

*This letter is dated October 2020*

## **Skinny Yellá: The Art of Winning Small Ball** *Investing in a Risky Low-Rate World*

Our economy has been shaken by the COVID-19 pandemic, yet as I pen this letter the U.S stock market as measured by the S&P 500 Index is up nearly 8% year to date, while the profits of the stocks within the index for the first half of the year declined by an average -34%.<sup>1</sup> Are the financial markets being propped up by monetary and fiscal policy? A look at history may be helpful in making this assessment. Let's take a look at where we've been to gain a better grasp on where we are and where we may go from here. In the words Babe Ruth, "Yesterday's home runs don't win today's game".<sup>2</sup> In this letter I will discuss why I think successful investing going forward will be more about getting on base than hitting home runs. More about doing the little things well, grinding it out rather than flashy heroics and quick profits.

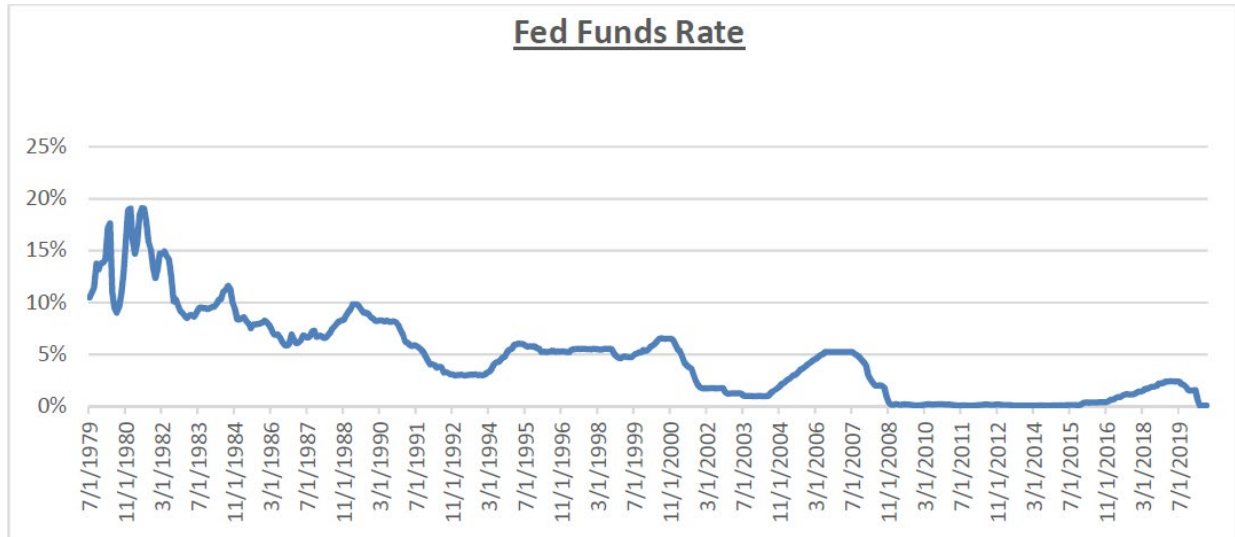
In 1979 the United States economy was mired in double digit inflation and monetary policy began playing a more prominent role, so let's start there. In 1979 I was 9 years old and, as you might expect, not paying attention to monetary policy. I could often be found with neighborhood friends engrossed in a game of wiffleball. Wiffleball is like baseball but played with a plastic bat and ball. We played with a white ball with holes on the top half but not on the bottom half, and a skinny yellow bat. That is until a new kid moved into the neighborhood with a big fat red bat which quickly became known as Big Red. So, we applied our small-town twang and gave our original bat a nickname too: Skinny Yellá. We now had two distinctly different options with Skinny Yellá and Big Red. The ball did not travel far off Skinny Yellá unless your bat speed was swift and your swing was extremely precise. Skinny Yellá had a sweet spot the size of pea. Before Big Red, we played quite a bit of 'Small Ball' in the neighborhood. Small Ball = singles, bunts, steals, grinding it out in low scoring games. But when Big Red joined the party, we suddenly began playing Long Ball. Home runs ruled the roost. Big Red had a sweet spot the

size of a grapefruit, so whoever was at the plate might hit a dinger (dinger =home run). Attempting to steal became less common. Why risk being thrown out stealing when you may be able to trot around the bases risk free?

