in this strategy and utilize a dollar-cost averaging tactic where periodic investments contribute to portfolio value, the return to the mean theory makes sense as those periodic investments acquire more shares during divergence from the mean on the downside and fewer shares when the value of the securities is above the mean. The volatility of the stock market during the pandemic provides ample evidence that investors who hung in there benefited from the return to the mean strategy and the dollar cost averaging investment tactic.

Over the last year, a few large growth stocks dominated stock market returns while many other groups fell behind. Utilities were one group that took a major beating in 2023 and bounced back dramatically in 2024. Mid-cap stocks also experienced a strong rebound over the past year, leaving small-cap stocks in the rear. On the other hand, some of the well-respected big-cap stocks (otherwise known as the "Magnificent Seven" named after the cowboy movie of the same name), have lost momentum this year. This group of stocks is now referred to as the "Fab Four" since three of the names have fallen out of favor much like the outcome of the magnificent seven in the movie where only three of the gunslingers survived. Let's see how many of the 2023 market winners complete the trip back to their mean return.