

# December 2023

Two of our favorite quotes from this year:

“Economic models of the future are perhaps best understood as astrology faintly decorated with calculus equations.” - Derek Thomson

“Too many voters today are easily conned, deeply biased, impervious to fact and bereft of survival instincts. Contrary to myth, frogs leap out of heating pots. Stampeded cattle stop at a cliff edge. Lemmings don’t really commit mass suicide. We’ll find out about Americans in 2024.” - Mort Rosenblum

From Bloomberg's Evening Briefing on Friday:

All across Wall Street, on equities desks and bond desks, at giant firms and niche outfits, the mood was glum. It was the end of 2022 and everyone seemed to be planning for the recession they were convinced was coming. The biggest names at the biggest firms were predicting the S&P 500 Index was about to tumble and telling clients to prepare for a plunge in Treasury bond yields. Some strategists were talking up Chinese assets after Beijing’s sudden end to Covid-19 precautions. Together, these three calls—sell US stocks, buy Treasuries, buy Chinese stocks—formed the consensus view on Wall Street. Then came 2023. “I’ve never seen the consensus as wrong,” said Andrew Pease, the chief investment strategist at Russell Investments, which oversees around \$290 billion in assets. “When I look at the sell side, everyone got burned.”

From the front page of last weekend's WSJ:

## **Market Forecasts Missed Mark In 2023**

### U. S. stocks end a topsy-turvy year near records despite bearish predictions

BY GUNJAN BANERJI

Almost no one thought 2023 would be a blockbuster year for stocks. They could hardly have been more wrong.

The Federal Reserve raised interest rates at the fastest clip since the 1980s, a regional banking crisis felled Silicon Valley Bank and war broke out in the Middle East. Yet stocks kept climbing.

The S&P 500 finished the year up 24%, just 0.6% from its January 2022 record. The Dow Jones Industrial Average advanced 14% to top 37000 for the first time and set seven record closes in the final days of 2023. A mania surrounding artificial intelligence and big technology stocks sent the Nasdaq Composite soaring 43%, its best year since 2020.

It is a far cry from the doom and gloom many were bracing for at the start of 2023.

A year ago, everyone ... was calling for a recession. Instead, inflation continued falling, consumers kept spending and the unemployment rate fell to 3.4%, the lowest level since 1969.

In one of the biggest surprises of all, higher bond yields didn't turn out to be the boogeyman that many money managers feared. A historic bond rout—which drove 10-year Treasury yields to 5% in October for the first time in 16 years—sparked a stretch of stock volatility, but didn't stymie the rally for long.

Wall Street finally conceded that TINA, or the notion that “there is no alternative to stocks,” was over when a record torrent of cash flooded into money-market funds, the hottest investment of the year. Stocks found a second wind when bond yields pulled back: The 10-year Treasury yield ended the year at 3.860%, while the 2-year Treasury notched its biggest yearly decline since 2020, settling at 4.248%.

“When everybody's on the same side of the boat, it is time to look to the other side,” said veteran investor Leon Cooperman, founder of Omega Advisors. Cooperman said he didn't anticipate the big gains in stocks, particularly among the technology behemoths that drove much of the S& P 500's advance.

“I'll be the first to admit, the stock market exceeded my expectations,” Cooperman said.

Some investors say the strength shows that market moves often don't align with scary situations around the globe.

The war between Russia and Ukraine entered its second year and an attack on Israel by Hamas launched a war in the Middle East. The impact on markets was limited, and Brent crude futures ended the year down 10% at \$77.04 a barrel, the biggest annual fall since 2020.

Of course, 2023 wasn't without turmoil. Soaring interest rates caught a number of regional banks flat-footed. At Silicon Valley Bank, deposits and the value of its bond portfolio fell sharply, eventually triggering a bank run and evoking memories of the global financial crisis more than a decade ago. First Republic Bank and other lenders also collapsed. Bank stocks swung wildly.

The crisis left investors on edge that something else was sure to break in the financial system. The Fed, however, quickly shored up confidence when it said depositors wouldn't lose the money they had stashed away at the lenders, stemming bank runs and averting the risk of a deeper catastrophe.

“When the Fed tightens policy that quickly, something will break,” said Steve Brown, a chief investment officer at Guggenheim Investments. “Something did break, but they fixed it really quickly.”

Brown says he, too, expected a recession going into 2023 and was surprised by how many Americans weren't especially sensitive to the bruising pace of interest-rate increases. They opened their wallets for everything from Taylor Swift tickets to flights and restaurants. And profits started growing again at the biggest U.S. companies after three quarters of declines.

To be sure, many investors say it is premature to declare the Fed has pulled off a soft landing. Some investors are predicting a downturn in 2024, cautioning that it takes time for rate increases to ripple through the economy. In the past 11 Fed rate-hiking cycles, recessions have typically started about two years after the central bank begins raising interest rates, according to Deutsche Bank. This hiking cycle started in March 2022.

Others remain on edge, feeling it is too early to declare victory over inflation. Interest-rate futures suggest rates will fall more than a percentage point by the end of 2024. Whether the central bank will have to slash rates because of a recession or whether it will be able to avert a downturn remains a point of debate.

Some strategists warn that investors' extreme optimism about the economy and markets is itself a cause of concern. About two-thirds of investors recently polled by Bank of America are expecting a soft landing, an about-face from the start of the year.

Goldman Sachs Group analysts, who correctly predicted that the economy wouldn't enter a recession in 2023, said they expect the S&P 500 to end 2024 at 5100, around a 7% jump from current levels.

But if investors have learned anything from 2023, it is the difficulty of making accurate predictions about the market's next turn.

Few anticipated that a mania over artificial intelligence would help power stocks to new heights. A blockbuster earnings report from Nvidia in May crowned the graphics-chip maker as the stock market's next star and launched a frenzy around AI that persisted for much of 2023.

The enthusiasm propelled tech shares higher, helping mask poor performance in other corners of the market. Nvidia more than tripled to lead the S&P 500. The Magnificent Seven replaced FANG (or FAANG) as the favored nickname for the market's leaders. Nvidia, Apple, Microsoft, Alphabet, Amazon.com, Tesla and Meta Platforms swelled to represent about 30% of the S&P 500's market value and were responsible for much of its 2023 gains.

That left some strategists concerned about the narrow rally and the valuations commanded by those stocks.

Yet in the final weeks of the year, euphoria set in when the Fed indicated it would likely shift to trimming interest rates, rather than raising them.

An "everything rally" pushed up prices of assets—from gold to bitcoin to risky corporate bonds and investments in far-reaching corners of the stock market. Bitcoin prices more than doubled. The S&P 500 is ending the year on a nine-week winning streak, its longest such rally since January 2004.

From the NYT:

## **MORE THAN WORDS: 10 9 CHARTS THAT DEFINED 2023**

**By Steve Rattner**

**Graphics by Taylor Maggiacomo**

Mr. Rattner served as counselor to the Treasury secretary in the Obama administration.

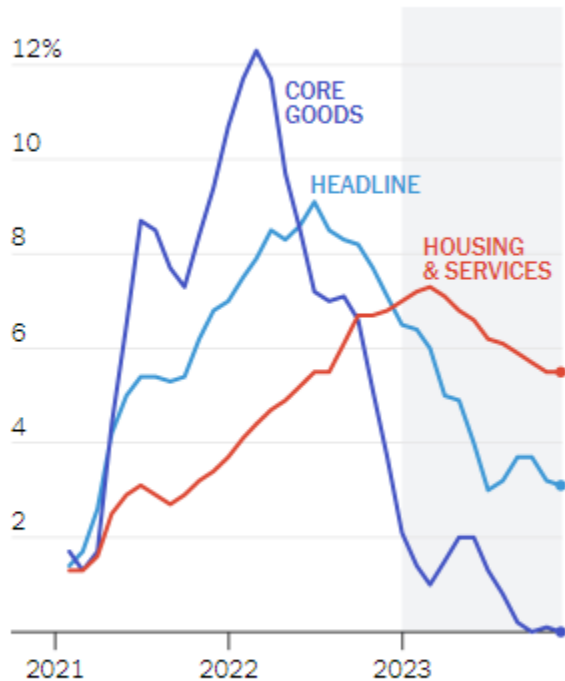
Dec. 28, 2023

Some years are defined by a single event or person — a pandemic, a recession, an insurrection — while others are buffeted by a series of disparate forces. Such was 2023. The economy and inflation remained front of mind until the war in Gaza grabbed headlines and the world's attention — all while Donald Trump's candidacy loomed in the background.

