NEWSLETTER

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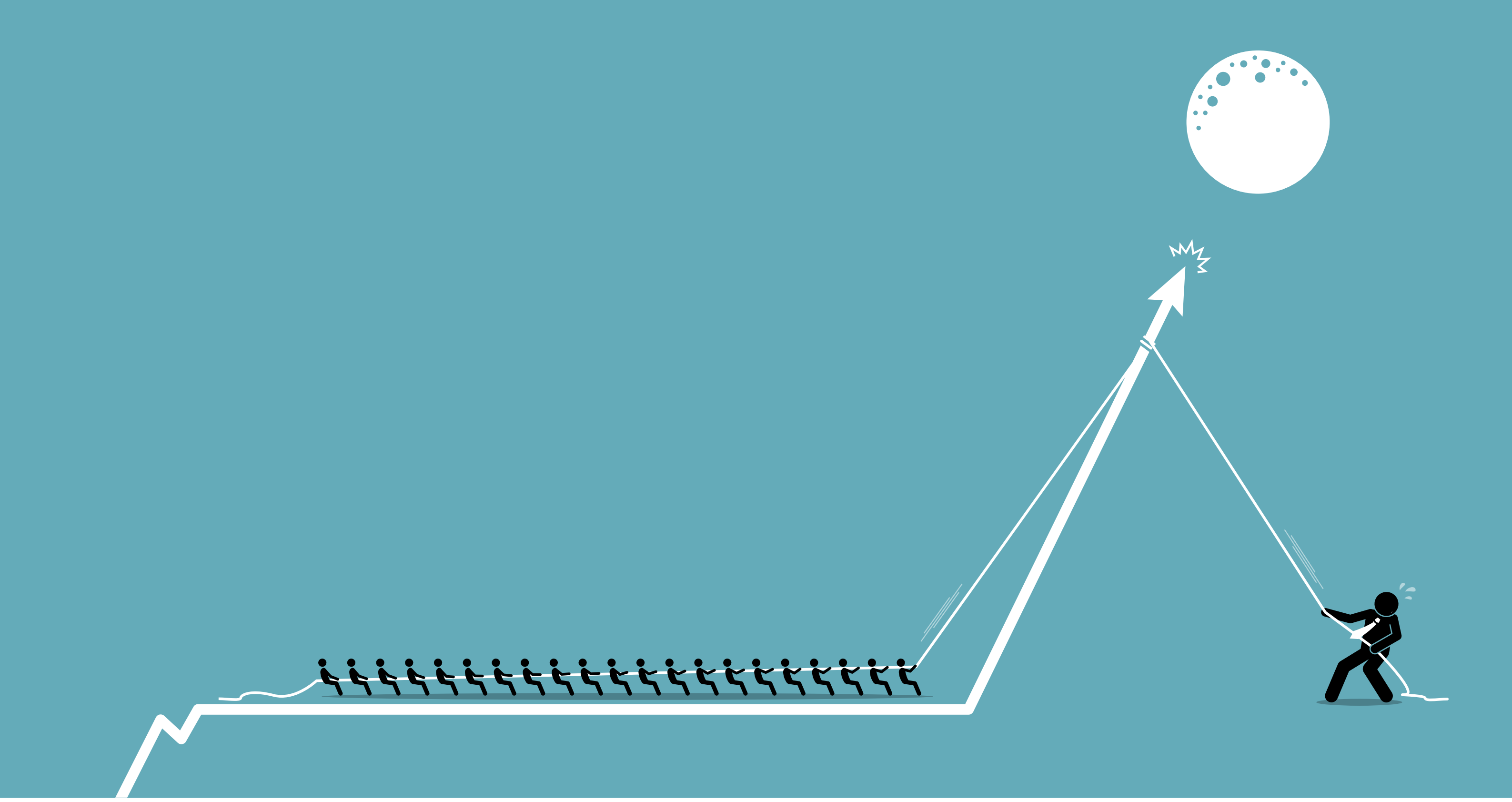
WISDOM/MADNESS OF CROWDS
Stocks with lottery-like characteristics have been shaped by a new generation of speculators who believe they can beat the house.



WISDOM/MADNESS OF CROWDS

"I TELL PEOPLE THERE ARE TWO RULES TO INVESTING: STOCKS ONLY GO UP, AND IF YOU HAVE ANY PROBLEMS, SEE RULE NO. 1."

DAVE PORTNOY, SELF-PROCLAIMED KING OF DAY TRADERS TO HIS 2 MILLION TWITTER FOLLOWERS.

Dave Portnoy is the founder of the Barstool Sports website, which he sold to a casino in a deal worth $450 million. The sports-betting industry was a $150 billion business in 2019, but as sport was shutdown by the pandemic, Portnoy and many other gamblers turned their attention to the financial markets.

This new breed of investors have produced some strange behaviour in stock prices, epitomised by rental car giant Hertz. When the pandemic brought travel to a halt around the world, the 102-year-old company became one of the first household names to file for bankruptcy. The company's $19 billion debt - even its enormous fleet of some 700,000 cars had been leased - threatened to wipe out its shareholders. While debt holders often get some fraction of their money back, equity investors rarely getting anything out of a bankrupt company.

Seasoned investors were surprised then when the news of Hertz's bankruptcy did not produce the expected panic selling, instead it sparked a frenzy of buying that saw its share price rise ten-fold.

