

# CIO Strategy Bulletin

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## Insurrection, Rebellion, Speculators and Investors

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**This week, two separate articles. The first is a look at Reddit vs. Wall Street and lessons for investors. The second discusses the evolution of market conditions and a look at what's to come as the pandemic ends.**

## Insurrection, Rebellion, Speculators and Investors

The storming of Washington on January 6<sup>th</sup> was an insurrection, an act of rising in arms or open resistance against established authority. Acting to throw out the results of the 2020 US national election based on a false premise - that the election was stolen via massive voter fraud - meets that definition. An important feature of that that day was that it was made possible by social media platforms able to both spread disinformation and organize the actions of its leaders and participants.

The events on Wall Street this past week have been characterized in a similar light. While "Reddit vs. Hedge Funds" is highly unlikely to be of the historical importance of January 6<sup>th</sup>, the collective actions of millions of individual investors to bid-up the highly-shorted shares of generally underperforming companies have been viewed by some as an act of rebellion against financial authority in the form of wealthy hedge fund operators and their investors. Viewed that way, holding one share of GameStop (GME) was a way to take a stand against Wall Street.

We think these recent Wall Street events may be viewed quite differently in the end. In 2021, with time, money and technology as fuel, retail investors have formed an online community whose stated purpose may be political, but it is certainly equally motivated by the idea of fast profits and the collegiality of sport. The rapid trading of speculative shares that achieve unsustainable valuations has happened before. Such periods have not ended well for small investors. In equities markets, the period from 1999-2000 is an analogue. Then, many "dot.com" concept firms attracted mass investor appeal in the absence of viable business models. Many of them fell to zero, leaving small investors with billions of dollars in losses.

Right now, the 100 most shorted shares in the US equity market represent just 0.7% of its total value even after this week's events. In our view, the dangers of "naked shorting" - multiplied by the power of options and the power of the internet as an organizing mechanism - will become apparent in the days and weeks ahead. In the meantime, as stressed investors close their positions, it would not surprise us if there are ripple effects that drive prices of quality, liquid investments down, distorting broader markets for a short time.

## Hedge Fund Losses Are Real. So is the Need for Capital

While it is not possible to calculate the exact amount of the losses last week, headlines indicate that short positions of just one company, GameStop, may have cost investors more than \$10B (Market Insider, 1/29/2021). Mark-to market losses in hedge fund short positions in GME are even higher, according to S3 Analytics, a data science firm that maintains a “short interest and crowded trades” database. S3 Analytics claims that GME shares “sold short” have declined by just about 5 million over the last week, marking an 8% dip in short interest. (1/29/2021, CNBC.com)

Sophisticated hedge funds were among those who realized substantial losses exiting short trades. Point72 was reported to have lost nearly 15% of its assets and D1 Capital Partners was similarly reported to be down 20% in January. And early last week, Citadel and Point72 were reported to have invested \$2.75B in the hedge fund Melvin Capital, ensuring its survival as the short squeeze engulfed that firm.

There were many other unusual events this past week. Robinhood, the trading company whose eponymous investing platform enabled many of the trades recommended on Reddit, was required to raise \$1 billion overnight from its investors and also tapped credit lines of \$500 million. Robinhood placed trading restrictions on the shares of 50 companies on Friday. It did so to meet the capital requirements associated with Wall Street’s byzantine stock settlement and custody rules. Many other Wall Street firms also restricted trading in certain shares during the week. In addition, there were service outages at several online brokerage firms whose sites became slow or inactive. And there were also required exchange mandates to halt the trading of certain company stocks given their unusual intra-day volatility.

When such events happen at the same time, it indicates that markets are operating inefficiently and that the checks and balances built in to protect normal market function have been triggered. This is more for the benefit of market makers than investors.

**Figure 1: GameStop's Wild Week: The stock took off on a trading frenzy fueled by a Reddit message board**



Source: CNBC, 1/29/2021, [Dow Drops More Than 600 Points Amid GameStop Trading Frenzy...](#). Past performance is no guarantee of future returns. Real results may vary. For illustrative purposes only. This should not be construed as an offer of, or recommendation of companies discussed.

## Elements of the “Rebellion”

There are several factors that have led to these events.