Although we suddenly began launching dingers like 4th of July fireworks, did my friends and I become better hitters after the arrival of Big Red? No. The answer is absolutely, unequivocally NO. In fact, one could argue that Big Red made us less skilled at the art of hitting. Yep, that grapefruit sized sweet spot provided a large margin of error, disguising imperfections in our swings like make-up on a pimpled face.

Eventually we missed Small Ball. We longed for those days and when a home Run was a big deal, something to get excited about as opposed to something that happened nearly every inning. So we began deciding before each game whether we would be allowed to use Big Red. When younger kids joined the game, we'd let them use Big Red while the rest of us used Skinny Yellá. Then other bats besides Skinny Yellá and Big Red began arriving on the scene. There was an orange bat that seemed to strike a nice balance. In hindsight, Optimal Orange would have been a good name for that bat. Optimal Orange provided some of benefits of both Small Ball and Long Ball. We settled in to using Optimal Orange most games unless extenuating circumstances warranted using Big Red or Skinny Yellá. Strong winds in the batter's face and a field with an extraordinarily deep home run fence were circumstance that might warrant using Big Red. By contrast, a small field and/or the wind blowing out could justify using Skinny Yellá.

Interest Rates significantly impact our economy much like the chosen bat impacted our neighborhood wiffleball games back in the day. Lowering interest rates give the economy a boost much like expanding the bat's barrel circumference gives a boost to the wiffleball batter. Lowering interest rates is considered expansionary or accommodative policy. Raising interest rates is contractionary or restrictive policy and analogous to shrinking the bat barrel. Over the last several decades, interest rates worldwide have trended down. The United States has been no exception. The following chart graphs the Fed Funds Rate in the United States from 1979 to present:



Source: Chart created based on data from Federal Reserve Bank of St. Louis.<sup>3</sup>

A quick glance at the above chart reveals that expansionary policy has dominated contractionary policy over the last 40 years. It appears we've gone from Skinny Yellá to Big Red, with efforts to sustain an Optimal Orange severely derailed.

The Federal Funds Rate is a critical factor affecting our economy. Set by The Federal Reserve (also referred to simply as The Fed) the Fed Funds Rate is the interest rate banks, savings and loans, and credit unions charge each other for overnight loans to meet reserve requirements. The lower the Fed Funds Rate, the more likely banks will maximize their lending capacity and hence also the amount of capital infused into the economy. A closer look at the chart above reveals how The Fed has significantly lowered the Fed Funds Rate during the 6 most recent recessions to help spur economic activity:

- **The 1980 Recession:** The Fed Funds Rate dropped from 13.82% in January when this short recession began, and was at 9.03% when the recession ended in July of the same year.<sup>3</sup>
- **The 1981-1982 Recession:** The U.S. Economy was in recession from July of 1981 to November of 1982. During this time period, The Fed Funds Rate declined from over 19% to about 9%.<sup>3</sup>

