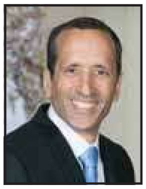
Stop the Game!



By Jonathan Caplan

In contemporary political discourse, replete with polarizing rhetoric and questionable media reporting, weaving false narratives is the modus operandi for many talking heads from their bully pulpits. But false narratives are emerging in many other walks of life outside of the political realm. Personally, I find these false narratives disturbing, and believe they interfere with our ability as a society to find solutions to our most pressing needs.

One of the false narratives that I am hearing more regularly is that Wall Street is "rigged against the little guy." This narrative is intended to convince the prospective individual investor, referred to by the media somewhat pejoratively as "the little guy," that he cannot be a successful investor. They argue that the titans of Wall Street ensure that "the odds are stacked against them." In my estimation, nothing can be further from the truth.

Now I am not suggesting that large and powerful investment banks and hedge funds do not have any number of advantages over "the little guy." Much of their advantage is due to their access to large swaths of proprietary research and information as well as highly competent and human capital. Yes, there are many cases of questionable behavior and ethical lapses on Wall Street. But, the vast majority of financial institutions and investment banks play by the rules, albeit benefitting from many of their inherent advantages.

Just because large players have certain advantages does not mean that the "little guys" cannot be successful investors. Many disciplined investors of varying degrees of wealth have seen their equity portfolios grow dramatically over long periods of time. If financial assets rise in price over time, there is no reason why small investors cannot win. As I have posited a number of times in prior articles, a cogent financial plan can be the key to living a comfortable retirement.

The most recent and deleterious false narrative is now being promulgated by a large band of mostly younger investment neophytes who are hell-bent on "taking on the big boys." To achieve this end, they choose a means of boldly speculating on stocks with questionable investment merits. In recent weeks, you have probably become aware of a nascent brokerage platform called Robinhood, and a once obscure social media site called Reddit. The trading ideas are spread on social media and then executed by a band of speculators, who collectively believe they can turn Wall Street upside down.

The problem is that in certain cases they have had some short-term success. The daily price action during the past few weeks of stocks such as Gamestop and AMC Entertainment has been nothing short of breathtaking. As an example, Gamestop shares on January 12 were trading under $20 per share. By January 27, the stock rose over 15-fold. With potential returns that juicy, why shouldn't we all be speculating in this coterie of stocks being promoted on social media sites such as Reddit?

To answer this question, I would like to explain what we believe are the fundamental drivers of stock price performance. While there are many factors that can drive price movements in the short term, long term price performance is driven by growth in revenue and profits. Some of the best performing stocks in recent years, such as Facebook, Amazon, Apple, Netflix, Google and Microsoft, have been consistently growing revenue and profits. In fact, I believe that technology stocks were the primary reason for any gains in market averages in 2020, a year when the economy overall was ravaged by the effects of the COVID-19 pandemic.

Getting back to Gamestop, a casual observer could have thought that, based on its January stock performance, the company must have announced that they have discovered a comprehensive solution to global warming or the cure for cancer. In fact, alas, there has been no such positive fundamental news.

In one press release on January 11, the company reported holiday sales were down 3.1%, not surprising considering the weak retail environment, but uninspiring at best. While e-commerce sales have been growing rapidly, that growth has been more than offset by the sharp decline in their chain of "brick and mortar" stores. While the CEO says he believes that the company will see profitability in the fourth quarter, Yahoo Finance data shows that Wall Street analysts on average expect losses in fiscal 2021 and fiscal 2022.

The upshot is that this company is facing strong structural headwinds that could call into question its long-term viability. This would not seem to me the type of investment that should be the centerpiece of an equity portfolio.

Now in some ways a number of these speculators have been successful. Their coordinated attack on Wall Street short sellers left a few hedge funds with staggering losses. One hedge fund, Melvin Capital, required a privately funded bailout due to its massive losses shorting Gamestop.

So what is wrong with a strategy of trying to beat the pants off the titans of Wall Street? If groups of small investors can band together and work in concert to take advantage of the Achilles' heels of the "big boys," is that not a clear sign of democratization of investment success? In my next screed I will attempt to undo the myth that the Robinhood/Reddit community is destined to succeed and has likely already caused financial harm to many followers.

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