2Q2021 White Paper
Irrational Investing in the Spotlight

SPAC
NFT
Non-fungible token
Stock

Imagine the stock price of a company—that has not reported any earnings in two years—skyrocketing more than 1700% in less than a month with no underlying fundamental explanation. Imagine paying more than $200K to be the owner of an online video clip of Lebron James dunking a basketball. Or imagine a social media platform with more than five million users providing a stage for anyone, regardless of experience, to post unsubstantiated stock tips. Surprisingly, people listen! No, this is not your imagination. This is some of the outlandish and speculative behaviors we have seen infiltrate the markets this year. This noise has fueled volatility in select areas of the market, it has flooded media headlines, and tempted some to question the core investment principles of due diligence, patience, and discipline as keys to long term investment success.

How may the current economic environment be contributing to the emergence of speculative behavior? What are some similarities to the five distinct phases of a bubble? Investors should proceed cautiously, regardless of the rhetoric, because these trendy products should not be considered alternatives to traditional investments. Instead, the erratic behavior we have seen is a side effect of the pandemic and the policies surrounding the past year. It is noise that will eventually fade as responsible investing conquers foolishness.

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What is Driving Mass Speculation?

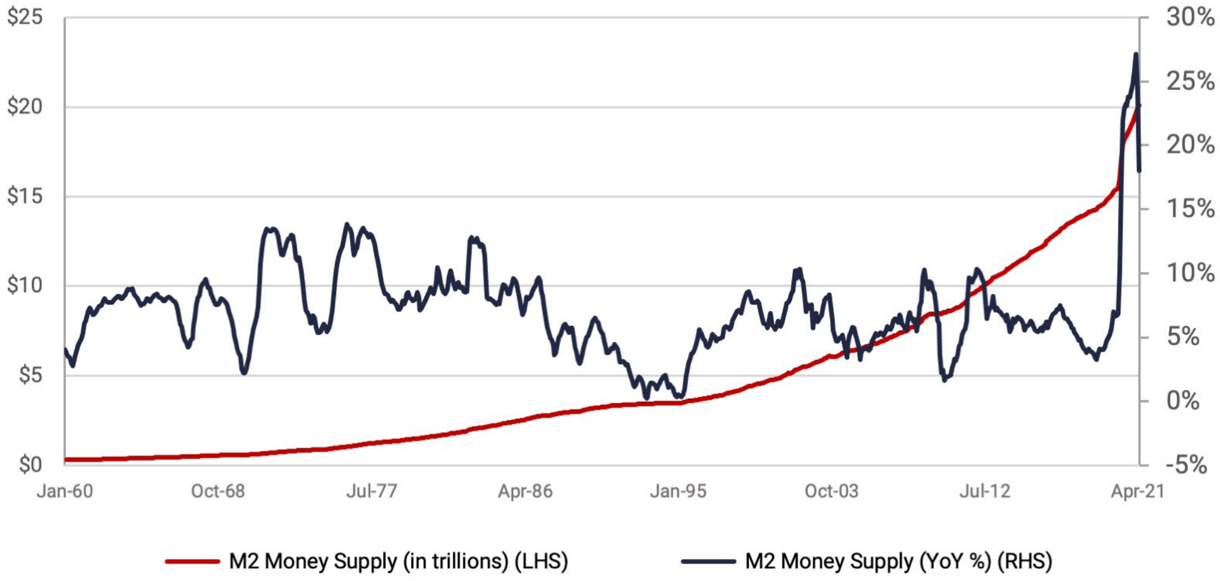
Speculative investments and market bubbles are nothing new, they have been part of our society since the beginning of time. Not every bubble looks the same but after the dusts settles it is relatively easy to identify the driving forces that inflated the bubble and the signs that may have been ignored. Below we outline four key factors that we think are fueling speculation and making certain areas look bubble like.

1. **Staggering surge in money supply:** The actions taken by the Federal Reserve and the Federal Government to combat the negative impact of COVID-19 led the way to the largest influx of liquidity in U.S. history. The M2 money supply, which measures currency, checking, savings and money market accounts, has ballooned to more than $20 trillion. **(Chart 1).** This figure represents ~100% of nominal GDP and has grown by $4.6 trillion since February 2020.

