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Premium

A fund manager at a $629 billion firm lays out his strategy for 'making money at the expense of machines' during the stock market's sell-off — and shares 4 sectors he's betting on

Vicky Ge Huang

- **Steven Chiavarone, co-manager of the $395.3 million Federated Hermes Global Allocation Fund, says investors should stay put and not panic just because of Thursday's market sell-off.**
- **The investor is looking for opportunities in the technology, consumer, industrial, and biotech sectors as the economy continues on the path of recovery.**
- **He also explains why the fund's portfolio management team places their highest conviction bet on small caps as the economic recovery takes hold.**

On a day when the S&P 500 index fell 3.5%, the Dow Jones Industrial Average shed over 800 points, and the tech-heavy Nasdaq plunged almost 5%, Steven Chiavarone thought investors should not panic but stay put.

"There's no apparent catalyst in terms of poor economic data releases or negative news flow, so my best guess here is that you've had a couple of technical indicators that triggered," said Chiavarone, who is a co-portfolio manager on the $395.3 million Federated Hermes Global Allocation Fund. The firm manages $629 billion in assets.

Highly valued tech stocks dragged the stock market lower Thursday, setting off the worst single-day loss for US stocks since June.

The S&P 500's relative strength index, which is a momentum indicator that measures the speed and change of price movements, hit 80 on Thursday. Meanwhile, the large-cap index was trading 15% above its 200-day moving average for the first time since January 2018.

"Eighty is a pretty extreme reading, there are not too many times it gets that high," Chiavarone told Business Insider on Thursday. "A lot of algorithms out there are built to look for certain technical indicators and levels, and when they're triggered, it sells. That probably happened today."

However, if a meaningful pullback happens, Chiavarone said he has "absolutely no qualms about making money at the expense of the machines that don't understand the whole picture."

The manager, who co-runs the multi-asset fund with five other investors, adopts a top-down macro approach when it comes to taking sector bets and selecting securities.

Federated Hermes, Inc.

Steven Chiavarone is co-manager of the $395.3 million Federated Hermes Global Allocation fund.

"We think the overarching theme in the marketplace right now is an economy that has exited recession and is entering recovery. That is first and foremost a good environment for stocks," he said, adding that stocks are providing capital protection and are more attractive compared to the 10-year Treasury notes, which have been yielding 50 to 60 basis points.

Within the universe of U.S. stocks, Chiavarone and his team are betting on sectors that are poised to do well coming out of a recession.

"Those sectors that do best are tied towards economic growth," he said, noting that technology, consumer staples, industrials, and biotech are the four sectors that stand to benefit as the economy heals from the COVID-19 crisis.

“You’re going to continue to see a recovery in the consumer, particularly as we continue to add jobs,” he said. “So we like consumer sectors. I think you’re going to see a stockpiling of medical equipment and medication in response to the pandemic so areas of biotech and pharma are attractive.”

Small caps as a recovery play

As the market rally broadens, Chiavarone said the team’s highest conviction lies in small cap stocks, which he defines as those included in the Russell 2000 index.

Small caps are most likely to outperform on the way up because small companies are more tied to the underlying growth of the economy compared to large and mega cap companies.

“Just as smaller companies, in general, were most impaired from the cyclical downturn in the economy, they will also, therefore, benefit the most from a cyclical rebound,” he said.

Small caps could also make the most out of a low-interest-rate environment because 50% of small-cap company debt is bank debt, which oftentimes comes with variable rates. Whereas for companies in the S&P 500, most of their debt structure is fixed-rate and only 10% is bank debt, according to Chiavarone.

“The likelihood that those rates are going to stay low for an extended period of time given the Fed’s dovish pivot towards average inflation targeting tells us the debt expense of small cap companies is a tailwind today and is likely to remain a tailwind for some time,” he said.

For investors who are unconvinced, small caps historically tend to outperform large caps by about 25% in the first year following a recession bottom, and the “digital industrial revolution” will only lead the market to aggressively seek out and reward smaller companies that seek to disrupt the status quo, he said.

Some of the small-cap stocks in the Federated Hermes Global Allocation Fund include Achillion Pharmaceuticals, Inc. (ACHN), Systemax Inc. (SYX), and Photronics (PLAB), according to its portfolio fact sheet.

Past performance is no guarantee of future results.

Fund and firm assets in the article are as of June 30, 2020.

Source for historical small cap performance vs. large caps after recession bottom: “Russell 2000 vs. S&P 500,” Bloomberg, 2020.

Views are as of Sept. 4, 2020, and are subject to change based on market conditions and other factors. These views should not be construed as a recommendation for any specific security or sector.

The holdings, which are referenced in the article, made up the following percentages of Federated Hermes Global Allocation Fund’s portfolio as of 6/30/20: Systemax, Inc., 0.0022%; Achillion Pharmace Common Stock, 0.0012% and Photronics, Inc., 0.00001%.

The holdings percentages are based on net assets at the close of business on 6/30/20 and may not necessarily reflect adjustments that are routinely made when presenting net assets for formal financial statement purposes. Because this is a managed portfolio, the investment mix will change.

Mutual funds are subject to risks and fluctuate in value.

There is no guarantee that any investment strategy will be successful.

Small company stocks may be less liquid and subject to greater price volatility than large capitalization stocks.

Stocks offer higher return potential, but their prices are more volatile than those of bonds. Unlike stocks, Treasury notes are guaranteed as to the payment of principal and interest.

High-yield, lower-rated securities generally entail greater market, credit/default and liquidity risks, and may be more volatile than investment-grade securities.

Bond prices are sensitive to changes in interest rates, and a rise in interest rates can cause a decline in their prices.

International investing involves special risks including currency risk, increased volatility, political risks, and differences in auditing and other financial standards.

The fund may make short sales of securities, which involves unlimited risk including the possibility that losses may exceed the original amount invested.

S&P 500 Index: Is an unmanaged capitalization-weighted index of 500 stocks designated to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

Russell 2000® Index: Measures the performance of the small-cap segment of the U.S. equity universe. The Russell 2000 is a subset of the Russell 3000® Index representing approximately 10% of the total market capitalization of that index. It includes approximately 2000 of the smallest securities based on a combination of their market cap and current index membership. The Russell 2000® Index is constructed to provide a comprehensive and unbiased small-cap barometer and is completely reconstituted annually to ensure larger stocks do not distort the performance and characteristics of the true small-cap opportunity set.

Dow Jones Industrial Average ("DJIA"): An unmanaged index which represents share prices of selected blue chip industrial corporations as well as public utility and transportation companies. The DJIA indicates daily changes in the average price of stocks in any of its categories. It also reports total sales for each group of industries. Because it represents the top corporations of America, the DJIA's index movements are leading economic indicators for the stock market as a whole.

Indexes are unmanaged and investments cannot be made in an index. Index and market performance is for illustrative purposes only and is not representative of any specific investment.

Investors should carefully consider the fund’s investment objectives, risks, charges and expenses before investing. To obtain a summary prospectus or prospectus containing this and other information, contact us or visit FederatedInvestors.com. Please carefully read the summary prospectus or the prospectus before investing.

Federated Hermes, Inc.
1001 Liberty Avenue
Pittsburgh, PA 15222-3779
1-800-341-7400
FederatedHermes.com

Contact us at **FederatedHermes.com** or call 1-800-341-7400.
Federated Securities Corp., Distributor
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