- ***The 1990-1991 Recession:*** In July of 1990 the U.S. economy again entered into a recession when the Fed Funds Rate was over 8%. When the economy emerged from recession in April of 1991, the Fed Funds Rate was just below 6%.<sup>3</sup>
- ***Early 2000's Recession:*** At the turn of the century, The Fed Funds Rate was near 6%. After growing briskly for nearly a decade, economic growth in the U.S. slowed drastically after the millennium prompting The Fed to lower interest rates. In March of 2001 the economy officially entered a recession which lasted until September 2002 for the longest recession on record since World War II. By July of 2003, the Fed Funds Rate was only a hair above 1%.<sup>3</sup>
- ***The Great Recession:*** This severe recession officially began December 2007 with the Fed Rates 4.24% and ended June 2009 with The Fed Funds Rate near zero. The Fed had already begun to lower interest rates mid-2007 and continued to do so throughout this recession until eventually lowering the Fed's Fund rate to near 0% in December of 2008 where it remained until 2016.<sup>3</sup>
- ***The COVID-19 Recession:*** The current pandemic recession we find ourselves mired in officially began in February 2020 when the Fed Funds Rate was at 1.58%. The Fed wasted no time lowering interest rates. On April 8, 2020 the Fed Funds Rate was dropped to near zero and remains there today.<sup>3</sup>

Lowering interest rates is one of the easiest, quickest and most effective ways to give the economy a boost, and The Fed has not been bashful about pulling that lever when the economy is shrinking.

With each game of wiffleball back in the day, we gained additional intelligence as to how particular variables affected the game. This was by no means limited to the bat. The ball, how far apart the bases were, whether a home run fence existed and if so, how far that fence was located from home plate, the width of fair-ball territory and the number of players on each team are just a few additional factors that immediately come to mind.

Eventually, before each neighborhood wiffleball game we would decide collectively what the rules would be. We used Big Red on lazy glory seeking home run derby days. We used Skinny Yellá when we wanted more

challenge and strategy. But most days, we went with Optimal Orange. But some days we would disagree. Kids' moods do not always harmonize. So, we began picking a commissioner (aka Commish) before each game. Commish would decide what bat was to be used, who was on each team, so on and so forth. We took turns being Commish. Commish had the important job of setting the rules to maximize the fun for everyone given the circumstances of the day. Setting the stage for an exciting fun-filled game of wiffleball between two evenly matched teams was the goal. The skill of each player, the wind, the mood, the size of the chosen yard for the day... The variables to consider were endless, but the variables that we could control were limited. Likewise, The Federal Reserve (The Fed) is able to control some of the variables in our economy which helps cope with the factors they cannot control.

The United States' Federal Reserve Banking System was created in 1913. The mission of the Federal Reserve System is to foster the stability, integrity, and efficiency of the nation's monetary, financial and payment systems to promote optimal macroeconomic performance. In 1935, after the Great Depression, within The Fed the Federal Open Markets Committee (FOMC) was formed to make monetary policy decisions. The FOMC today consists of 12 members that are highly educated and experienced matters of finance. The group is led by the Fed Chair. Much like our Wiffleball Commissioner, the Fed Chair leads the effort of tinkering with the rules to maximize the probability of positive results.<sup>3</sup>

In wiffleball terms, today's environment of near zero interest rates and massive government spending could be described like this: Batters are using Big Red and the pitcher is lofting a plastic ball smothered in duct tape making hard line drives more likely. The home run fence is closer to home plate than normal, and bases closer together to increase the chance batters reach them safely. Despite the Long Ball accommodations, we are achieving Small Ball results. Fewer baserunners and fewer runs scored. The poor results are not due to a lack of talented ballplayers, but rather due to adverse conditions. Strong winds blow inward toward home plate while heavy rain pelts the ballplayers.

Relating our wiffleball analogy to the current environment, COVID is the primary driver of the strong winds and heavy rain. Businesses compete against each other like sports teams do. COVID has affected each business in a unique way but to simplify here we can place them into 3 groups:

**Group 1 – The Rope-A-Dopes** – This group has been devastated the most by COVID. Restaurants, hotels, airlines, and other industries focusing on travel and leisure could be placed solidly in this group.

**Group 2 – The Average Joes** – These companies have been hurt by COVID but no more or less than their competitors, and the companies have not been devastated.

**Group 3 – The Lucky Ducks** – The companies in this group actually benefited from COVID in that demand for their products increased due to home quarantines and other aspects of the pandemic. On-line retailers, in-home entertainment companies and manufacturers of sanitization products could be placed in this group.