Chart 1

Supply of Money Has Skyrocketed Due to COVID

Data is as of April 2021.Source: Bloomberg Finance LP, Verdence Capital Advisors.



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2. **Record low interest rates and frothy valuations:** Not only are short- and long-term interest rates at historically low levels but real bond yields (the rate of return taking into consideration inflation) are negative across the yield curve. **(Chart 2).** In addition, there is still more than $13 trillion worth of global debt yielding less than zero. Lastly, the MSCI AC World Index has made 35 fresh record highs this year alone and the price to earnings multiple is more than 20% above its past 20-year average (as of June 21, 2021).

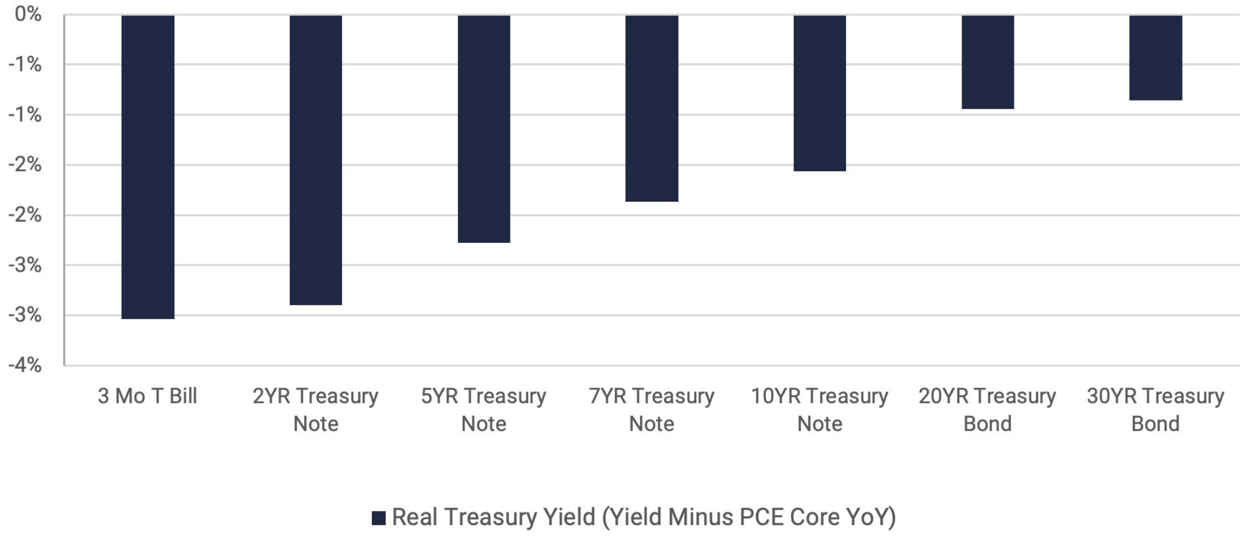
3. **Investing at your fingertips:** The convenience and accessibility of investing has morphed in recent years thanks to the evolution of financial technology (Fintech). While Fintech has many different meanings, the ability for investors to utilize retail brokerage sites and buy and sell stocks without an investment adviser has impacted the investing world. In addition, no fee equity trading now offered by many brokerage firms has expanded the ability for a wide array of people to invest.

4. **Fear of missing out:** While U.S. consumers were under stay at home orders, they were also online and using social media more.[1] Digital platforms that focused on stock and investment tips emerged. These sites provide a podium for anyone—regardless of their investment expertise—to offer stock/investment advice. By consumers leaning more on online sources as a means of digesting and dispensing "news", misguided information spread, and with it, the psychological fear of missing out for investors.

Chart 2

Finding Yield in Traditional Bonds is Challenging

Data is as of June 15, 2021 using PCE Core YoY as of May 2021. Source: Bloomberg Finance LP, Verdence Capital Advisors.