For one such seasoned investor, the billionaire hedge fund manager Carl Icahn, this completely unexpected turn of events was to prove extremely costly. Having bought close to 40% of Hertz over six years, he threw in the towel on the first business day after Hertz filed for bankruptcy,. His loss would amount to a staggering $1.8 billion, after selling out at $0.72 a share. He would then watch from the sidelines as just ten trading days later, an army of home based small investors propelled Hertz shares up to $6.

Not one to look a gift horse in the mouth, Hertz's management persuaded the bankruptcy court to allow the issue of another $500 million of its worthless shares to the public. Bloomberg described Hertz's share sale prospectus containing 'more dire warnings than a bottle of bleach'. This was still not enough for the US Securities and Exchange Commission, whose chairman went on national television to make clear the regulators concerns. The share offer was then pulled and a scandal averted.

The Robinhood smartphone trading app alone had 170,000 customers trading Hertz shares after it went bust. Enticing customers with free stocks and advertising free trading with with just one-click, trading apps have attracted a new and youthful customer base: the average Robinhood customer age is 31, half of whom had never invested before. With an interface that makes investing appear like a game and offering easy access to complex leveraged investments, these trading apps have been accused of encouraging their customers to skip training wheels to go straight to motorcycles.

The most traded US stock by far in 2020 was Tesla, accounting for nearly seven cents of every dollar on average each day. The founder and CEO, Elon Musk, long dismissive of Wall Street, is a 'huge fan of small retail investors' and regularly appeals to them directly though social media. His 44 million followers on Twitter are indicative of Tesla's passionate base of consumers and investors.

These helped to lift Tesla shares by more than 700% last year. Tesla is now the world's most valuable car company and Elon Musk the richest man on the planet.

Tesla's market value sits at around $800 billion, after having sold around 500,000 vehicles last year. Toyota is valued at around $200 billion, having sold over 9.5 million. But Tesla's stock price is not driven by what is happening at the company today, nor even its plans for tomorrow - it is driven by speculation about what Elon Musk may have up his sleeve in the distant future. How much of Musk's vision will be realised is pure speculation judging by Wall Street analysts, who have set price targets for Tesla stock that range from a +25% rise to a -90% fall.

Elon Musk has a particular dislike for short-sellers, after years of powerful investors taking short positions in Tesla, whom would profit from its stock price falling (the returns from 'shorts' move in the opposite direction to the stock price). He has then been revelling in the huge losses suffered by some hedge funds with big short positions in the video game retailer GameStop, after an online community of investors mobilised to lift its share price by over 1,700 percent in January. But here is the rub: GameStop is a loss-making business with a forward price/earnings ratio of around -150; that *minus* means investors are paying 150 dollars for each dollar of the company's forecast *losses* in the coming year.

Retail investors accounted for as much as 25% of the US stock market's activity last year, up from 10% in 2019. One of these new retail investors when interviewed by the Financial Times declared:

"THE ONE THING I'VE LEARNT, IS THAT RIGHT NOW IN THE STOCK MARKET, A COMPANY'S HEALTH DOES NOT CORRELATE WITH THE STOCK PRICE ONE BIT."

Stock analysts and fund managers must now weigh whether fundamentals like profitability even matter, for when the crowd backs a long shot, its target's stock price can become a self-fulfilling prophecy.

History does offer a warning. In the early 1900s, Wall Street was not interested in the little guy, so an individual wanting to trade stocks usually did so in a 'bucket shop' rather than through a stockbroker. Bucket shops could be found in stores, hotels and cafés, where people could walk in off the street and buy stock on margin. Bucket shops were adept at fostering a get rich quick mentality through betting on stocks.

But newspapers of the time told a different story, with tales of lost fortunes, bankrupts, ruined reputations and destroyed families. Before their rise, losing everything in the stock-market was something that only the wealthy suffered, not ordinary people. The bucket shops changed that.

Today's trading apps employ more sophisticated ways of profiting from the novice stock trader, but with no less risk of history repeating itself. Hertz has lost three-quarters of its value since its bankruptcy rally and will likely close out at zero. Tesla's share price has halved on two occasions since 2018. Unlike Tesla, GameStop has no magical new tech nor is it an industry disruptor, its just another bricks and mortar retailer trying to navigate the transition to online sales. There is a colourful narrative in which retail investors are sticking it to Wall Street, but as valuations and fundamentals are scoffed at by crowds of novice traders, gravity will ultimately decide the winners and losers.

The average Robinhood trader opens an account with $5,000. While long-term investing is generally safer, it can lack excitement. Small stakes, short-term speculative trading can inject a high octane boost to the highs and lows, without risking a lifetime of savings.

The golden rule of speculation is to never invest what you cannot afford to lose. Even the self-proclaimed captain of day traders, David Portnoy, allocated just $5 million of his $100 million fortune to his day-trading account.

AS THE BUBBLE CREATED BY GAMESTOP DEFLATED, PORTNOY ADMITTED TO SELLING OUT AT A $700K LOSS, BREAKING HIS INVESTING RULES ONE AND TWO.

ALL INVESTMENTS INVOLVE THE RISK THAT YOU MAY NOT GET BACK ALL THE MONEY YOU INVESTED

THE VALUE OF AN INVESTMENT CAN CHANGE QUICKLY AND MAY GO DOWN AS WELL AS UP

PAST PERFORMANCE IS NOT A RELIABLE INDICATOR OF FUTURE RETURNS

INVESTORS SHOULD BUILD A DIVERSIFIED PORTFOLIO TO SPREAD RISK

Asia
Pacific