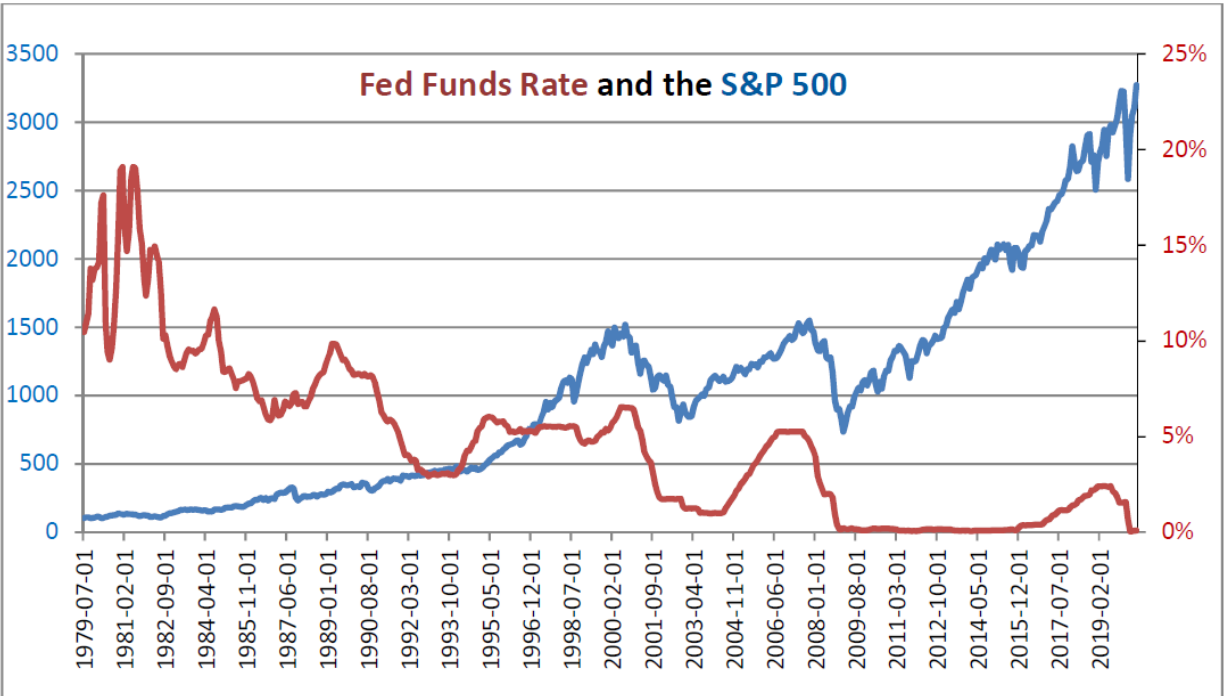
Our hearts ache for businesses in Group 1. These businesses have been devastated by COVID to no fault of their own. We called this group the Rope-A-Dopes, in honor of the late great Muhammad Ali. In 1974, Muhammad Ali took on Heavy Weight Champion George Foreman. Foreman was a heavy favorite to beat Ali. Round 1 was fairly evenly fought. Ali had come out swinging and landed many punches on Foreman, but Foreman was well trained in cutting off the ring and escaping. Near the end of the first round Foreman was landing punches and round ended in a near draw. Ali realized he had been taking about two steps for every one step that Foreman had taken. Ali knew he would tire before Foreman if he continued with the same strategy. So in round 2 he changed approaches to the secret plan he'd told fans that he had if needed. Rather than chasing Foreman around the ring, Ali did nearly the exact opposite. He spent much of rounds 2 through 7 leaning back on the ropes that defined the ring borders. He taunted Foreman to throw punches at him, but it was difficult for Foreman to land those punches to the head when Ali was on the ropes. Ali exerted minimal energy as he leaned back and accepted vicious blows to his body and arms. Although Foreman landed double the amount of punches that Ali landed, scoring wise the fight was nearly even after 7 rounds. Ali had bounced off the ropes each round enough to use his quickness and land higher point value head punches. Entering Round 8, Ali sensed Foreman's exhaustion and Ali became the aggressor. Ali TKO'd the exhausted Foreman that round. Ali's strategy of leaning on the ropes and accepting massive blows to his body and arms with the intention of wearing down his opponent became known as the Rope-A-Dope strategy.<sup>4</sup>

