Better To Be Lucky Than Good?

“Money is made by sitting, not trading.”
- Jesse Livermore

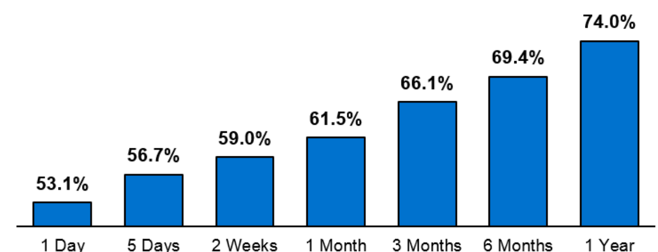
Now introducing Danny Tran, a 22-year old former department store shoe salesman turned star stock trader on TikTok. Earlier this year, Mr. Tran was sitting around with nothing to do and some stimulus money burning a hole in his pocket. So in January, Mr. Tran found a new hobby – he started trading stocks. His philosophy? Well, that’s just the thing – he didn’t have one. In one of his TikTok videos, Mr. Tran admitted “I don’t know what the (expletive) I’m doing. I just know that I’m making money.” Over the next few weeks, Mr. Tran had garnered the attention of nearly half a million followers on TikTok.

Now, this is not a criticism of Mr. Tran, or any number of market first-timers that have gotten their feet wet in the markets since the pandemic broke out. The point we’re trying to raise is that speculation has become a larger factor in the stock market over the past few months. One reason for this is that many market rookies are treating trading stocks as an alternative to other forms of gambling.

In a way, this reasoning makes sense. As opposed to gambling, where “the house always wins”, the stock market generally goes up (see chart at right).

On any given day since 1950, there’s been a 53% chance that the S&P 500 Index will close higher. As that time horizon gets longer, the odds of positive returns increases significantly. It’s just that easy, right?

Stocks Can Be A Good Bet
Odds of Positive Returns
S&P 500 Index, Since 1950



Source: Factset, FFWM Research

There’s the rub. Simply “making money” in stocks can be as easy as employing a “buy and hold” strategy. But what that strategy requires is the patience and long-term view of an investor, and not the short-termism of a speculator.

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At First Financial Wealth Management, we always strive to maintain the perspective of a true "investor" and not that of a "speculator." Money-management giant BlackRock did a good job illustrating the differences between these perspectives, which are summarized in the table at right.

INVESTORS	SPECULATORS & TRADERS
Major Trends	**Major Trends**
Foundation upon which long-term direction is built given long-term return objectives	Not interested in the long-term
Medium-Term Cycles	**Medium-Term Cycles**
Vary in length, but usually two or three per year that can drive annual investment returns	Only helpful for contextual background
Short-Term News / "Noise"	**Short-Term News / "Noise"**
Require fortitude and conviction to ignore, but usually have little impact on long-term returns	With 24-hour news cycle, capitalizing here makes this difficult

Source: BlackRock

Overall, there are three main types of information that dictate investment decisions:

- Major trends that persist over years and are the underlying foundation of long-term investment direction,
- Medium-term trends and cycles that can determine prices and market moves,
- Short-term news (or "noise") which can influence very short-term market moves but can easily reverse.

Our investment philosophy aims to generate solid risk-adjusted returns over full market cycles. This, naturally, places more importance on the "major trends" than short-term news. "Medium-term cycles" can be exploited opportunistically to take advantage of market anomalies in order to generate a little extra return in client portfolios. Any investment decisions made based on these medium-term trends usually involve only a small portion of a client portfolio, so as not to put at risk the bulk of the account's principal.

While we are certainly aware of short-term "noise" we do our best to filter that out and not let it impact our long-term views. This can be a difficult chore, especially when speculators are grabbing headlines and getting rich. It's in these times that this quote from Fred Schwed (author of *Where Are the Customers' Yachts?*) becomes more relevant:

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"Speculating is an effort, probably unsuccessful, to turn a little money into a lot. Investment is an effort, which should be successful, to prevent a lot of money from becoming a little."

Back to the speculators and first-timers. This year has been pretty much the perfect situation for speculation to (temporarily) move markets. Stimulus checks and limited entertainment options have left millions of Americans bored and sitting on extra cash. New trading platforms – the prime example being Robinhood – offer low (or no) cost trading along with the ability to open accounts with very low initial balances. Add on top of this the ability to share ideas and coordinate trading efforts through social media, and you have a recipe for some pretty wild price fluctuations. As we've mentioned in previous editions, speculators conferring with each other on Reddit and other forums have caused stocks like GameStop to go on roller-coaster rides this year.