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The Anatomy of a Bubble

Over history we have witnessed several investment/market bubbles. The Dutch tulip mania in the 1600s, the dotcom bubble, commodity bubbles and multiple housing market bubbles represent just a few. While one may be able to identify the forces behind the beginning of a bubble, it is nearly impossible to control the human element and typically bubbles are inflated because of misguided human psychology. One well renowned American economist, Hyman Minsky, astutely characterized the five distinctive phases of a bubble. Below we define each of these and then apply them to some of the trendy investments/products we are witnessing.

There are five distinctive phases **of a bubble**

1. Displacement

- Investors get overly enthusiastic about a new product, theory, innovation, or investment environment.

2. Expansion/Boom

- The excitement spreads and investors/consumers start buying the product at a feverish pace, pushing prices higher than anyone can justify. Typically, this gets widespread attention and psychology shifts to the dangerous "fear of missing out."

3. Euphoria

- Given the astonishing momentum, all rationale valuation of the product disappears. At this point the price rises to new heights. The idea that you can get rich quick, and the price will never drop becomes a common misperception.

4. Crisis

- This stage is nearly impossible to predict. It takes a small number of investors whose euphoria turns into skepticism. Once the price starts falling, investors that were driving the price to unexplainable levels begin to rush to sell.

5. Contagion

- As the asset rapidly declines, margin calls get triggered and investors panic by selling at any price. Depending on the bubble and how infiltrated it is in the markets and/or economy, the bursting can spread into other areas of the market.

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Table 1

Identifying the Steps in an Investment Bubble

Steps in a bubble are referencing Economist, Hyman P. Minsky. Exact terminology may be altered.
Source: Stabilizing an Unstable Economy, Hyman P. Minsky (1986), Investopedia, Verdence Capital Advisors.

Bubble Phase	MEME Stocks	SPACs	Cryptocurrency	NFTs
Displacement	✓	✓	✓	✓
Expansion/Boom	✓	✓	✓	✓
Euphoria	✓	✓	✓	✓
Crisis	✓	✓	✓	✓
Contagion	✓	X	✓	X

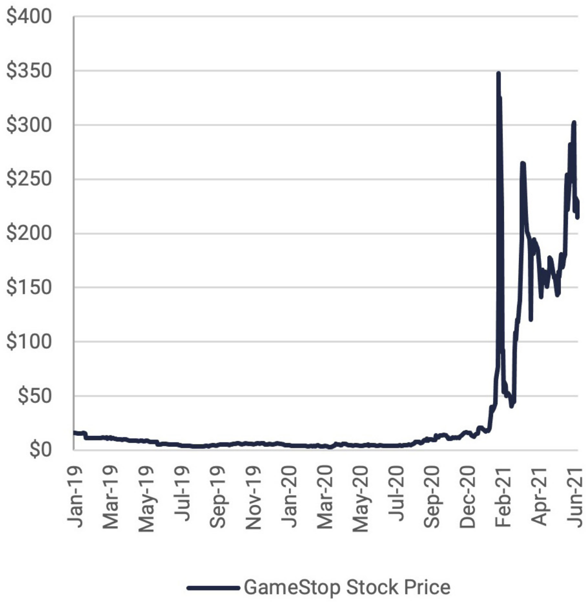
As can be seen in **Table 1,** several of these acronyms and speculative investments/products that we have seen blossom over the past year already have exhibited many of these characteristics. For example:

- **GameStop (ticker: GME)** a well-publicized MEME stock (i.e., a stock that sees an increase in activity due to recommendations on a social media site), GameStop has already gone through all five stages. Earlier this year we saw the MEME stocks induce significant volatility in the market as they collapsed and caused indiscriminate selling across many areas of the equity market (see stages four and five). **(Chart 3).**

Chart 3

GameStop: A MEME Stock Bubble

Data is as of June 15, 2021. Source: Bloomberg Finance LP, Verdence Capital Advisors.