Figuratively, most U.S. companies have taken brutal punches in 2020. COVID caused mandatory shutdowns of businesses and even entire industries for significant lengths of time. Many of these businesses are still not able to operate at full capacity. For businesses, being forbidden from producing and selling products and services is a heavy weight slug to the head. Many businesses have been TKO'd already, and more will certainly file for Chapter 11 or simply fold up their tents and cease doing business. Others, despite being bruised and bloodied, will emerge standing tall when the pandemic is finally over. They are working hard to execute their own Rope-A-Dope strategy to make that happen.

Due to their current troubles, the Rope-A-Dope teams are likely the cheapest of the bunch and the Lucky Ducks the most expensive. Fortunately, an investor is not required to buy or sell. With patience, persistence and in-depth due diligence the prudent investor may be able to purchase the better companies in Group 1 at a bargain price, Group 2 at a good price and Group 3 at a fair price.<sup>5</sup>

The factors to consider are numerous when purchasing equities, but at the end of the day, we believe the decision is based on three primary factors that should influence almost all life's purchases: goals, quality, and price. At the heart of each of these three factors is risk. Buying items that are not in synch with our goals greatly increases the risk of not being successful. Compromising on quality increases the risk of disappointment. Over paying for items increases the chances of low or even negative returns. Price matters. Price always matters!

The price of the S&P 500 Index has risen dramatically over the last 40 years, and declining interest rates have undoubtedly played a significant role. Simple mathematics can help explain. When persons and businesses can borrow at lower rates, they are much more likely to do so. More products and services are transacted with those borrowed funds which increases corporations' profits and helps push up their stock price. Declining rates also make fixed income investments less attractive, which makes stocks by comparison more attractive. Investment dollars moving away from fixed income into equities can also help push up equity prices. Lower rates serve as a justification for higher valuations on equities. In short, investors are willing to pay more for stocks when rates are low.



Sources: Chart created based on data from Federal Bank of Saint Louis and Yahoo Finance<sup>3</sup>

In 1979, the S&P 500 closed the year at 99.71 with earnings of \$12.65. Investors were willing to pay on average 8 times (99.71 divided by 12.65) earnings for a company’s stock. Stated another way, stocks had an earnings yield of 13% in 1979 (12.65 divided by 99.71). That’s a pretty lofty yield but makes more sense when you consider in December of 1979 people with cash could by 3-month CDs yielding over 13%. Hence, investors demanded an even higher yield from stocks before taking on the extra risk.<sup>6</sup>

Let’s apply the same simple math to 2019. In 2019, S&P 500 closed at 2,278.20 with profits of \$141.07. Investors were willing to pay on average 16 times earnings for a stock, twice the multiple they were willing to pay in 1979. That translates to an earnings yield of 6% which does not sound too exciting until you consider the national average on 3-month CDs at that time was less than 2%.<sup>7</sup>

Earnings growth has contributed to the stock market’s appreciation over the last 40 years, but declining interest rates have arguably contributed nearly as much. Basic math tells us about ½ the stock market growth in the past 40 calendar years was due to rising profits and other ½ was due to investors simply being willing to pay more for those profits. Declining interest rates are at the top of the list as to why investors would pay more for stocks.<sup>8</sup>

