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Speculation vs. Gambling

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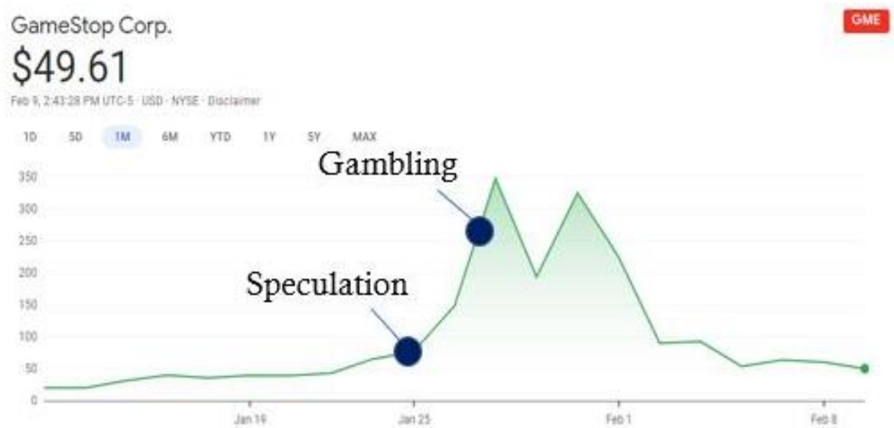
JHH Wealth, LLC

February 12, 2021 Letter to Clients

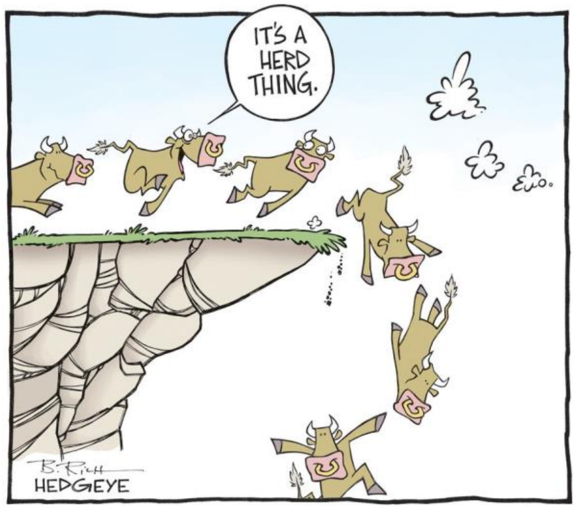
Speculation vs. Gambling

An acquaintance of mine acquiesced to the hype around GameStop ‘going to the moon’ and bought some shares at around $300/per. This gamble has not paid off, seeing as GameStop shares did not go to the moon, but rather are headed towards the center of the earth. In follow up discussions with my acquaintance, the GameStop purchase was justified as a speculative buy and every now and then you need to ‘risk it for the biscuit.’ This justification concerns me.

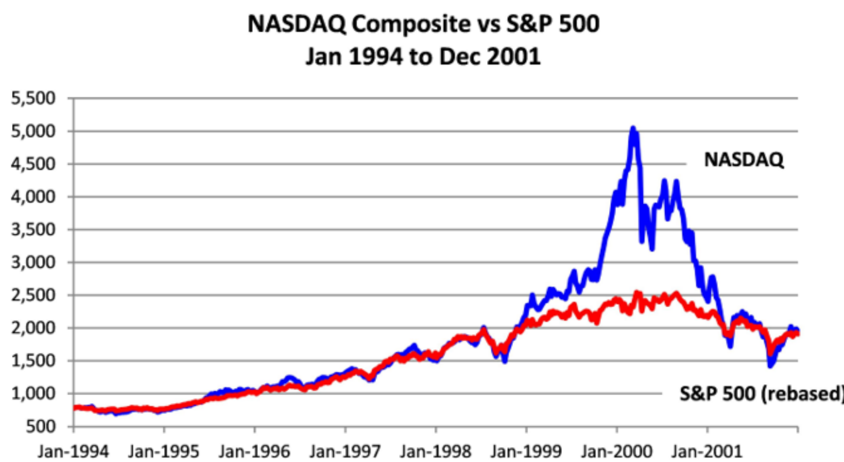


It is important for clients to know the difference between speculation and gambling. When investors speculate, they open positions in packages of assets that are riskier than the market. True speculation involves analysis of a company’s attributes such as rarity, growth potential, product development, etc. If the proper analysis is conducted, investors can enjoy market outperformance. GameStop lacks these positive attributes. In many segments of the investment world, we do not see speculation, but rather money being thrown at trending fads untethered from value or proper risk. This is gambling. Though GameStop is a specific example, we are concerned that it has become a trend on a broader scale.

Gambling replacing speculation in the investment universe is nothing new. It occurs when people flock to certain investments due to fear-of-missing-out. The value of an underlying asset is forgotten, and herd flow becomes the general theme.



One example is the late 1990's. Financial advisors were inundated with client calls to invest in companies with lackluster attributes. Though many of these companies had compelling stories, they were managed by inexperienced executives who did not understand how to return value to shareholders. One such story was a company called Global Crossings (GC). GC was to lay cable on the ocean floor, providing faster and more accessible internet on a global scale. Many investors believed GC was going to be the backbone on which the new 'dot-com' companies were to operate.