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- **Special Purpose Acquisition Companies (i.e., SPACs)** fell into bear market territory and have remained stagnant for months. Once investors realized that SPACs could not compete with the traditional private equity market, the speculation quickly turned sour. The only factor we have not seen is contagion, possibly because SPACs are smaller and are targeted to a narrower investment group.
- **Cryptocurrencies** look like the dotcom bubble when investors had to own any company with a dotcom on the end of it because they were convinced the price could never go down. Similarly, the cryptocurrency market has turned into something that was once developed from a product that may have some underlying value (i.e., blockchain) into a new "coin" being concocted nearly daily. Some of which were created as a joke (e.g., Dogecoin) and investors jumped onto purchasing these once the price moved higher or a social media site listed the product as going "to the moon." The dangerous "fear of missing out" emerged and novice investors flocked to the product. These buyers have seen a roller coaster that has even sparked temporary volatility in the broad market.
- **Non-Fungible Tokens (i.e., NFTs),** in our view, are the wildest products of all the speculative things we have witnessed over the past year. When purchasing an NFT the purchaser acquires a digital asset such as art or a video. The purchaser gets "bragging rights" and while the image may be unique there is no way to prevent someone from copying it off the internet and replicating it. The buyer owns the rights to the image but not the actual image. For example, someone paid nearly $3 million to purchase the rights to the image of Jack Dorsey's (CEO and founder of Twitter) first tweet. We have seen this product lose its allure as overall sales of NFTs peaked at nearly $180 million in early May and have since plummeted to under $10 million.[2]

> Some cryptocurrencies **were initially created as a joke** (e.g., Dogecoin) and investors jumped to purchase these once the price moved higher or a social media influencer listed the product as going "to the moon."

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Is Speculation the New Alternative?

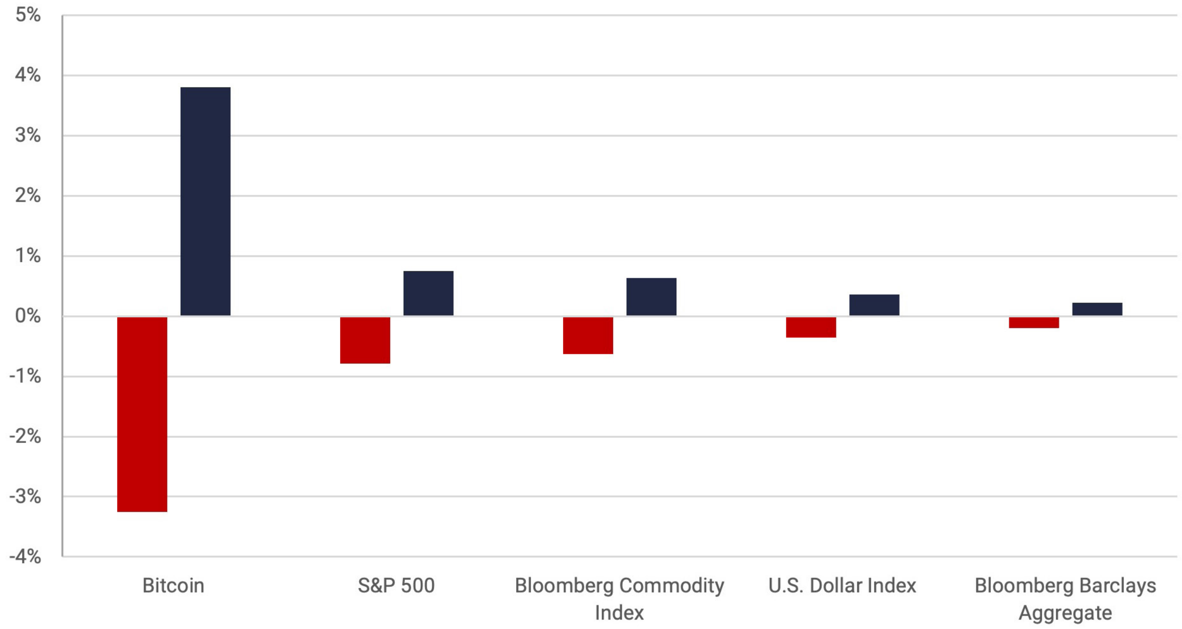
Too often do we hear that some of these speculative investments are displacing the importance of traditional alternative investments (e.g., private equity, currencies, real assets) in a well-diversified portfolio **(see our detailed explanation of what a true alternative investment is, see our 3Q2020 white paper >> link).** That is a misguided perception of these products. Some of these products have no underlying value as the price is not driven by earnings or valuations but only by what someone else is willing to pay for it. What happens to the price when there are no buyers? In some instances, we have seen acronyms that traditionally help a responsible investor choose an investment like ROE (i.e., return on equity), EPS (i.e., earnings per share), PE (i.e., price to earnings multiple) or YTM (i.e., yield to maturity) be replaced with YOLO (i.e., you only live once), FOMO (i.e., fear of missing out) or DD (i.e., double down). These are to name a few; the others are too profane and offensive to even mention.