# 1. Inflation Fell, Incomes Rose

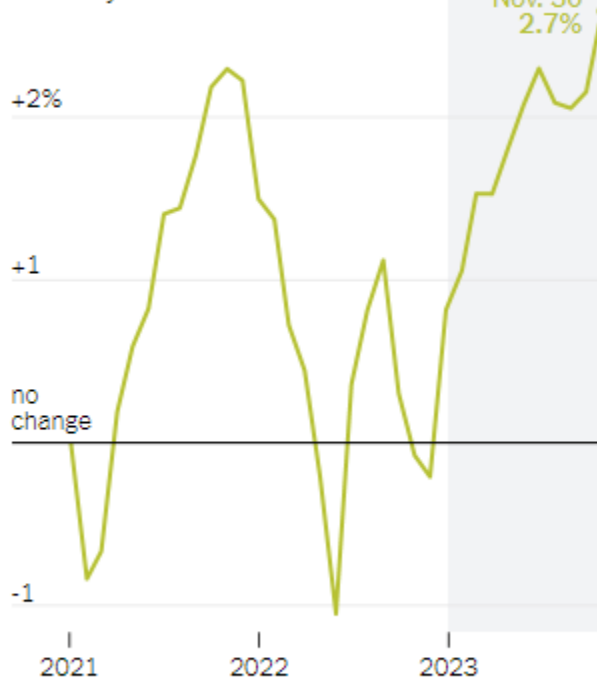
## Inflation

Year-over-year change in the Consumer Price Index



## Inflation-adjusted labor income

Real incomes, indexed to January 2021



Sources: Bureau of Labor Statistics, Bureau of Economic Analysis - Note: Inflation and income data through November; Real income refers to wage and salary income per capita, adjusted for inflation using the Consumer Price Index.

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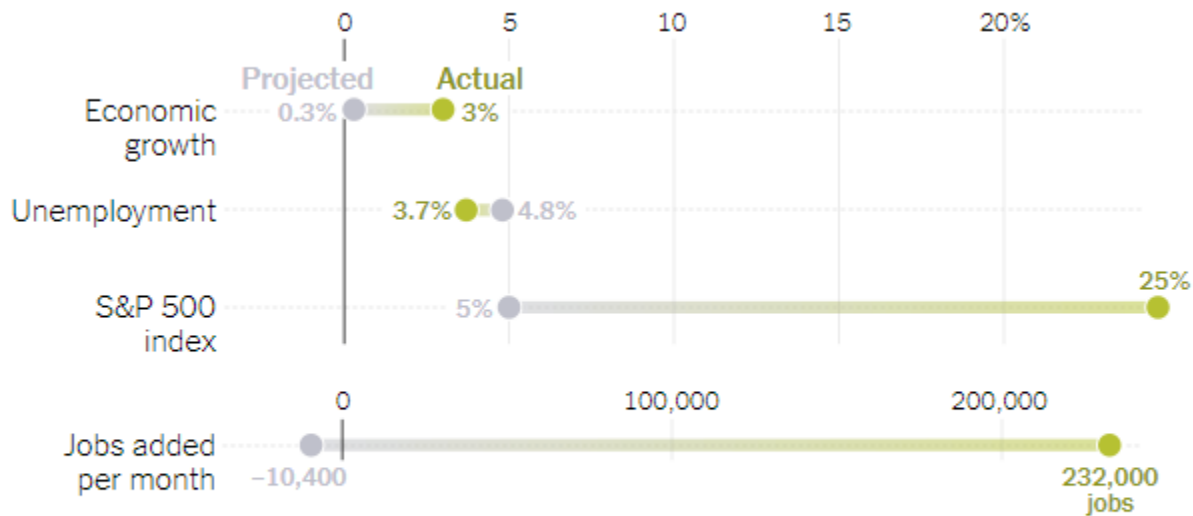
Americans still fretted about rising prices, even as inflation subsided significantly. In fact, the prices of some goods actually fell. Gasoline dropped to an average of \$3.12 a gallon from a high of \$5.02 a gallon in June 2022.

This was not enough to soothe most Americans, many of whom believed their purchasing power was still eroding. Few appreciated that their inflation-adjusted (“real”) incomes rose in 2023 as inflation fell close to the Federal Reserve’s target of 2 percent.

By November, real incomes were 2.7 percent above their January 2021 levels. Moreover, inequality narrowed as those at the bottom saw their wages rise faster than those at the top.

## 2. The Economy Exceeded Expectations

### What Experts Thought Would Happen vs. What Actually Happened



Sources: Bureau of Labor Statistics, Bureau of Economic Analysis, Atlanta Fed GDPNow, Bloomberg, Wall Street Journal Economic Forecasting Survey - Note: The 2023 G.D.P. figure is constructed using the first three quarters of real data, along with the Atlanta Fed GDPNow estimate for the fourth quarter. Inflation and unemployment data through November.

Nor were Americans moved by the surprising plethora of positive economic news.

The economy was projected to lose 10,400 jobs a month. Instead, it gained an average of 232,000 a month.

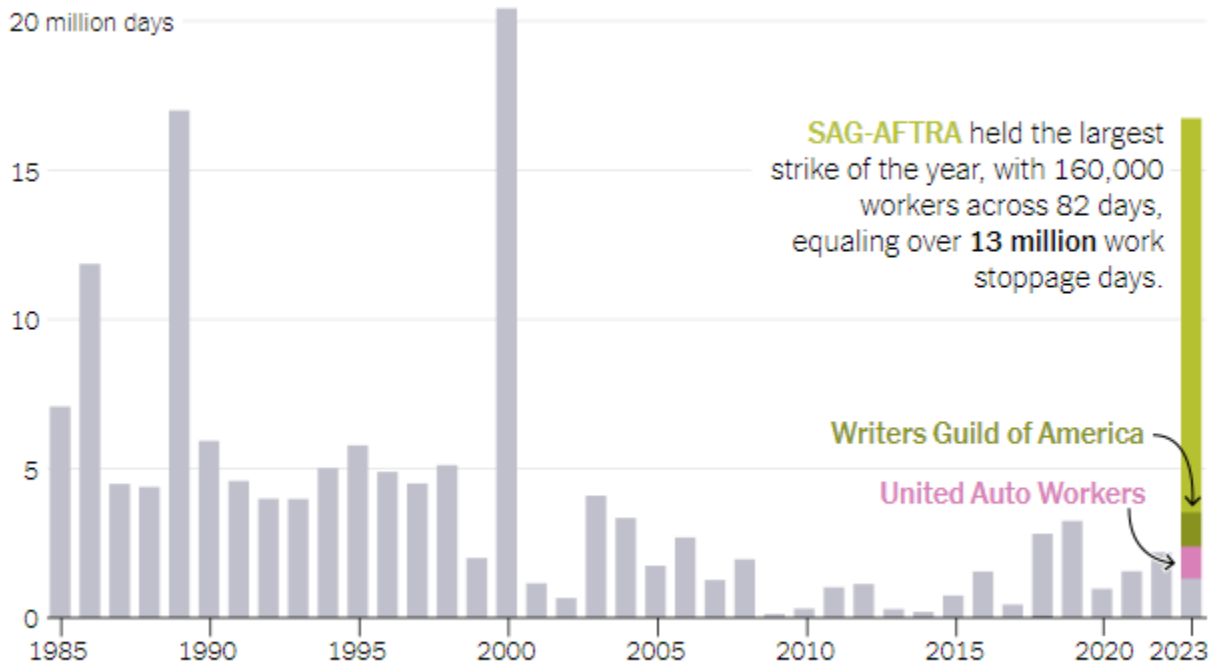
The unemployment rate, which started 2023 at a five-decade low, was projected to rise to nearly 5 percent by the end of the year. Instead it ticked up only trivially, to 3.7 percent.

More than 80 percent of economists predicted that 2023 would end in a recession. Instead, the economy is likely to have expanded by a remarkable 3 percent.

On top of that, the stock market boomed. In 2023, the S&P 500 index rose to near record highs, powered primarily by the technology stocks known on Wall Street as the magnificent seven — Apple, Amazon, Alphabet, NVIDIA, Meta, Microsoft and Tesla.

### 3. Workers Struck Back

#### Workdays spent on strike



Source: Bureau of Labor Statistics - Note: 2023 data through November

The combination of the robust American jobs machine and rising prices led workers to demand better pay to an extent not seen in more than two decades.