But speculation can go beyond obvious gambles like GameStop. Many of the leaders from last year – stocks that benefitted from "work from home / stay at home" – have struggled recently. Stocks like DoorDash, Zoom Video and Peloton have all fallen 35% or more from recent 52-week highs. These types of price declines indicate to us that speculation had spread beyond that handful of stocks popularized by bored homebodies like Mr. Tran.

The question is, how much of the market's move over the past year is due to pure speculation? Quantifying the impact of speculation on the broader market is nearly impossible, but a "guesstimate" can be made by deconstructing the S&P 500's gains into three components: earnings expectations, valuation multiples, and the impact of speculation.

In the period immediately following the outbreak of the pandemic, nobody could foresee what impact a global shutdown would have on earnings. Initially, this uncertainty triggered panic selling in the stock market (falling over 30% in a few short weeks) that was driven primarily by declines in what investors were willing to pay for highly uncertain future earnings (shrinking price / earnings multiples accounted for the vast majority of the decline). It was mid-May by the time earnings estimates had troughed, and during

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this time the yield on the 10-year Treasury declined significantly from around 1.0% to just 0.7%. This drop in yields made stocks look relatively more attractive (a return of the "T.I.N.A." thesis – "There Is No Alternative" to owning stocks) and expansion in price-earnings multiples offset the drop in earnings expectations, causing the market to advance nearly 30% from the March lows.

Yields continued to fall into early August, when the yield on the 10-year Treasury bottomed at 0.5%, leading to a further expansion in equity multiples. Earnings expectations also began to recover during this time, providing an additional boost to the stock market.

So, for much of 2020, the overall increase in value for the stock market *as a whole* could be attributed to the inverse relationship between interest rates and price-earnings multiples, as well as improving earnings estimates. However, there were essentially two separate stock markets during that time.

On the one hand, "growth" stocks led the market higher as interest rates fell, with the Russell 1000 Growth Index posting a 60% gain between the market bottom and the low in interest rates. This makes sense in that the value of "growth" stocks relies more upon the discounted present value of future earnings; if interest rates are low and falling, then these future earnings become more valuable in the present. "Value" stocks, on the other hand, rose as well (40% gain for the Russell 1000 Value Index) but not nearly as much as their "growthier" counterparts.

Since interest rates bottomed in early August, the yield on the 10-year Treasury has risen to over 1.7%. Just as "growth" stocks benefit from low and falling rates, rising rates should have a negative impact. That has not been the case, though, as the Russell 1000 Growth Index has risen another 13% since rates bottomed.

What's behind this? The answer, more than likely, is speculation.

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This speculation was most apparent in those companies that were valued on expected earnings from the distant future. Tesla, for example, more than tripled in value as interest rates rose from 0.5% to over 1.7%. With expected earnings largely unchanged over that time, these gains were likely the result of rampant speculative buying.

Cracks are beginning to emerge in this speculative frenzy. Since peaking in late January, Tesla has lost roughly $250 billion in market value. The darlings of the Robinhood traders have largely come back to Earth, and "growth" stocks more broadly have also retreated. Taking over market leadership has been the more cyclically-leaning "value" sectors of the market, with the Russell 1000 Value Index outperforming its "growth" counterpart by 11% in 2021.

Regarding our client portfolios, we recently trimmed our overweight allocations to riskier areas of the market in order to manage total portfolio volatility. While we believe the time has come to prepare for this change in market leadership by adding more exposure to cyclical areas of the market, we realize that the equity market could experience some volatility following such a strong run over the past year. In sum, client portfolios maintain their cyclical orientation.

Within equities, we've recently increased our clients' exposure to larger, more developed international markets. We've also made moves to increase exposure to smaller companies in the US and have added targeted exposure to more cyclical areas of the US large cap space. In the fixed income area, we remain focused on more credit-sensitive securities (with less exposure to the more cyclical areas of the market) with shorter maturities as a hedge against potentially rising interest rates. Within the alternative market segments, we recently increased our exposure to "real assets" (think commodities and real estate) as a hedge against the potential for higher inflation. We have maintained our exposure to the diversified alternative sector as a hedge against potential market volatility.

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Are not deposits	Are Not FDIC Insured	Have No Bank or Federal Government Guarantee	May Lose Value