Mitch on the Markets

Portfolio Manager Investing Insights

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Investor Frenzy Is Nearing A Tipping Point

Readers of this column are likely aware of some of the bizarre events transpiring in the equity markets today. Among them, stories of Reddit chatrooms driving short squeezes and massive single-day moves (in both directions) in companies with relatively weak fundamentals. If parts of the environment feel like the 1990's dot-com bubble to you, I'm right there with you.

Some of the numbers are eyebrow-raising, to say the least: Morgan Stanley reported growth of approximately 900,000 new self-directed accounts in the second half of 2020; Charles Schwab (which is now combined with TD Ameritrade) has been routinely breaking records for daily client trades, processing some 8 million daily; the online trading platform, Robinhood, which targets millennials and younger investors, saw 500,000 downloads in December alone; a record 10 million new brokerage accounts were opened in 2020.[1]

Normally, I would support retail investors opening accounts and starting down a long-term path of saving and investing for the future, but not in this format. I'm concerned many of these investors are new to investing, and are trading on speculation, over-concentrating in 'hot' positions, and committing too much of their liquid net worth to short-term trading. I hope I'm wrong, but there is a long history of this type of enthusiasm/euphoria leading to major losses. History tells me that volatility and 'heat chasing' mints more losers than it does winners.

There is also growing evidence that retail investors are pushing even further out onto the risk curve by using leverage. Investors borrowed a record $722.1 billion on margin through November 2020, Charles Schwab reported a 16% increase in average margin loans balance in the last three months, and analysts at Piper Sandler noted that off-exchange trading – which captures the retail market – accounted for 48% of total trading in the first two weeks of January. Investor enthusiasm could be approaching a crescendo, which has historically given way to a reckoning of some kind.[2]

The more I see the stories build and engulf the financial media narrative, the more I am inclined to double-down my focus on quality and diversification. The temptation of triple-digit gains with just a few trades – and the 'fear of missing out' that many investors feel when they see get-rich-quick stories – often lures even

the most disciplined investors to get in on the action. Doing so goes against just about everything I've ever learned about investing, however. When the market's sirens are singing, it's crucial to stick to the plan.

Most investors can get where they need to go over the long-term by owning a diversified portfolio of stocks (generally speaking, 30 – 60 stocks). Positioning a portfolio across sector, style, size, and country will almost always provide exposure to the best performing areas of the market while minimizing the impact of the weak performing areas of the market. Volatility gets smoothed out over time, and an investor can earn attractive, equity-like annualized returns. It doesn't have to be more complicated than that, and investors don't need a huge win in a single stock bet to get there, in my view. The journey to long-term wealth is also a lot less stressful, in my experience.

Bottom Line for Investors

In my view, some of the bizarre behavior we're seeing in the market is a clear signal that investor enthusiasm is approaching a crescendo, which usually gives way to a correction of some kind to clear out some of the froth (and, unfortunately, wipe-out many over-risked and over-leveraged investors). My advice: avoid getting caught up in the swirl of rumors, chatrooms, sharp one day move, and hot stocks, and steady your investment ship to stay focused on a diversified portfolio of quality, earnings-generating companies. If you want to take some chances on some individual stocks or short-term trading, fine – but my advice is to never commit more than 10% of your liquid net worth to it.

ABOUT MITCH ZACKS

Mitch is the CEO & Senior Portfolio Manager at Zacks Investment Management. Mitch has been featured in various business media including the Chicago Tribune and CNBC. He wrote a weekly column for the Chicago Sun-Times and has published two books on quantitative investment strategies. He has a B.A. in Economics from Yale University and an M.B.A in Analytic Finance from the University of Chicago.

[1] Wall Street Journal. January 25, 2021. https://www.wsj.com/articles/small-investor-surge-shows-no-sign-of-slowing-11611574200

[2] Wall Street Journal. December 27, 2020. https://www.wsj.com/articles/investors-double-down-on-stocks-pushing-margin-debt-to-record-11609077600?mod=djem10point

Weekly Market Update

Important Market News We Think Worth Considering

IN FOCUS THIS WEEK

- Energy sector performance in 2021
- Rise of U.S construction spending
- Silver being hyped to rise like GameStop
- Economic forecasts see strong 2021 growth

Will the Energy Sector Recover in 2021?