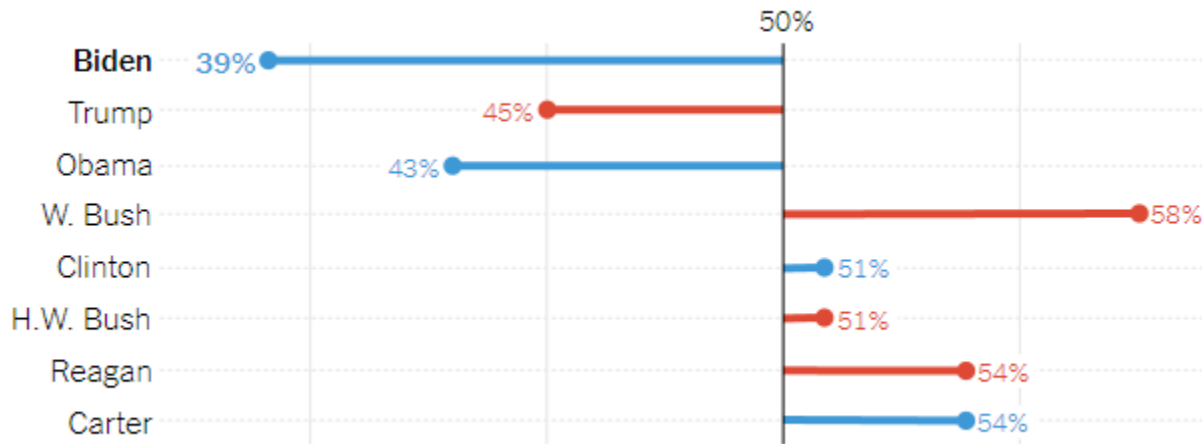
From actors to hotel employees and auto workers, Americans took to the picket lines. Through November, workers spent almost 17 million days on strike, more than from 2009 to 2022 combined.

While the disputes were mostly about pay, other concerns bubbled up, principally around potential job losses from technological advances. Autoworkers took issue with the possible impact of electric vehicles.

Screenwriters and actors were concerned about artificial intelligence (along with the loss of royalty payments as viewers increasingly turn to streaming services).

## 4. Poor Presidential Approval

### Approval ratings in December before Election Day for second term



Source: Gallup

Usually a strong economy buoys an incumbent president. Not this year.

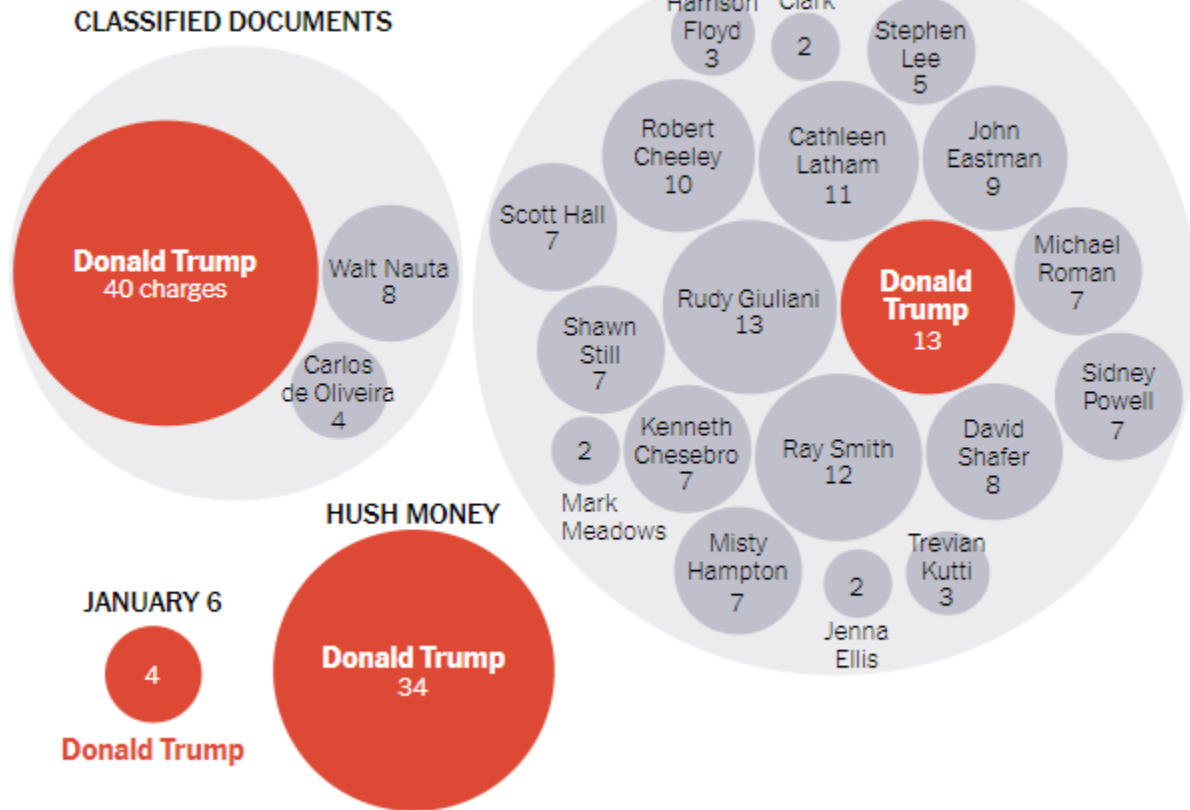
President Biden's approval rating, which peaked at 55 percent early in his term, ended the year at just 39 percent, the lowest of any modern incumbent at this point in his tenure. Just 22 percent of Americans believed the country was on the right track; only 17 percent feel they are better off than before Mr. Biden became president.

Even Jimmy Carter, bedeviled by high interest rates, slowing economic growth and inflation, was more popular at this point in his term. Why? Two of many complex reasons stand out to me. First, for two-thirds of voting-age Americans, the current inflation is the highest of their adult lifetimes. And second, two decades of subpar income growth has threatened the notion that each successive generation will live better than the previous one.

## 5. Trump's Multiple Indictments

### Number of charges

Size of circle corresponds to number of charges each person received



Sources: Fulton County Superior Court; Department of Justice; Manhattan District Attorney's Office

Of course, Mr. Trump remained a dominant political figure, despite his indictments on 91 counts. Indeed, to paraphrase Nietzsche, that which didn't kill him only seemed to make him stronger.

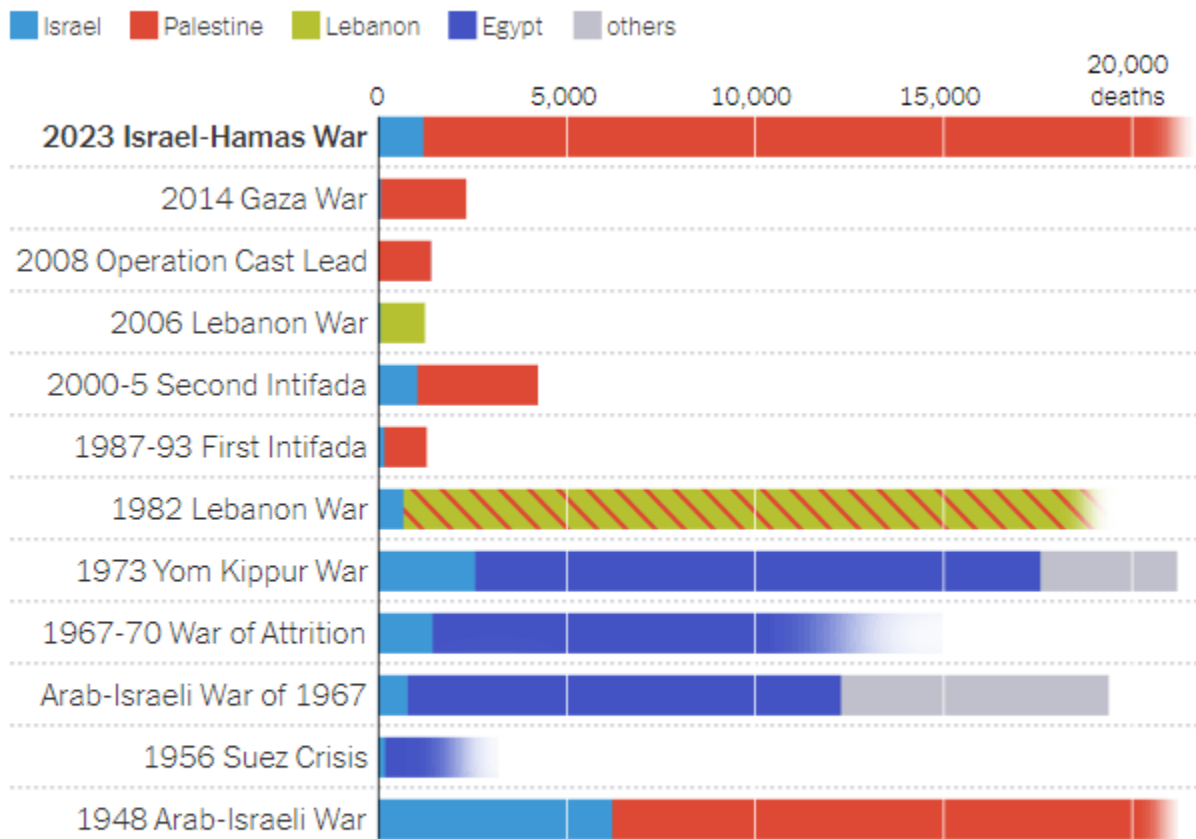
His dominance of the field of Republican presidential aspirants increased to 61 percent in the most recent polls, up from 45 percent at the beginning of the year. And each round of indictments brought a surge of fund-raising receipts.

