March Madness – Picking Top Seeds

March Madness is in full swing, but there has not been as much "madness" as we have seen in previous years. We finished the first two rounds last weekend and have begun the Sweet Sixteen matchups. How have your brackets fared? For those "bottom fishing" investors out there who like to pick upsets, there weren't many during the first few rounds. The majority of the top seeds are still in the fight, specifically UVA, UNC, Duke, and Gonzaga. Those who picked the higher ranked teams are leading their respective bracket challenges. Even with the dearth of upsets, the perfect bracket is rare, as evidenced by the fact that there is currently only one perfect bracket left (across the major online bracket game platforms). So, what are the odds? According to NCAA.com, "If every game were a coin toss, the odds of predicting 48 wins in a row are 1 in 281,474,976,710,656." For a perfect bracket at the end of the entire tournament, it's said to be roughly "1 in 9.2 quintillion" but "That's assuming you have 50-50 odds to get every game correct, which is obviously not the case." In other words, the odds are not in your favor.

NCAA Basketball Tournament: Top Seeds often Win Championships

SEED	FINAL FOUR	CHAMP GAME	NATIONAL CHAMP
1	56	33	21
2	28	12	5
3	16	11	4
4	13	3	1
5	6	3	0
6	3	2	1
7	3	1	1
8	5	3	1
9	1	0	0
10	1	0	0
11	4	0	0
12	0	0	0
13	0	0	0
14	0	0	0
15	0	0	0
16	0	0	0

Note: The data goes back to 1985, when the tournament was expanded to 64 teams.

(Image Source: NCAA.com)

Just like it's extremely difficult to fill out a perfect March Madness bracket, it is impossible to create a perfect portfolio. You can't always have a 100% win rate with all of the outperformance and none of the downside. It just doesn't exist. However, the tools we use help our process to create portfolios, identify opportunities, and manage risk. In the spirit of March Madness, we will review some themes around the market. We'll explore some Cinderella stories, top seeds, and take note of a potential bracket buster.

Cinderella Story:

There's often a Cinderella team or two that captures the Country's attention during March Madness. These teams are the ones that make it far further than one could have reasonably expected. Sometimes it's a #11 seed team that makes it all the way to the Final Four, like Loyola-Chicago Ramblers in 2018, or maybe a #8 team that wins the whole thing, like the Villanova Wildcats back in 1985. These are the teams that come out of no-where and take the Tournament by surprise. Sometimes the same thing can happen in the marketplace. Maybe it's a trend that continues that you would not have reasonably expected, or maybe a low ranked sector or country begins to gain momentum.

One area that fits the Cinderella criteria is Utilities, which has maintained one of the top sectors in the strong domestic equity uptrend we have witnessed thus far in 2019. The Utilities space is typically thought of as more of a "safe-haven" in times of market turmoil because the stocks within that sector tend to be less volatile and often carry a decent yield. This is exactly what we saw in the 4th quarter of 2018, as investors fled the "riskier" sectors of Technology and Growth in favor of the Utilities space. However, the 1st quarter of 2019 has seen both Utilities continue to advance, and the Growth names rebound, which speaks to the broad nature of the recovery we have seen in recently.

Top Seeds Keep Winning: Consistency is Key

In college basketball there's a phrase used to describe the powerhouses in the sport - "blue bloods." It's based on "tradition, consistency and resources" that determine the blueblood status. Today the "blue blood" teams are UNC, Duke, UK, and Kansas, with the former three still left in the tournament. These teams have been perennial winners. Today, there are some "blue bloods" in the sector and style space that have exhibited consistency and are thus in "blue" - Technology and US Large Cap Growth.

Bracket Busters: Potential Portfolio Busters

Where are all the bracket busters in this year's NCAA Tournament? According to Sports Illustrated, "For the first time since 2009, all four No. 1, No. 2 and No. 3 seeds have made the Sweet 16." There's been a lack of upsets this year. Remember the term "bracket buster" usually refers to a low ranked college basketball team that upsets a highly ranked team in the Tournament. These upsets are tough to predict and are extremely rare. On average the higher seeded teams win. That said, there are typically a handful of bracket busters in every tournament, whether it's UVA losing to UMBC, the first #1 seed team to lose to a #16 team, or UC Irvine beating Kansas St in this year's tournament. Just like in trend following we know that not every strong name will outperform going forward, so we need a process to identify the next leader. We also know that we can't predict every market event or catalyst, but it's still a good idea to stay up to date on important trends to avoid potential bracket busters, i.e. portfolio busters.

While not necessarily a portfolio buster, the Energy sector, both on the commodity and equity level, could be the "lower seed school" that upsets a highly ranked team or ends up becoming a future leader, like Gonzaga, a former bracket buster, is today. For much of 2018, the Energy Sector traded in a choppy fashion before collapsing in October, falling from $78 to a low in December of $54, over 30%. However, over the past couple of months, it has rallied approximately 24%. The move coincides with improvement across the Energy-related commodities. On a relative strength basis, Energy, in general, should be avoided, but if it starts to gain strength, this laggard could become the next "bracket buster" that turns into the next leader.

Please contact us to learn more about rules-based disciplined investing and how it can help your clients. The Bluegrass Asset Management team can be reached at 502-429-0196, ask for John Casconi, Rodger McAlister or Jennifer Grilliot.