We believe the volatility alone has no place in a well-diversified portfolio of traditional liquid and illiquid investments. In addition, we believe the level of risk one must take to potentially "hit it big" coupled with limited correlation statistics makes it impossible to warrant these products as something that can replace a traditional alternative investment or justify them as a separate asset class. They do not fit in the category of alternative investments which one can fundamentally value, have low correlations and in some instances low volatility. In addition, compared to traditional liquid investments such as stocks, bonds, commodities and currencies, the daily volatility of these underpin our view that the risk is too high to justify the reward. **(Chart 4).** The chance of perfectly timing a product that has such violent daily swings is nearly impossible. Instead, an investor has tied up capital that could be used to allocate to their well-diversified portfolios. Capital that could be lost completely.

Chart 4

Volatility Does Not Fit With Traditional Asset Classes

Data is as of June 15, 2021. The average daily price moves are as follows – Bitcoin from 2010, S&P 500 from 1927, Bloomberg Commodity Index from 1960, Bloomberg Barclays Aggregate from 1976 and U.S. Dollar Index from 1967. Source: Bloomberg Finance LP, Verdence Capital Advisors.



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The Verdence View

The Federal Government's stimulus and extraordinarily easy monetary policy have pushed the money supply to astonishing levels. This is coinciding with equity valuations looking frothy as well as interest rates hovering near record lows. As a result, we have seen an increase in the number of people speculating and using the "I can't lose" or "It's easy money" mentality when investing. They are chasing returns by following momentum or the latest trend instead of reason. This narrow minded, undiversified way of investing is an idea that runs counter to the foundation of how we advise our clients seeking long term investment success.

While investing has become increasingly accessible for anyone through the evolution of technology, it does not mean that to be responsible one can abandon due diligence, patience, diversification, underlying valuations (e.g., price-to-earnings multiple), and fundamental analysis. To quote the great, Warren Buffet, "risk comes from not knowing what you are doing." It is noteworthy that throughout this white paper, I rarely call these products investments. This is for good reason; some have no investment characteristics and no clear way to establish concrete value. Instead, these products offer a new way to gamble.

History suggests that to be a successful long-term investor, it is important not to chase risk in hopes of timing the market perfectly. Speculative "get rich quick" investments tend to ascend far above expectations and ultimately crash below what can be explained. **Those investors who are tempted to jump on the speculation bandwagon should first consider this quote from esteemed economist, John Maynard Keynes, "Markets can stay irrational longer than you can stay solvent."**

If you have any questions or comments, please feel free to reach out to your financial advisor.

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Important Disclosures:

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1. https://www.statista.com/topics/6241/coronavirus-impact-on-online-usage-in-the-us/

2.https://www.cnbc.com/2021/06/15/nft-price-crash-what-next-for-digital-collectibles.html, as of June 15, 2021.

Additional notes:

The MSCI AC World Index is an Index of emerging and developed market equities.

The Bloomberg Galaxy Crypto Index is an Index of the largest cryptocurrencies traded in the U.S. market.

The Bloomberg Barclays Aggregate Index is an Index that measures the investment grade taxable U.S. bond market.

The Bloomberg Commodity Index is an Index that measures futures in the U.S. commodity market.

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