For example, Mr. Trump raised a stunning \$13 million in the seven days after his New York indictment, and a stunning \$4.2 million following the release of his Fulton County mug shot.



## 6. Israel and Gaza

### Arab-Israeli war death toll estimates



Sources: Israel Defense Forces; Gaza Health Ministry; The United Nations Relief and Works Agency for Palestine Refugees in the Near East; United Nations; Human Rights Watch; B'Tselem; Shin Bet; Associated Press; Palestinian Central Bureau of Statistics; New York Times - Note: Figures reflect available death counts and estimates by nationality. Estimates and counts vary among sources. Faded bars reflect high variance in available estimates.

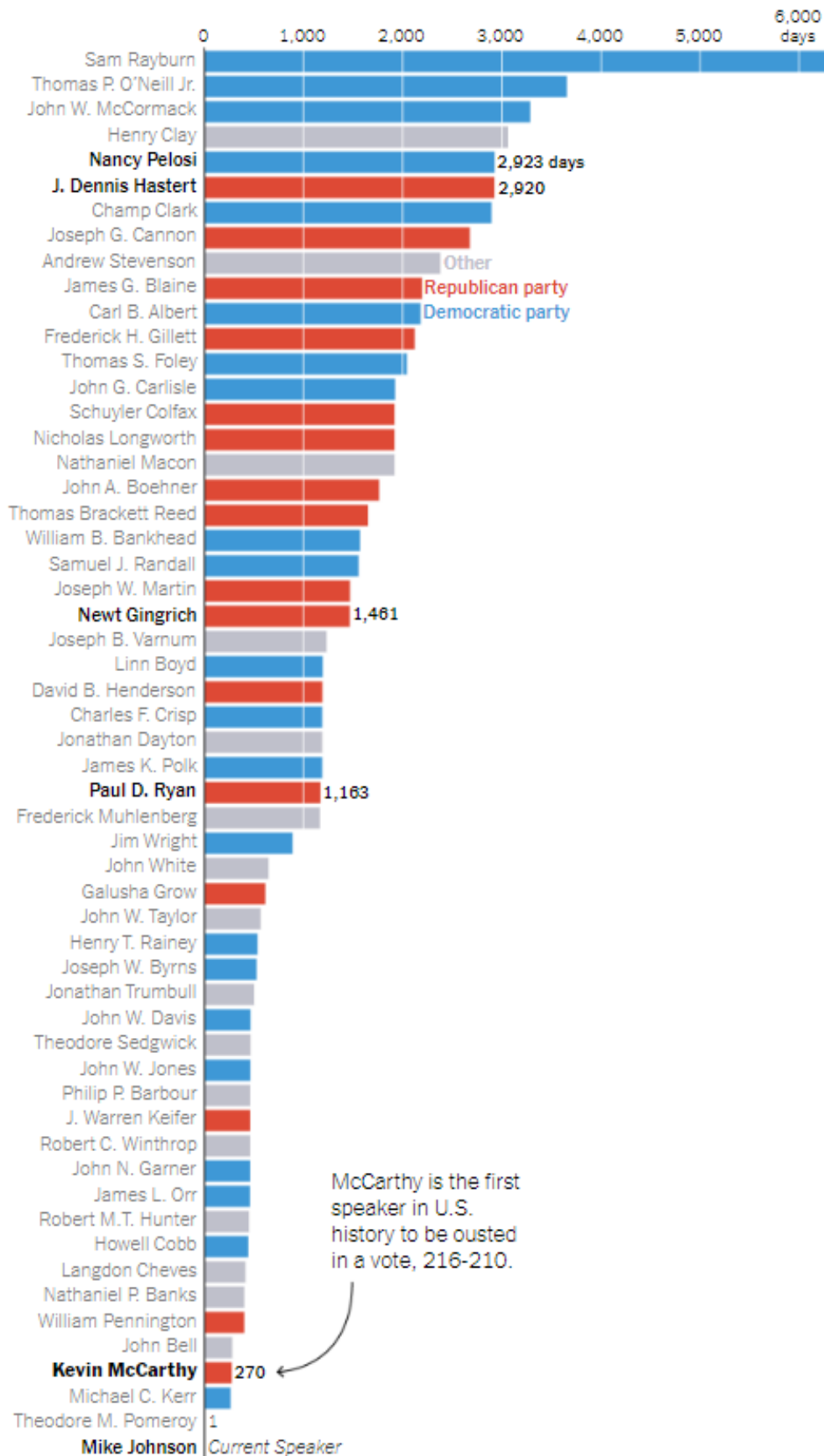
Economics and politics notwithstanding, the most significant event of the year was the war in the Middle East, which after just three months may be the deadliest Arab-Israeli conflict since 1948.

Israelis and non-Israelis alike found staggering the ability of Hamas to launch such a sophisticated surprise attack and the brutality that ensued. Israeli civilians were tortured, raped and murdered. Thousands of Palestinians — more than two-thirds of them women and children — have since been killed in Gaza by Israel's retaliatory air strikes.

Public opinion in America, squarely on the Israeli side at the outset, began to shift, particularly among the young. By November, a majority of voters between the ages of 18 and 34 felt more sympathy for Palestinians, up from 26 percent in October, according to polling from Quinnipiac University.

## 8. G.O.P. Chaos

### Days as House speaker



Congress set a new low bar for itself.

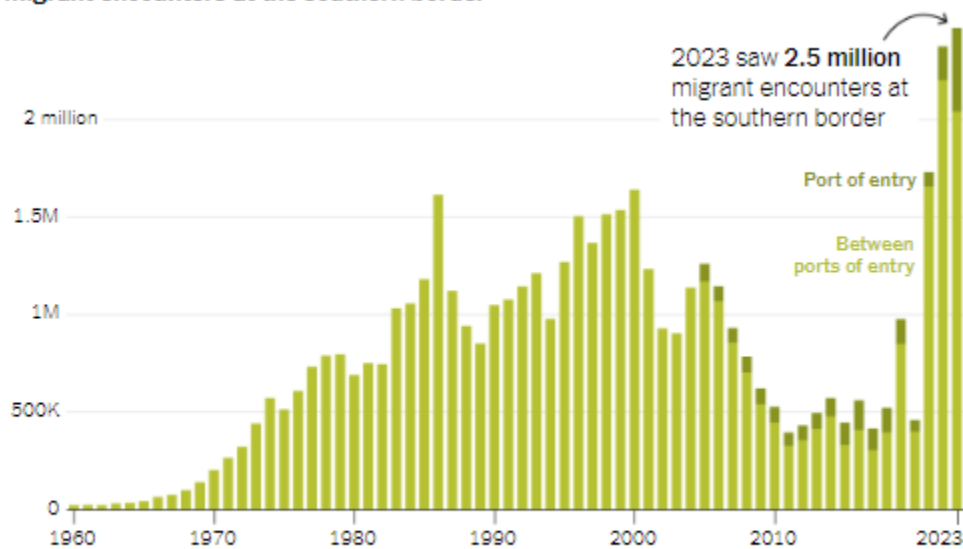
In the House of Representatives, Kevin McCarthy fought through 15 ballots — the most since the years before the Civil War — to become speaker. And then he lasted just 270 days in the role, as a faction of far-right Republicans battled with more moderate party members.

That contributed to Congress notching its most unproductive year in modern history, with just 27 bills clearing both chambers and the White House. In comparison, the previous Congress passed more than 70 bills in its first year, and the Truman-era “Do Nothing” Congress approved almost 400 bills in its first few months.