The first is the “democratization” of investing. The simplicity of accessing “Wall Street” has never been greater. New “technology” firms have simplified everything from account opening, to account funding, to the completion of forms required to allow options trading. This has driven a massive increase in the number of investor accounts. Just last week, Robinhood’s app was downloaded 177,000 times and its active mobile user based exceeded 2.7 million clients (New York Times, 1/30/2021).

Second is the plunge in the cost of trading. Retail trading commissions – away from bid-offer spreads – were commonly \$40 per trade when “online discount brokers” came into existence 30 years ago. The decision by many firms to drop commissions to zero has made trading appear frictionless. Of course, these firms do not trade for free. They sell their trades in bulk to third parties who, in return, pay them for “flow”. So, there are hidden charges that cost investors money.

A third factor is time and capital. Covid-19 has caused people to stay home and screen time is way up as any investor in streaming services surely knows. There are many new, small investors with liquidity at hand due to less spending and an increase in subsidized income during the pandemic. Finally, there is leverage due to the increased use of options to express investor positions that greatly exceed their true trading capital.

The fourth factor is social media and personal examples of “easy” profits. On websites like Reddit and on media sites like TikTok, stories of fast wealth are rampant. Self-identified experts on these sites are providing advice on buys and sells minute by minute, without regulatory oversight. Interestingly enough, these sites also contain narratives about people who have lost all of their savings trading in these markets. They are regarded as heroes in the campaign against Wall Street. The traditional media has played brilliantly into this hype, which draws ever more interest into the “opportunity.”

The final factor is our times. Populism has been on the rise for more than a decade now. For many in the US, it is framed as a struggle of the working class against Big Business or Wall Street; a struggle between “the people” and the political establishment regardless of who’s running it. What is ironic about seeing the recent trading “against short sellers” as a populist act is that in the end, many of those who see themselves as the heroes will likely end up taking major economic losses. And for libertarians, regulations will not likely be eased as a result, but strengthened to maintain to protect the broader public.

### Implications for Investors

Looking at all of these factors, what began as a rebellion is more likely to end as a temporary mania. While there is undoubtedly real damage to certain funds who held short positions in these securities, **when professional investors step away and close positions, many of the small investors will be trading against themselves.** This is the classic outcome of pure momentum trading. When fundamentals become unimportant, retail investors may be exposed to extraordinary movements in prices, ultimately to the downside. For example, on Thursday, GameStop shares fell 44% after Robinhood and Interactive Brokers restricted trading. Thus, it is our view that investors should not play in these markets. There are likely to be many stories of retail investors selling as their losses mount at the end of this saga.

In a small 2008 preview, investors who were drawn in by a quick 150% rise in German carmaker Volkswagen learned about the true cost of the “Fear of Missing Out.” The jump followed a previous doubling in the shares. Those who bought at that point, lost 60% in a week’s events and the shares never achieved those 2008 levels again (see figure 2).

More recently, the bankrupt car rental firm Hertz rallied over 500% over two weeks in June 2020, as a group of short-sellers and small investors bid up the stock, despite clear fundamentals pointing to the company’s ultimate demise. The arguments heard from some speculators – to save the firm from demise – are the same heard now. The euphoria did not last. Hertz shares rose 450% in a week, before erasing nearly all of those gains, resulting in a 66% loss for investors in the subsequent week (see figure 3).

**Figure 2: Volkswagen's Historic Short Squeeze of 2008 and Subsequent Value**



**Figure 3: Populists vs Short-Sellers First Battled it Out Over Hertz in 2020**



Source: Bloomberg and Factset as of January 31, 2021. Past performance is no guarantee of future returns. Real results may vary. For illustrative purposes only. This should not be construed as an offer of, or recommendation of companies discussed.

The narrative that this type of trading will ultimately pit individuals against Wall Street looks likely to be false. Efficient markets require well-capitalized firms to transact and settle trades. This is the bread and butter of Wall Street, something it does well and efficiently. In the event that smaller firms suffer losses due to the inability of investors to settle accounts, that is not likely to hurt major market makers and custodians. In fact, these events may benefit incumbent Wall Street and larger brokerage firms. The size of this “rebellion” is more likely to hurt the firms that want to attract small investors and ultimately facilitate losses for their clients who are more likely to hold shares as markets fall to normal.

