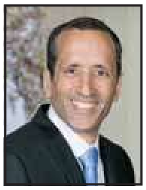
Stop the Game



By Jonathan Caplan

In last month's column, I described the phenomenon of what could be described as the rise of young speculators attempting to manipulate the prices of select stocks. These "merry men" gravitated to trading platforms such as Robinhood and have virtually banded together on social media to collectively drive an agenda. Many individuals have expressed their hope of "punishing" Wall Street short sellers while generating outsized profits in their own trading accounts.

This quest reminds me of one of my favorite movie comedies of all time, "Trading Places." Seeking revenge on their former employer, Duke & Duke Commodity Brokers, Billy Ray Valentine (played by Eddie Murphy) and Louis Winthorpe III (played by Dan Aykroyd) successfully intercepted the Agriculture Department's orange juice crop report while delivering a falsified report to the Duke Brothers.This led to a showdown on the commodity exchange floor in which Valentine and Winthorpe made millions while the Duke brothers were bankrupted in one trading session. After counting his newfound fortune, Valentine quipped to his former boss, "I made Louis a bet here! See, Louis bet me that we couldn't both get rich and put y'all in the poor house at the same time. He didn't think we could do it. I won."

The idea, however, that two undercapitalized traders could become instant millionaires at the expense of their well-heeled bosses is fantasy. And that is why I am concerned that speculators believe they can become instant millionaires by trying to upend the natural forces of the markets. At the root of the problem is what I would describe as the gamification of Wall Street. Investing is no longer about research, due diligence and allocating money in a diversified portfolio of quality stocks. Many newcomers to the investment world now believe that all you need is "a dollar and a dream." along with a little help from other like-minded speculators.

Profits for Everyone?

I would be the first to admit that virtually all investors can do well investing in the stock market and can realize healthy returns over a long investment horizon. Wall Street is not a "zero sum game." The stock market historically does well over long periods of time because most companies grow and generate increasing profits over time. Shareholders are rewarded by higher dividends, higher stock prices, or both. Thus, all investors are potentially winners.

The same does not hold true for speculators in individual stocks, particularly the types that are frequently targeted by Robinhood traders. The problem is that many of the target companies have very questionable prospects and/or are facing formidable financial challenges. And therein lies the problem: speculating in stocks just because they may be vulnerable to sharp stock movements can easily become a zero-sum game. What is meant is that if/when the stock price falls back to earth, there will be many losers along with the winners who were early to spot the opportunity.

But Is It Really That Risky?

To understand why I discourage investors, and even speculators, from taking part in this phenomenon, I look at the unusually high degree of risk of being on the wrong side of the trade. When a stock rapidly doubles or falls in half on no fundamental news, this should be a clear signal of the highly speculative nature of getting involved.

When investment professionals build a portfolio of stocks for clients, we tend to be acutely conscious of the fact that too much concentration in any one stock, particularly a highly volatile stock, has associated potential pitfalls. When a stock or sector falls out of favor, one could end up with a permanent loss of capital. And that makes it all the more difficult to recoup those losses for long periods of time.

For those who remember the dotcom boom/bust of the late 1990s and early 2000s, you may be aware of the danger of a permanent loss of capital. Many of the largest and well-capitalized dot.com companies experienced massive declines in stock prices when the bear market ensued. While some of those companies eventually rallied back, it took many years for those who invested heavily in the sector to recoup losses. Moreover, many other companies went bust or were acquired at a fraction of their all-time high prices.

This is why I believe it is so important to write about such an esoteric topic. In the investment world, one bad investment can have devastating and, at times, irreversible consequences. No matter how much success one has had speculating in the past, one is always one bad trade away from causing significant harm to his/her financial health.

A Word to the Wise

When market phenomena such as the advent of the emergence of speculative trading becomes front page news, I begin receiving calls from my clients regarding whether they should try to get involved. My immediate reaction is to "just say no."

I will not deny that success in these types of strategies are possible. Many have made money. Many have lost money. But I recommend viewing this type of activity for what it is: speculation. Many of us enjoy the thrill of gambling or speculating in the hope of making a killing. We buy lottery tickets. We play games of chance in casinos. But we know that the odds of success are generally not in our favor. Because of this, we tend to set limits on those activities as excessive risk taking can lead to unhappy outcomes.

The most important thing to remember is that investment success is attainable if one remembers to always be conscious of the fundamentals of investing, and being able to separate the idea of speculation from the principles of investments.

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part ways. And should they choose to divorce, they are often not traveling down the contentious or litigious path but are choosing to end their relationships in an amicable fashion. Mediation and collaborative divorces are becoming more and more popular because people are choosing to no longer waste money, and invest in a commodity worth far more—time and future co-parenting relationships.

Eventually we will know the true impact of COVID, but what we have seen is a shift in values that we can all appreciate.

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