By the end of the year, Congress had passed none of its 12 appropriation measures and had failed to act on an urgent need for aid in Ukraine and Israel and to address the mounting border crisis.

## 9. Surge at the Border

**Migrant encounters at the southern border**



Source: U.S. Customs and Border Protection, Congressional Research Service - Note: Data for "inadmissibles" encountered at ports of entry have limited availability. Exact encounters are shown since 2010, and FY 2005-09 are projected from national encounters data.

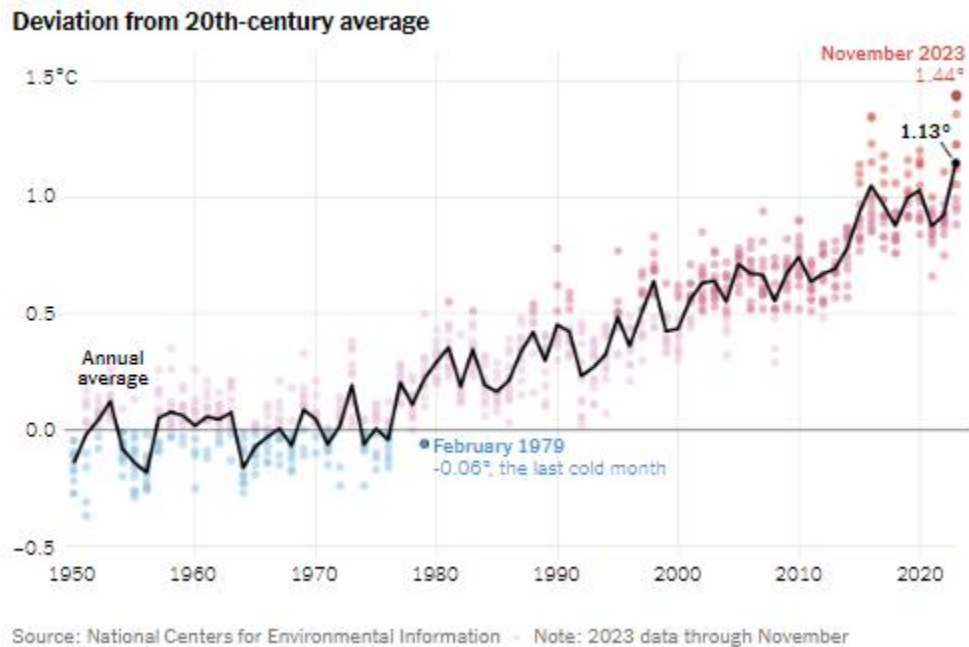
The flood of migrants seeking to cross our southern border surged to record levels, creating a political crisis for Mr. Biden.

Misinformation added to the commotion. The 2.5 million “encounters” in fiscal year 2023 cited in press reports represented the number of migrants who were apprehended by U.S. Customs and Border Protection.

Roughly one million of those apprehended were released inside the U.S. to await hearings in our underfunded and backlogged immigration courts, creating a major challenge for New York and other cities to which many traveled. Beyond the 2.5 million encounters, a (relatively) modest 600,000 more were believed to have sneaked into the country without being caught.

Of the 1.4 million new court cases added in fiscal year 2023, just 100,000 have been resolved.

## 10. The Hottest Year on Record



As if we needed another reminder of the climate crisis, global temperatures notched another record high in 2023. Bizarre weather events, from flooding in California to hailstorms in Texas, led to a record number of billion-dollar disaster claims in the United States.

Further afield, Antarctic sea ice hit a record low. Passage of the biggest climate package ever in 2022 spurred a surge in construction of renewable energy facilities this year. But emissions continued to rise globally, largely from faster-growing developing countries, particularly China and India.

From Bespoke on Dec. 26th:

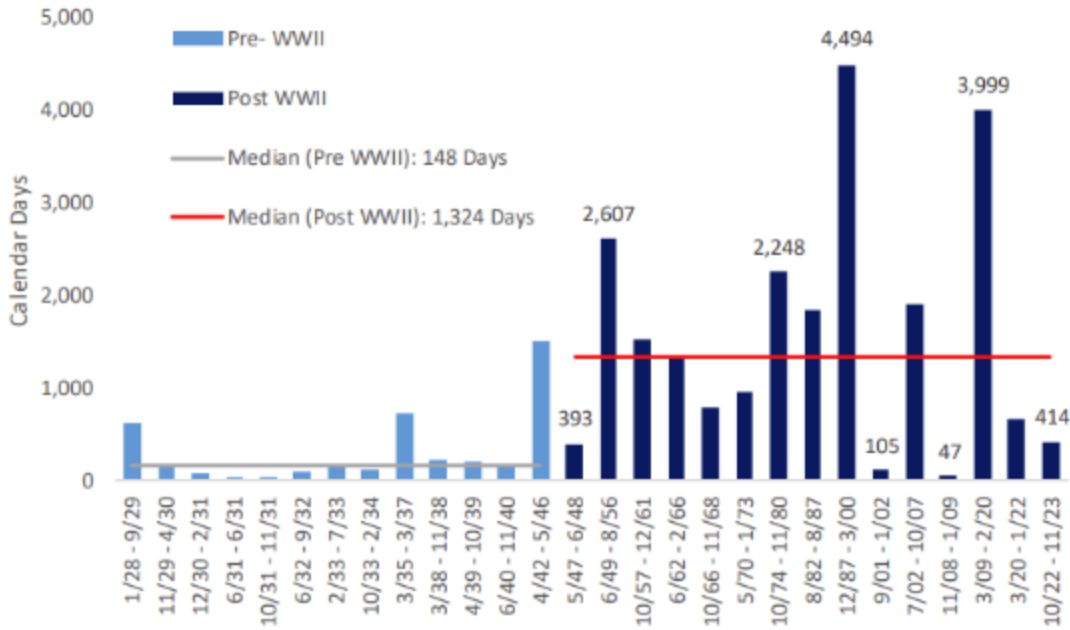
### How Long Bull?

With a gain of more than 30% off its lows and the index now trading at new all-time highs on a total return basis, it's getting harder and harder for bears to argue that we're NOT in a bull market.

The chart below ... highlights the length of prior bull markets for the S&P 500 going back to 1928. One thing that really stands out is how short bull markets were in the first half of the 1900s and how long they've been since then. Prior to WW2, the median bull market for US stocks lasted just 148 days. Since WW2, the median bull market has lasted 1,324 days.

The current bull market recently crossed the 400-day mark. If it were to last as long as the median bull since WW2, though, that would take us all the way out to the end of May 2026!

## S&P 500 Bull Markets (Length): 1928 - 2023



## Follow-ups

From Bloomberg:

### SPAC Mania's Ugly End Yields \$46 Billion of Investor Losses

- At least 21 former SPAC merger targets went bankrupt in 2023
- Failures span electric-vehicle makers, indoor farming firms

By Jonathan Randles and Amelia Pollard  
December 27, 2023

Wall Street's affair with blank-check firms, the finance fad that pushed companies onto the stock market during the Covid-19 pandemic, ended this year with a string of big bankruptcies and even bigger losses for shareholders.

At least 21 firms that went public by merging with special purpose acquisition companies, or SPACs, went bankrupt this year, according to data compiled by Bloomberg. Measured from their peak market capitalizations, the insolvencies bookend the loss of more than \$46 billion of total equity value.

The failures span money-losing electric vehicle startups and forward-thinking farming companies. Blank-check firms were good at propelling their targets to the public market even when they lacked well-formed financials, said Gary Broadbent, an executive guiding former SPAC AppHarvest Inc. through its liquidation. Many weren't "ready for primetime," he said.

Some were more promising than others, but all drew dollars from excitable investors caught up in the SPAC craze, including mom—and-pop traders. Plenty of shareholders are now suing SPAC sponsors over their losses.

The largest SPAC bankruptcies included that of flexible workplace provider WeWork Inc., which boasted a \$9.4 billion market value after going public in 2021. It succumbed to Chapter 11 last month with plans to jettison expensive office leases. Electric vehicle makers Proterra Inc. and Lordstown Motors Corp. also carried sizable market values, topping out at roughly \$3.7 billion and \$5 billion, respectively, before filing for bankruptcy earlier this year.

Many of these companies sought protection from creditors less than two years after going public. Software firm Near Intelligence Inc. filed Chapter 11 in December, less than 9 months after its stock debuted on the Nasdaq.

Of course, many predicted the ongoing wave of bankruptcies. Critics (including HCM) called the SPAC frenzy a bubble soon after it began.