Finally, on a longer-term basis, there is the fundamental question of valuations to consider. Manias are not good for Wall Street generally and can hurt investor confidence. Initially, when professional traders like hedge funds are hurt in one part of the market, they are often forced to sell their profitable positions to generate liquidity. On a longer-term basis, periods like this may cause investors to question valuations more closely. We have written before that in the technology sector of the market, investors in a post-Covid world will look more intensively at the ability of technology firms to sustain their pandemic-inspired growth rates. Those that can will be rewarded, but those that cannot sustain their revenue momentum are likely to be re-rated downward. (Please see [“The Danger of Growth at Any Price”](#) and [What to Do About It, July 12, 2020](#)).

This “GameStop” episode comes at a time when several sentiment indicators have suggested growing levels of market complacency, including a spike in call option volumes relative to puts, falling intra-market correlations, and a drop in overall short interest. After the significant rally in both growth and value equities since November 2020, some market consolidation remains likely in the short-run. This episode is likely to make this period of consolidation more volatile.

Ultimately, fundamentals drive markets. Corporate cash flow and earnings, the ability to execute strategy, build and sustain market share, and to do both in an ethical way will be, in our view, be the determinate of value and wealth creation over time. Our advice: avoid this mania.

## What the Market Is Telling Us About the Post-Covid Economy

This is a time of great human suffering. In the West, new COVID infections remain near record highs in early 2021. In contrast, global equity markets posted a 19% return in 2020, even as tens of millions lost their jobs. In early 2021, markets are churning around flat levels, with some larger gains in Asia and for economically sensitive shares elsewhere.

Major rallies before the appearance of good economic news is hardly unprecedented. In 2009, even as the US economy lost millions of jobs throughout the year, global equities generated a total return of +35% as future prospects for an upturn appeared. This is what we expect is happening right now.

Covid-19 is now likely to experience a seasonal decline, even as we read about more contagious variants. Then, we expect an acceleration of vaccinations. This week’s trial results from Johnson and Johnson are better than the headlines suggest, with high efficacy rates for a single vaccination and good protection against severe disease and hospitalizations. Increasing vaccinations as the virus becomes seasonally less virulent will speed the end of the pandemic, with both events likely to drive the virus into submission.

Once this happens, we expect a strong economic recovery from Covid, one that is likely to persist for years alongside low interest rates. That recovery will be fueled by financial stimulus, households whose balance sheets are enlarged by savings, businesses who are investing more as political pressures abate, a reopening of socially close businesses (some 15% of the global economy) and the refilling of supply and finished goods pipelines. Such will be the likely rise of this New Economic expansion ([see Outlook 2021](#)).

## Too Much Cash?

At this time, we are asking clients how much cash they need to hold as a strategic holding. That question is timely as investors in 2010 doubted the recovery and held too much cash for nearly a decade. Loss aversion, an individual's tendency to prefer avoiding losses to acquiring equivalent gains, is the explanation given by behavioral economists for this tendency. But let's look back. From 2010-2020, those who waited in USD cash earned 6.0% cumulatively, but lost 14% after inflation. Those who invested in global equities (using the broadest measure) earned 180%. US equity total returns from 2010-20 were 322%, inclusive of the 34% drop within 2020 (see figure 4).

We do not want investors to repeat such poor decision-making in the cycle to come. Real interest rates are negative and are poised to remain so. Even though volatility may be poised to rise, equity market valuations are still far more attractive than safer fixed income given our outlook. Investors who wait for the next market calamity to invest are market timers who very rarely succeed compared to those who invest wisely and hold investments through the majority of time when economies grow.

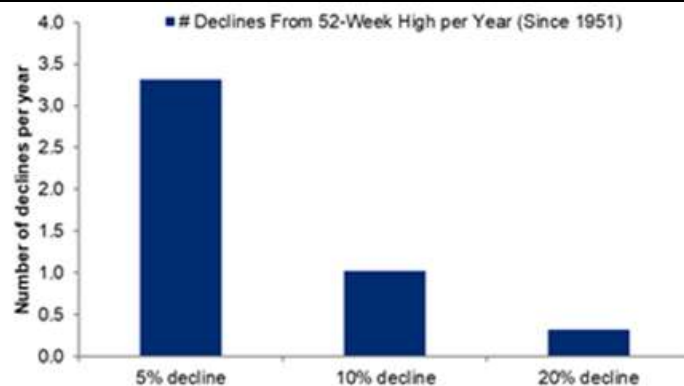
We now see roughly half of ultra-high-net-worth investor portfolios positioned with too much cash. Economic progress is normal. Positive returns for asset prices occur in most years. We would expect them to occur again routinely when the present crisis has ended. In the years after the 2009 rally, global equities went on to post positive returns in nine of the following eleven years. Simply stated, the rebound period after a recession does not mark the end of market rises, but the beginning.