The Federal Reserve's role was intended to be like our wiffleball commissioner making rule changes in both directions with relatively equal frequency. However, accommodating policy has dominated over restrictive policy. The Fed's role, in our view, has instead been much more like an indulgent grandparent helping a grandchild repeatedly in need, with the mollycoddled grandchild being the U.S. economy. Speculating as to who is to blame for our economy's excessive neediness over the past 4 decades would likely cause misery. Accepting the fact that The Fed has nearly zero ability to lower rates further is a reality investors must acknowledge to help avoid potential misery. Returns for the equity markets over the next 40 years are likely to be lower than the past 40 years due to the fact that interest rates have nearly no room to go lower. Even if corporate profits rise at the same pace the stock market won't benefit from a tailwind provided by declining interest rates. A headwind from rising rates is much more likely. But the game goes on. We expect there will still be investment gains to be made, but the environment will be more challenging.

In wiffleball terms, we'll likely be playing mostly Small Ball going forward. Memory tells me that games played with Skinny Yellá were the most gratifying, so let's embrace Small Ball! We'll need to really grind it out to push runs across home plate, but at the end of the day a run is a run no matter how achieved. A glorious windblown deep over the fence homerun off the bat of Big Red has the exact same value on the scoreboard as an into the wind single off Skinny Yellá followed by a stolen base, sacrifice bunt and a sac fly. Thoughtful calculated risk analysis and strategy are even more important when playing Small Ball. When attempting to steal second base on a curve ball in the dirt, the chances of sliding in safely is exponentially higher than if attempted on a fastball strike. The more homework the baserunner (or better yet the signal calling third base coach) has done as to learning when the respective pitcher tends to throw curves, the greater the chance of success.

This is not a doomsday letter, but rather a Be Prepared letter. Volatility and steep short-term drops in the stock market have been commonplace historically. Severe volatility should be expected in the future as well. Especially considering the current visceral political climate, highly leveraged government balance sheet, and the continued COVID contagion have seemingly been shrugged off in recent months at a time when The Federal Reserve has virtually zero room to cut interest rates further. Stock market

corrections are as unpredictable as they are inevitable. Trying to predict exactly when those corrections will occur can be a dangerous misuse of time. Adding an equity position after they do occur can be like stealing a base on a curve in the dirt, a calculated risk that takes courage.<sup>9</sup>

Being prepared involves maintaining ample cash reserves for expenses that may not be covered by income, like a solid defense backing up the pitcher. Being prepared means owning a carefully constructed portfolio tailored to your personal financial situation and long-term goals. Adding incrementally to positions that show promise is a seemingly small step that can help put runs on the board like bunting a baserunner into scoring position. Being prepared means only investing funds in the stock market that can be committed to the longer term. Many innings may be needed to score runs. Being prepared is accepting what we cannot control and taking action based on thoughtful analysis for those aspects that we can control. These factors in my opinion are paramount to helping achieve financial success, which my team is here to help you achieve. Today's low rates and high prices are tomorrow's wind blowing in which we cannot control. But we maintain control as to deciding which pitches to swing at, which to let pass by, and when to lay down the bunt.

Proceed with caution. Proceed with discipline. Be realistic and rational. Cooler heads can prevail. Set personal bias aside and seek a better understanding. Stay laser focused on acquiring long-term winners, while seeking to take advantage of opportunities presented by short-term price volatility to acquire quality long-term investments at a fair price. Be patient and diligent. Keep the big picture in perspective, but also dig into the details and get your hands dirty because there is no substitute for intense effort at and below ground level. These beliefs are engrained in the moral fibers of your portfolio manager team. I am proud to be with Madison Group at Morgan Stanley and honored to work with you. Thank you for your trust and confidence.

In less than 100 days, 2020 will be in the history books. May we each have grown in this year of challenges, have prospered despite the adversity, and continue on a path of improvement in 2021 and beyond!

Paul McCauley  
October 2020

<sup>1</sup>The Standard & Poor's (S&P) 500 Index tracks the performance of 500 widely held, large-capitalization US stocks. An investment cannot be made directly in a market index. The S&P 500 Index closed at 3,230.78 on December 31, 2019. On October 15, 2020, the index closed at 3,483.34 up 7.8% on the year. As of June 30, 2020 the S&P 500 year-to-date was 46.29 compared to 69.95 per share as of June 30, 2019, a decrease of 33.82%. Source: Reuters.