Going public via SPAC has historically been faster and faced less scrutiny than traditional initial public offerings. During the boom, companies targeted by blank-check firms also often made more optimistic projections about the trajectory of their businesses than would be seen in old-fashioned IPO processes.

## SPAC Bankruptcies Keep Piling Up

More than \$46 billion of SPAC equity laid to rest by bankruptcies this year

Company	Month of Bankruptcy Filing	Peak Market Cap
WeWork	November	\$9.4B
Lordstown Motors	June	5.1B
AppHarvest	July	3.7B
Proterra	August	3.7B
Virgin Orbit Holdings	April	3.5B
IronNet	October	3.5B
Cyxtera Technologies	June	2.6B
Bird Global	December	2.4B
Rockley Photonics	January	2.2B
Starry Group	February	1.8B
Pear Therapeutics	April	1.6B
Sunlight Financial Holdings	October	1.3B
AgileThought	August	1.2B
Boxed	April	1.0B
Shift Technologies	October	897.0M
Near Intelligence	December	779.0M
Gelesis Holdings	October	524.0M
QualTek Services	May	330.7M
Parts ID	December	304.1M
Kalera	April	185.1M
Nogin	December	167.1M

Plus, arrangers had incentives to complete less-than-pristine mergers. Early investors could redeem SPAC shares at \$10 if they didn't like the deal, for one. Excitement over meme stocks and the promise of high valuations encouraged private companies to complete blank-check mergers at a rapid pace, said Usha Rodrigues, a law professor at the University of Georgia who has studied SPACs.

The result was a glut of SPACs which Rodrigues described as “a ticking time bomb” of corporate failures that materialized in 2023. “Everyone should have seen this cliff coming,” Rodrigues said.

## **More Trouble**

More trouble is likely on the way as higher interest rates weigh on company balance sheets. About 140 other former SPACs will likely need more financing in the next year in order to keep operating, according to data compiled by Bloomberg in mid-December that estimates a company's cash needs.

SPAC companies were also more likely than their corporate peers to raise doubts about their future, according to Hudson Labs, an investment research software firm that analyzes regulatory filings. Nearly 44% of SPAC companies that filed annual reports in 2023 have reported going-concern warnings compared to roughly 22% of non-SPAC companies, Hudson Labs said.

Some shareholders are hoping lawsuits can help recover their losses. Lordstown stockholders accused sponsors behind its SPAC of overstating demand for its flagship Endurance truck. As Lordstown was preparing to go public in 2020, the company touted a backlog of 38,000 vehicle pre-orders. But unlike Tesla Inc. and other competitors, Lordstown didn't require a deposit and shareholders claim company officials were aware those lofty Endurance pre-orders were unlikely to net actual sales.

Lordstown's stock fell after short-seller Hindenburg Research accused the company of overstating demand for the Endurance. Lordstown never sold close to the number of Endurance trucks it had once projected. After the company filed Chapter 11 in June, its chief financial officer testified the company sold less than 40 vehicles.

Lordstown officials and its SPAC sponsor have denied wrongdoing. The vehicle maker's proxy statement disclosed that Endurance pre-orders weren't binding and didn't require deposits, the company said. Lordstown stockholders were provided enough information to decide for themselves if the stock was worth the risk, they said.

Federal regulators have been slow to respond to the SPAC craze, even as Gary Gensler, chairman of the Securities and Exchange Commission, has been a vocal critic of the maneuver. In March 2022, the SEC proposed new rules that would require additional disclosures about sponsors and bolster investor protections. Shortly after, Wall Street giants started to distance themselves from deals involving blank-check companies and the SPAC pipeline dried up.

But the failures keep coming. Just last week, Bird Global Inc. — the company whose electric scooters once blanketed major cities' sidewalks — filed for Chapter 11 protection. Once the holder of a \$2.5 billion market value, the firm revealed in court papers it had \$3.3 million of cash when it entered court protection.

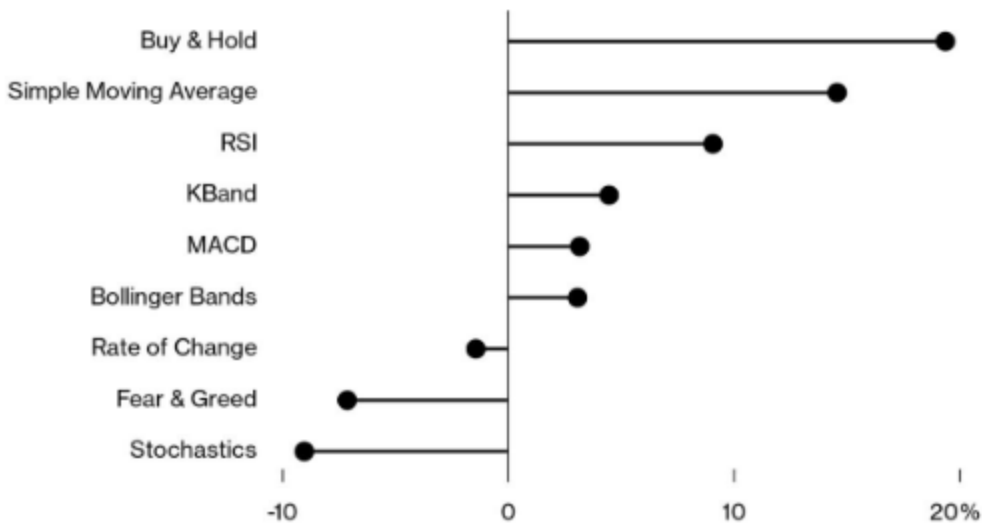
From Dec. 8th's Bloomberg Evening Briefing:

After the beating they've taken in bonds over the last two years, investors could be forgiven for wondering if it was ever a good idea to rely on fixed income in the first place. Now there's new research that validates such suspicions, and upends some serious conventional wisdom when it comes to building that retirement nest egg. **(HCM's assertion since inception.)** A group of academics set out to test the old chestnut about how a diversified portfolio of bonds and stocks is the best way to save for the future. What they found was that a mix of half domestic, half international equities **(a Vanguard study that we previously shared found that 20 to 40% international equities was most effective)** actually beat blended portfolios in both money made and capital preserved. With fixed income suffering subpar returns amid the Federal Reserve's monetary tightening, some have argued traditional investing advice needs a rethink. "As long as the equity investors are able to stick it out," says study co-author Scott Cederburg at the University of Arizona, "they end up being better off with very high probability than somebody who's trying to smooth out those short-term movements by diversifying into bonds."

With just a few weeks left in the year, we can start looking back on 2023 and come to a conclusion about who was right, and who lost money. It turns out that for all the hair pulling about stocks and the Fed and rate cuts and so on and so forth, buying and holding equities was the winning strategy. The tried-and-true trounced 22 technical strategies used by traders to navigate their ups and downs, paying off handsomely given that the S&P 500 hit its low back on Jan. 5 only to climb steadily to its highest point on, well, today. While charting tools are rarely used in isolation, their lousy performance highlights the pain for anyone who heeded selling signals. ...

### Buy-And-Hold Beats Chart-Based Trading Models

Heeding sell signals in 2023's stock market has proved costly



Source: Bloomberg

Bloomberg



From Dec. 7th's WSJ:

## Nontraded REITs Vary NAV Measures

BY JONATHAN WEIL

The term “net asset value,” or NAV, is so commonplace for anyone buying a mutual fund, investors hardly give it a second thought. It has a standard definition. The number is audited annually. There is rarely a reason to question it.

But in a corner of the market that has grown rapidly—real-estate funds—the NAV label, while ubiquitous, doesn't have the same meaning. In most cases the funds, known as nontraded real-estate-investment trusts (**which we have repeatedly warned against**), have broad leeway to define their NAV measurements however they want.