The S&P 500 Energy sector was by far the worst performer last year, posting a -33.7% decline. The next worst performers were Real Estate (-2.2%) and Financials (-1.7%), while every other sector in the S&P 500 posted a positive return. The source of Energy's miserable performance in 2020 stemmed largely from plummeting demand for oil, as the global economy endured pandemic-induced shutdowns and major curbs to travel. The biggest global oil companies are posting their weakest annual performance in over two decades, with Exxon Mobil and BP reporting annual losses of $22 billion and $18.1 billion, respectively. The biggest oil companies have scrambled throughout the past year to revise their oil-and-gas assets and rethink or abandon expensive projects. From an investor perspective, the outlook for energy on the demand front is better, and generally speaking, one might reasonably expect some mean reversion following a terrible 2020. But the longer-term outlook for oil and gas companies is less certain, particularly as the climate comes into greater focus.[1]

U.S. Construction Spending Rises, But Not for All Categories

US construction spending continues to tick higher, but the spending is not benefiting all categories of real estate. Specifically, the final quarter of 2020 showed increasing divergence in spending between home builders and commercial contractors, with home builders seeing record growth. With mortgage rates remaining low and many Americans choosing to leave cities for more space in the suburbs, private residential construction is booming. Meanwhile, private nonresidential construction for buildings that house hotels, offices, health care facilities, and retail stores have dropped for six consecutive months.[2]

Silver Was Hyped as the Next GameStop. It Wasn't

Perhaps predictably, the GameStop/AMC mania of last week has given way to steep declines this week. In our view, for every story of a retail investor making huge profits in GameStop, there were probably ten untold stories of investors who posted big losses. This week, the story shifted to commodities, as participants on online forums suggested that a buying spree of silver could generate big GameStop-like gains. The chatter triggered a (very) short-term rally in iShares Silver Trust, but the ETF is now flat for the year. The bottom line: ***creating a short squeeze in silver, as was done in GameStop, is impossible.*** In order to create a GameStop-like outcome for silver, an investor would need to hold large quantities of the metal. Most retail investors don't hold any silver at all and would have a challenging time building up a position -- given the $50 billion market for coins, bars, and other silver investments -- and given restrictions on the size of positions that retail investors can take.[3] Predictably, the rally didn't last very long, and shares of silver producers are plummeting.

Our advice to retail investors as more of these online forum-driven trade ideas pop-up: steer clear.

Economic Forecasts See Strong 2021 Growth, But Lagging Job Gains

We take forecasts from the Congressional Budget Office with a grain of salt, as they are usually wrong. But the general thrust of the CBO's latest outlook for the US economy seems reasonable, as they are calling for the economy to return to pre-pandemic GDP output by the middle of 2021. The jobs market may not claw back to pre-pandemic levels as quickly, however. Temporary job losses have been turning permanent over the last two quarters, and many businesses are rethinking how many workers they need on staff to run efficiently. With online work and e-commerce being catalyzed by the pandemic, many jobs are no longer needed – and may never return. As the economy grows, new jobs will likely be created.[4]

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[1] Wall Street Journal. February 2, 2021. https://www.wsj.com/articles/bp-warns-pandemic-pain-to-persist-in-2021-11612264019

[2] AP News. February 1, 2021. https://apnews.com/article/economy-cdbba46384040bb938460dfb766f532d

[3] Wall Street Journal. February 1, 2021. https://www.wsj.com/articles/reddit-users-fuel-rally-in-silver-11612182810

[4] Wall Street Journal. February 1, 2021. https://www.wsj.com/articles/u-s-economy-expected-to-reach-pre-pandemic-peak-by-mid-2021-cbo-says-11612195200

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