Are There Hidden Risks Lurking in Your Portfolio?

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Dollar stores and off price retailers did exceptionally well in the aftermath of the 2008 financial crisis. Retail chains such as Dollar General, Five Below and TJX saw significant growth by providing cheap groceries and home goods to a growing group of cost conscious and lower income consumers. Investors responded to the impressive growth by piling into the niche area of this market. As a result, valuations for discount and off price retailers soared.

However, the market segment cracked in August after a broad sell-off. Dollar General took the strongest blow, plummeting over 22% during the month on the back of disappointing earnings. Long term out-performers Five Below and TJX were pulled down with the rest of the pack despite strong earnings and growth rates that continue to outpace the overall retail industry.

Was the sell-off warranted? Even though the growth outlook remains strong for this segment, there was a quick and fierce reaction from investors at the first signs of changing macro drivers, notably interest rates, which favor other sectors or segments of the market. At the same time, better employment numbers and hourly wage statistics led to growing skepticism about discount retailers' ability to gain market share at a constant rate, and keep pace with the growth rates demanded by high valuations. As a result, there was a largescale rotation out of the segment.

Broad based rotations into or out of a sector are a growing trend that exposes a portfolio to a risk that is not easily observable or quantifiable: the crowding factor. Unfortunately, it is being mirrored across the entire market as more investors chase the same opportunities. Even traditionally conservative sectors, such as consumer staples and utilities, can be driven by the effects of crowding.

There appears to be a pack mentality among investors today, most likely due to a variety of top down macroeconomic factors. For one, elevated levels of market uncertainty have led investors to seek out investment options with perceived safety. Sectors like Consumer Staples and Utilities typically exhibit low volatility characteristics, and are viewed favorably by the investment community.

Compounding the problem is investors' desperate search for yield. While fixed income investments have historically been the provider of ongoing income in a portfolio, historically low rates have led investors to seek out alternative sources of yield. These so called "bond proxies", including the more stable dividend-paying stocks, have proven to be an attractive option, and investors have responded by piling into the space.

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There appears to be a pack mentality among investors today, likely stemming from elevated levels of uncertainty in the market and the need for alternative sources of yield.

However, the low interest rate environment has pushed these bond proxies to all time high valuation levels. As these areas of the market become more and more crowded, their relative safety begins to diminish. For example, while volatility in the Consumer Staples sector remains low and yields are still attractive, current price multiples are nearly two standard deviations above historical multiples. Such demanding valuations can push implied expectations to unrealistic levels and leave little room for disappointment.

Understanding that crowding is a growing concern, can investors take measures to mitigate the risk? The short answer is yes, but it can be a challenge because traditional risk models typically miss it. Specific names or segments of the market are typically crowded for compelling reasons. They each likely have a good fundamental story with favorable macroeconomic exposures, and exhibit lower volatility as investors continue to buy. The low volatility characteristics actually push risk models and portfolio optimizers to favor these types of stocks.

As a result, there is a certain art to the process that requires an intuition and judgment as to what inning of the crowding game we are in. Of critical importance is the ability to distinguish a stock that has an interesting story but is not yet crowded from a stock that has unrealistically high implied expectations due to market positioning. However, there are more tangible steps you can take to help provide downside protection against the effects of crowding.

- **Know The Investment.** Crowding risk is not easily observable, nor is it quantifiable. A stock's trading history, sell side ratings and upgrades, momentum, and valuation relative to its historical average are all good indicators of the level of crowding in a particular name.
- **Understand What Is Sustainable.** Take a realistic look at a stock's implied growth rate and determine whether the company can maintain the rate long-term. In addition, if there is no valid fundamental reason why a stock's price has increased, investigate whether it has simply been run up by a rotational shift.
- **Diversify Risk.** Just as investors look to protect their portfolio from volatility and other forms of risk, it is important to safeguard a portfolio from taking a concentrated position in crowding risk. Investors should be cautious of how many high crowding risk names they have in their portfolio.

While crowding risk is not easily identifiable or quantifiable, there are tangible steps you can take to mitigate the risk in your portfolio.

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