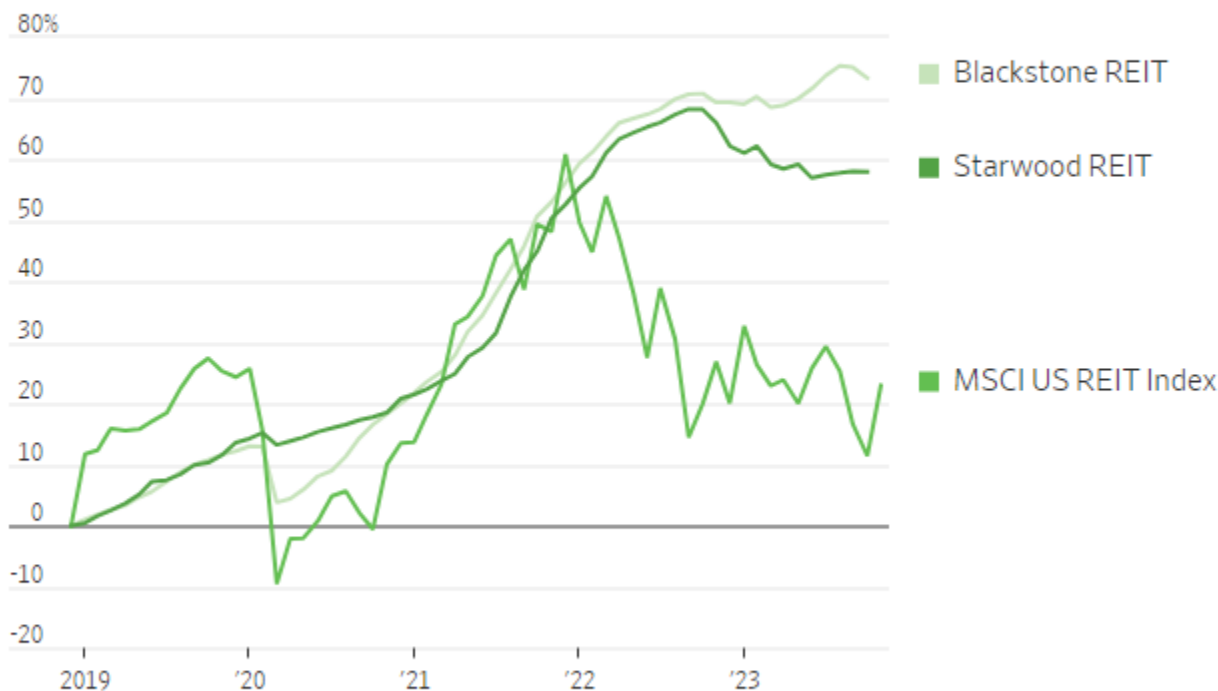
This raises issues of comparability between NAV measures at different funds. It also can lead investors to question whether values at some funds realistically reflect the performance of their underlying assets. Both have become a concern for investors since rising interest rates began hurting many [commercial real-estate values](#).

Shares of publicly traded REITs, which typically don't report NAV, have plunged; the MSCI US REIT Index is down 25% since the end of 2021. Yet NAVs have shown little volatility at some of the [biggest nontraded REITs](#) focusing on commercial real estate. The NAV per share at Blackstone Real Estate Income Trust, known as Breit and the biggest of these kinds of funds, is up 2% since the end of 2021, and Starwood Real Estate Income Trust's is down 5%.

### Holding Their Value

Nontraded REITs at Blackstone and Starwood have outpaced publicly traded REITs

#### Total return since start of 2019



Note: All performance figures are net total return. Blackstone REIT and Starwood REIT are as of Oct. 31. MSCI US REIT is as of Nov. 30.

Source: FactSet (MSCI US REIT), the funds (Blackstone REIT, Starwood REIT)

Investors in some cases have rushed to sell shares, prompting several funds to curb redemptions. **Blackstone** said last week that November repurchase requests for Breit were \$1.8 billion and that it fulfilled \$1.2 billion of these.

... In January, Breit repurchased \$1.3 billion of shares, but requests were four times that amount. The fund has capped redemptions for 13 consecutive months and restricts withdrawals to 2% of NAV per month and 5% per quarter.

How such funds calculate NAV is of particular importance to investors because, unlike publicly traded REITs, their shares don't trade on exchanges. They are sold mainly to individual investors through financial advisers. The NAV sets the price, and [investors sell shares back](#) to the company at the NAV. A limited secondary market exists, but transactions usually occur at a discount to NAV.

“Shareholders assume they know what the term ‘net asset value’ means and that it’s applicable across all product types. But the definition of net asset value can vary,” said John Cox, founder and chief executive officer of Cox Capital Partners in Philadelphia, an investment manager that specializes in nontraded funds. He said his firm bought shares of Breit and other nontraded REITs at discounts on the secondary market earlier this year.

“A lot of our business is based on explaining why NAV is not an indication of fair market value,” Cox said. “They should call it ‘price.’ They should say, ‘This is our price per share’ and just leave it at that.”

So how do many nontraded funds calculate NAV?

Generally, they say they estimate their assets’ fair values when calculating NAV with help from outside advisers and appraisers. They disclose lengthy valuation policies describing their methodology and include broad disclaimers.

“NAV calculations are not governed by governmental or independent securities, financial or accounting rules or standards,” Breit said in its latest annual report. “Further, there are no accounting rules or standards that prescribe which components should be used in calculating NAV, and our NAV is not audited by our independent registered public accounting firm.”

Starwood REIT and other nontraded REITs included the same language word for word in their annual reports.

Many also include cautionary language in their disclosures disavowing that their NAV metrics reflect their financial condition. The annual reports by Breit, Starwood REIT and others go on to say: “We calculate and publish NAV solely for purposes of establishing the price at which we sell and repurchase shares of our common stock, and you should not view our NAV as a measure of our historical or future financial condition or performance.”

Under generally accepted accounting principles, NAV per share for open-end mutual funds and other registered investment companies is a balance-sheet measure of net worth; it isn't just price.

According to fund filings, there are many adjustments nontraded REITs make to calculate non-GAAP NAV. Some don't subtract all their liabilities. Some include fair-value gains and losses on their own debt; others don't. Some update their real-estate assets' values more frequently than others or rely more heavily on third-party firms to value them.

A spokesman for Starwood declined to comment. Blackstone said that “if Breit’s NAV was governed by GAAP accounting, the result would be virtually identical” and that “our valuations are further supported by the fact that Breit has sold more than \$16 billion of assets across 321 properties at a premium to NAV since 2022, when interest rates began to rise.”

Blackstone also pointed to a transaction announced in January in which the University of California's investment arm [bought \\$4.5 billion of Breit shares](#) at their published NAV.

However, UC Investments' purchase came with [a big concession](#). Blackstone also pledged \$1.1 billion of its own Breit shares to pay UC Investments in case it failed to earn 11.25% a year after fees over a six-year holding period. Ordinary Breit shareholders [aren't offered such downside protection](#).

Some investors say the practice of using the NAV label on a non-GAAP financial measure might cause confusion. Securities and Exchange Commission rules prohibit companies in their filings from using "titles or descriptions of non-GAAP financial measures that are the same as, or confusingly similar to, titles or descriptions used for GAAP financial measures."

The SEC hasn't moved to stop the practice by nontraded REITs, notwithstanding its rule, passed in 2003 after a wave of accounting scandals. An SEC spokeswoman declined to comment.

Ted Christensen, a University of Georgia accounting professor, took issue with the practice. The NAV labeling, he said, "is similar to a company calculating a non-GAAP earnings metric and calling it 'net income.' "

From Morningstar:

## Why Investors Should Keep An Eye on Small-Cap Stocks

Historically, high index concentration implies high expected size premium.

**Larry Swedroe** Dec 6, 2023

The 2023 performance of the "Magnificent Seven"—Apple [AAPL](#), Amazon.com [AMZN](#), Microsoft [MSFT](#), Nvidia [NVDA](#), Alphabet [GOOG](#), Tesla [TSLA](#), and Meta Platforms [META](#)—has been nothing short of spectacular, leading to the increased concentration of marketlike portfolios. Increasing concentration reduces the benefits of diversification and increases a portfolio's exposure to idiosyncratic risks. While market-cap-weighted indexes, by their nature, will always have some concentration of risk in the largest stocks, thanks to the research team at Avantis, we can see that concentration levels for the 10 largest stocks in several common indexes are now at historic highs.

The following chart from [Avantis shows](#) that concentration levels have increased dramatically in recent years, while the levels for the smaller-cap and value indexes have been relatively stable. Note also that they are now significantly higher for the Russell 1000 Growth and S&P 500 indexes than they were before the dot-com bubble burst in March 2000. On the other hand, the concentration levels for the Russell 2000 and the Russell 1000 Value indexes are at or near their lowest levels.

## U.S. Large Cap and Large Growth Index Concentration Has Been on the Rise



The next table shows the historical concentration levels for various indexes, including their minimum, maximum, and average concentration levels.

### Concentration Levels of 10 Top Holdings (Jan. 31, 2000-Aug. 31, 2023)

Indexes holding large-growth stocks are at concentration-level highs, while other indexes are near or below average.