<sup>2</sup>Source of the Babe Ruth quote: [www.planetofsuccess.com](http://www.planetofsuccess.com)

<sup>3</sup>Source: Federal Reserve Bank of St. Louis ([www.stlouisfed.org](http://www.stlouisfed.org))

<sup>4</sup>Sources: [www.en.wikipedia.org/wiki/Rope-adope](http://www.en.wikipedia.org/wiki/Rope-adope) and [www.britannica.com/sports/rope-a-dope](http://www.britannica.com/sports/rope-a-dope)

<sup>5</sup>Investors typically are not prohibited from buying, holding or selling investment securities on the NYSE but there are exceptions which may include (but are not limited to) insiders, employees, and shareholders of companies being acquired or filing for bankruptcy among other specific situations. Source: [www.sec.gov](http://www.sec.gov)

<sup>6</sup>The Standard & Poor's (S&P) 500 Index tracks the performance of 500 widely held, large-capitalization US stocks. An investment cannot be made directly in a market index. The S&P 500 closing prices and earnings information were obtained from Reuters.

<sup>7</sup>The average 3 month CD rate in the United States in December of 1979 and December of 2019 was 13.34% and 1.76%, respectively. Source: The Federal Reserve Bank of St. Louis ([www.stlouisfed.org](http://www.stlouisfed.org))

<sup>8</sup>Source: The Economist ([www.economist.com](http://www.economist.com))

<sup>9</sup>There have been 20 stock market corrections since 1979, with stock market correction being defined as drop in value of 10% or greater in the S&P 500 Index. Source: [www.yardeni.com](http://www.yardeni.com) The Standard & Poor's (S&P) 500 Index tracks the performance of 500 widely held, large-capitalization US stocks. An investment cannot be made directly in a market index.

This material was originally created in October 2020 and is provided for educational purposes only. The information is not current and should not be viewed or considered as investment advice or an investment strategy. All opinions are subject to change without notice. Neither the information provided nor any opinion expressed constitutes a solicitation for the purchase or sale of any security. Morgan Stanley Wealth Management recommends that investors independently evaluate particular investments and strategies, and encourages investors to seek the advice of a Financial Advisor. The appropriateness of a particular investment or strategy will depend on an investor's individual circumstances and objectives. Past performance is no guarantee of future results.

This case study is hypothetical and presented for illustrative purposes only. The facts involved do not represent the actual experience of any specific client. Each client's situation is different and a client's experience and any recommendations made to a client will vary depending on the specific facts and circumstances involved. Past performance is no guarantee of future results. These strategies do not guarantee a profit or protect against loss and may not be appropriate for all investors.

The information set forth was obtained from sources we believe to be reliable, but we do not guarantee its accuracy or completeness. Past performance is no guarantee of future results.

This material does not provide individually tailored investment advice. It has been prepared without regard to the individual financial circumstances and objectives of persons who receive it. The strategies and/or investments discussed in this material may not be appropriate for all investors. Morgan Stanley Wealth Management recommends that investors independently evaluate particular investments and strategies, and encourages investors to seek the advice of a Financial Advisor. The appropriateness of a particular investment or strategy will depend on an investor's individual circumstances and objectives.

The views expressed herein are those of the author and do not necessarily reflect the views of Morgan Stanley or its affiliates. All opinions are subject to change without notice. Neither the information provided nor any opinion expressed constitutes a solicitation for the purchase or sale of any security. Past performance is no guarantee of future results.

**Indices are unmanaged. An investor cannot invest directly in an index.**

For index, indicator and survey definitions referenced in this report please visit the following: <https://www.morganstanley.com/wealth-investmentsolutions/wmir-definitions>

Morgan Stanley Smith Barney LLC. Member SIPC.

CRC 4770810 08/2025