The story was a hit. GC's stock price went from $10/per share to 170$/per share in a matter of months. As you may have guessed, the story ended with Global Crossing going bankrupt nine months later.[1] Global Crossing is one of countless examples where investors bought into stories but did not know the facts. Important considerations such as the balance sheet, current earnings, and competition were ignored. Even quality companies such as CISCO dropped 60% after being bought up to levels where earnings could not catch up to valuation levels for years.[2] All it took was a prick of the bubble, and investors lost vast portions of their wealth that took decades to accumulate.

The New Normal?

Mohamed El-Erian, the chief economic advisor at Allianz, recently coined the phrase 'The New Normal' to describe a shift in theme away from the conventional thoughts of the past and into speculation on every 'asset class' that can be bought with a dollar.[3] So, is this time different, or are we again shifting away from speculating and into pure gambling?

There are many recent examples of asset classes that fall under this 'New Normal.' For example, silver, Pokémon cards, Bitcoin, and comic books have all experienced explosive appreciation in value.[4] On the traditional investment (stocks & bonds) side, ARK exchange-traded funds have seen unprecedented gains, and, as a result, an explosion in popularity. In fact, ARK's assets under management have gone from the low billions to over 40 billion in a matter of months.[5] JHH believes that this explosive growth echoes the environment preceding the dot-com bubble burst.

Like the firms in the late 1990's, our firm has received an increasing volume of calls from clients asking to 'get in' on the gains seen in the aforementioned investments. And like the late 1990's, our clients have heard a compelling story – the excellent performance in these funds is due to concentration in companies with great stories and concepts. By no means is this an ARK hit piece, or a denunciation of any of asset classes enjoying immense growth.

"Failing to understand the lessons of history more than anything is what dooms investors to be victimized repeatedly cycle by cycle."

-Howard Marks

In fact, JHH's own portfolios, and therefore our clients, have enjoyed benchmark outperformance due to overweight in technology-focused funds. (Oh, and by the way, I personally have accumulated a rare comic collection that any nerd would admire). Rather, the similarities to the late 1990's are simply becoming too prevalent to ignore.

Is investing in hyper-growth the new normal, or will the bubble burst? Look at the average financial metrics of underlying companies in the ARKK exchange-traded fund (Exhibit 1). These companies exhibit negative return on invested capital, negative free cash flows, no profitability, and problems with competition (narrow wide moat). Simply put, we are concerned that the value of underlying assets has once again been forgotten, and too many investors are going all in on the 'gamble.' JHH thinks that, like the 1990's, gambling has once again replaced proper speculation. This has ended poorly during every speculative cycle in the past.

Exhibit 1 (Source: Morningstar Direct)

Financial Metrics

Metrics	Fund	Category	Index
Wide Moat Coverage %	6.54	17.85	17.90
Narrow Moat Coverage %	26.96	36.71	37.25
No Moat Coverage %	18.51	6.82	12.72
Financial Health	B+	B+	A-
Profitability	F	C	C+
Growth	B+	B-	B
ROIC	-12.09	4.74	8.10
Cash Return %	-50.13	53.72	0.42
Free Cashflow Yield ex-Financials	-400.00	65.49	46.27
D/C Ratio	28.29	42.02	40.57

Fund as of Dec 31, 2020 | Category: Mid-Cap Growth as of Dec 31, 2020 | Index: Russell Mid Cap Growth TR USD as of Jan 31, 2021

JHH Market Recap and Outlook

In March 2020, JHH believed the market downturn became too severe and many compelling speculative opportunities were presented. Generally, we stayed fully invested and overweight 're-open' sectors, albeit with a small cash reserve. Although we believe that many of these opportunities are now over-valued, we are not necessarily ready to take a bearish stance. There are favorable indicators – GDP growth is encouraging, unemployment is declining, and Federal monetary and fiscal support is rampant.[6] Regardless, we do believe that the clock is ticking on the current 'hyper growth' bull market where any catalyst could incite the gamblers to liquidate. As history has shown, when the selling starts it can be relentless until a value bottom is reached. We started by discussing GameStop – our opinion is that GameStop's chart may show the future of the speculative market.

So, what to do? JHH recommends not to gamble at this stage. Do not chase high flying areas that are benefiting from rampant disinformation and questionable stories – have we mentioned pot stocks? We are moving to long-term value allocations in our portfolios, with a slight underweight in risk via a cash position. The short-term indicators are screaming that a correction is imminent, and the cash position will allow us to buy into dips. We believe that the benefits of low rates and COVID re-openings will eventually diminish and a top will be reached.

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[1]https://www.washingtonpost.com/archive/business/2002/01/29/global-crossing-files-for-bankruptcy/fffcad1b-f522-479a-a9d4-659e74165b05/

[2] https://www.thestreet.com/technology/ciscos-boom-and-bust-a-history-lesson-11212172

[3] https://www.brinknews.com/this-is-the-new-normal-mohamed-el-erians-predictions-for-the-global-economy/

[4] https://www.polygon.com/2020/11/6/21551503/pokemon-card-charizard-appraisal-shadowless-collection-first-edition-prices

[5] https://www.barrons.com/articles/ark-etfs-might-be-too-popular-for-their-own-good-51611234009

[6] https://russellinvestments.com/us/resources/financial-professionals/economic-indicators-dashboard