To be fully invested, means to accept volatility in riskier asset classes. US equities post in an average year more than three drops of 5% and one of 10% (see figure 5). During economic expansions, recoveries from these period of volatility tend to be swift.

**Figure 4: World Equity and Bond Total Return Since End 2009**



**Figure 5: Frequency of US Equity Market Corrections by Size**



Source: Haver and Factset as of Jan 8, 2021.

Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Past performance is no guarantee of future results. Real results may vary.

## Moves We Are Making Now

We have written that there are three equity opportunities for investors. There are stocks whose value will, in our view, rise as "mean reversion" (the return to more normal valuations) occurs as the pandemic ends. Then, there are the firms most likely to achieve growth in revenues and profitability more rapidly as the economy expands. Finally, there are the long-term runners, the dividend paying marathon stocks that may generate both income and appreciation.

Our allocation changes last week represent the very first small steps away from assets we emphasized solely for their recovery potential rather than long-term growth prospects ([Quadrant: Euphoric for Good Reason](#)).

Given the recent outperformance of US small- and mid-cap equities, we have reduced the overweight to reflect their now average long-term risk-adjusted return prospects. Since our April 2020 recommendation, US Small- and Mid-Cap shares are up 80%.

We have created a designated position in global healthcare equities. The sector offers greater stability, sustained growth, and is near all-time lows in relative valuation to other sectors.

We have also reducing overweights in China and north Asian equities. This region has outperformed strongly and we are now back to a market-weight reflecting their long-term value in portfolios. We are maintaining a broad overweight to emerging markets, favoring regions where price recoveries are far less progressed, such as Southeast Asia and Latam.

We are also making changes in our fixed income positions. We are switching our US high yield bond allocation to variable rate loans. This move reflects the sharp rebound in high yield credit and our preference for an asset with much lower historic volatility. We further expect to make additional upgrades to higher quality fixed income assets over time, especially where present income and growth are under-appreciated.

**Here is a table of the recent changes taken by the CPB Global Investment Committee**

| <b>Figure 6: Before:<br/>Prior Recommendations of Citi Private Bank GIC</b>   | <b>After:<br/>New Asset Allocation Summary</b>  |
|---|---|
| <p><b>Largest Overweights</b><br/>           +2.8% Emerging Market Equities<br/>           +2.7% Developed Markets Small and Mid Caps<br/>           +2.0% Developed Markets Ex-US (Large Caps)<br/>           +2.0% Global REITS<br/> <b>+9.5% Total Equities and REITS</b><br/>           +1.5% Gold</p> <p><b>Largest Underweights</b><br/>           -6.5% European Government Bonds<br/>           -3.2% Japan Government Bonds<br/>           -2.0% Treasuries<br/>           -10.0% Total Fixed Income</p> | <p><b>Largest Overweights</b><br/>           +2.0% Emerging Market Equities<br/>           +2.0% Developed Markets Ex-US (Large Caps)<br/>           +2.0% Global Healthcare<br/>           +2.0% Global REITS<br/>           +1.0% Developed Markets Small and Mid Caps<br/> <b>+9.0% Total Equities and REITS</b><br/>           +1.5% Gold<br/>           +1.0% High Yield (loans) and EM debt</p> <p><b>Largest Underweights</b><br/>           -6.5% European Government Bonds<br/>           -3.2% Japan Government Bonds<br/>           -2.4% Cash, Short-Term US Treasuries<br/>           -9.5% Total Fixed Income</p> |

Source: Citi Private Bank OCIS as of January 31, 2021. Past performance is no guarantee of future returns. Real results may vary. For illustrative purposes only. This should not be construed as an offer of, or recommendation of companies discussed.

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