Index	August 2023	Period Max.	Period Min.	Period Avg.
Russell 3000	26.5	26.5	13.7	18.0
S&P 500	30.9	30.9	17.0	21.7
Russell 1000 Growth	51.5	51.5	17.1	30.2
Russell 1000 Value	17.5	34.5	16.2	24.4
Russell 2000	3.2	8.6	1.6	2.9
Russell 2000 Growth	6.2	12.1	3.1	5.2
Russell 2000 Value	4.8	9.2	2.9	4.5
MSCI EAFE	15.0	17.3	10.9	13.2
MSCI Emerging Markets	22.8	32.5	15.1	20.5

### The Size Premium

What, if any, are the implications of the increased level of concentration beyond the obvious increase in risks to idiosyncratic shocks? Logan Emery and Joren Koeter, authors of the November 2023 study “[The Size Premium in a Granular Economy](#),” investigated how this phenomenon affects the difference in returns between small and large firms—the size premium. They began by noting that recent [prior research](#) found that concentrated stock

markets dominated by a small number of very successful firms are associated with less efficient capital allocation, sluggish initial public offering and innovation activity, and slower economic growth.

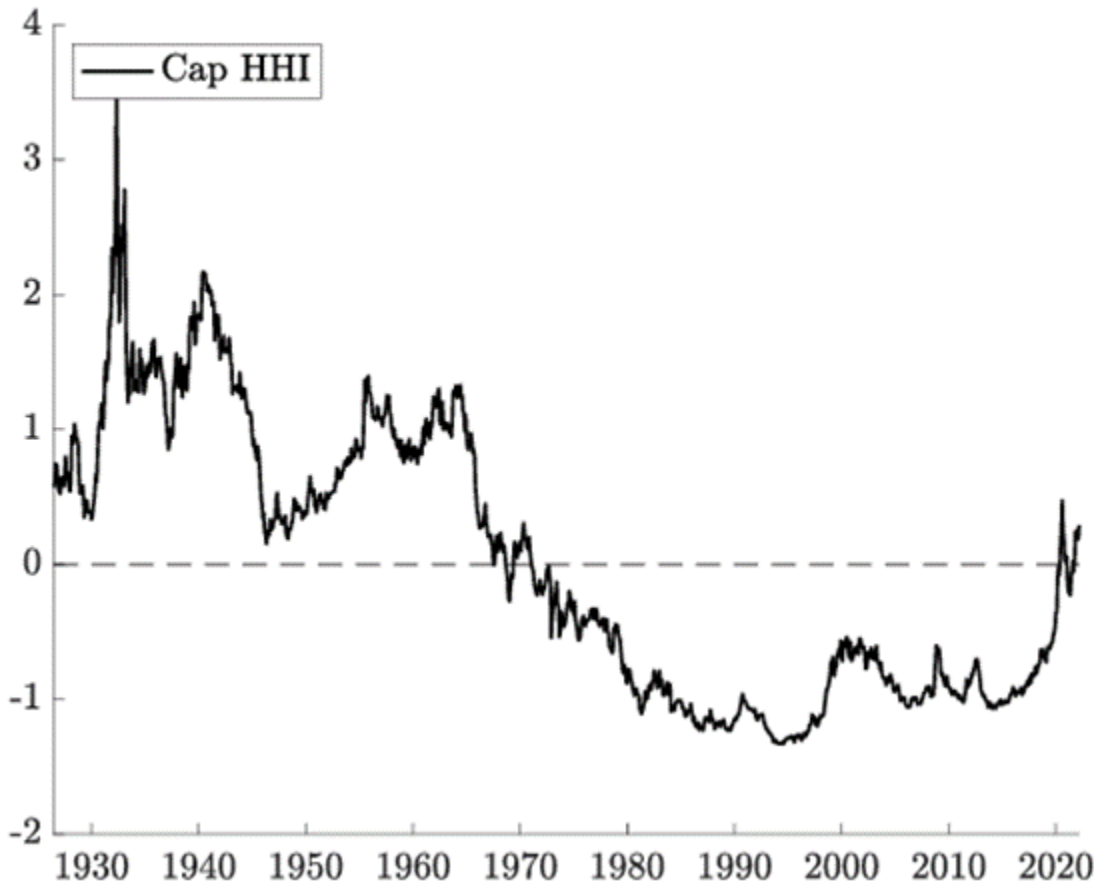
Emery and Koëter hypothesized: “If stock market concentration implies that too little capital is allocated to small firms, the decreased demand for the equity of small firms will increase their expected returns. This capital allocation effect suggests that higher stock market concentration should increase the expected [ex-ante] size premium.”

They measured market concentration using the [Herfindahl-Hirschman Index](#). Their sample covered U.S. stocks over the period 1926-2021. Following is a summary of their key findings:

- The stock market was significantly more concentrated before 1970 than it has been in the past several decades. However, it has increased substantially in recent years to levels not seen since the early 1970s.

### Stock Market Concentration

This figure plots the time series of stock market concentration (Cap HHI) for U.S. firms from 1926 to 2021. Cap HHI is standardized to have a mean of zero and standard deviation of one.



- The expected size premium (the difference in returns between the first and fifth quintiles) increased during periods of higher stock market concentration. A one-standard-deviation increase in stock market concentration increased the expected returns of small firms by 9.4 percentage points per year and decreased the expected return of the largest firms by 0.83 percentage points per year—most of the effect was caused by the small firms. The effect was statistically and economically significant in both the earlier (1926-85) and later (1985-2021) sample periods.

- The average size premium was 6.33% per year over the period 1926-2021. Given that a one-standard-deviation increase in stock market concentration increased the expected returns of small firms by 9.4 percentage points per year, a one-half standard deviation decrease in concentration would cause the size premium to vanish.
- Smaller firms are less likely to complete a seasoned equity offering during periods of higher stock market concentration.
- The increase of the size premium during these periods took place predominantly among firms with a greater demand for equity financing—the effect was concentrated among growth firms (but not value firms) and firms in industries with a greater dependence on external equity financing.
- Higher stock market concentration was associated with smaller firms receiving less investor attention as measured by turnover, analyst coverage, and downloads of firm financial information.

Their findings led Emery and Koëter to conclude: “These results suggest there is less demand for the equity of smaller firms during periods of higher stock market concentration, which makes it more difficult for these firms to raise equity financing and increases their expected returns.”

Interestingly, Emery and Koëter found a countereffect caused by concentration. They calculated the value-weighted idiosyncratic shocks to the 10 largest firms as a shock to the granularity (unique/idiosyncratic risk) of the stock market. They found:

“Positive shocks further tilt the market portfolio toward these largest firms such that investors required additional compensation for the increased exposure to the idiosyncratic risk of these firms. Moreover, investors become willing to pay a premium for other firms to diversify this increased idiosyncratic risk. Taken together, these effects create a discount in the value of large firms and a premium in the value of small firms, which result in lower and higher expected returns going forward, respectively. ... The expected size premium [using the cap HHI] decreases by 0.77 percentage points per quarter following a one standard deviation increase in idiosyncratic shocks to the ten largest firms. ... This result supports the conclusion that the capital allocation and granular diversification effects are simultaneously present.”

However, they concluded that there was evidence of the granular diversification effect “but find it is dominated by the capital allocation effect overall.”

Their findings led Emery and Koëter to conclude: “It is important to account for stock market concentration when evaluating the size premium over different sample periods.”

### **Investor Takeaways**

The empirical evidence demonstrates that as the stock market concentration level increases, the expected return to small stocks relative to large stocks (the size premium) increases. Investors should note that, as shown above, today’s concentration levels are historically high, implying a high expected size premium. [Research also shows](#) that the spread in valuations is the best predictor we have of equity premiums. According to [Figure 8 in Edward Yardeni’s recent report](#), the current valuation spread between small and large stocks is at historically wide levels. Also note how wide the spread is between the MegaCap-8 stocks and small stocks.

The empirical research shows that retail investors base their investment decisions on recency bias. Thus, to their detriment, they tend to ignore the long-term historical evidence such as presented by Emery and Koëter. Forewarned is forearmed.

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## Positions

As a general rule we sell any individual stock with a 20% or greater loss that we no longer consider a buy at the end of the year in all accounts, and may do so in taxable accounts even if we still consider the stock a buy and there is an equally attractive opportunity, or we believe it is likely that we will be able to profitably reenter the position after the 30 day wash-sale rule has expired. There were no such sales this year.

**CHCT** - On 11/1 this Healthcare Facility REIT had a Negative Earnings Surprise of 3.3%. Subsequently, 1 of 2 analysts that updated their Earnings Estimates reduced, 1 of 4 analysts lowered their Recommendation to Hold, and all 4 lowered their Target Prices. On 12/7 we sold CHCT for a client at 28.08.

