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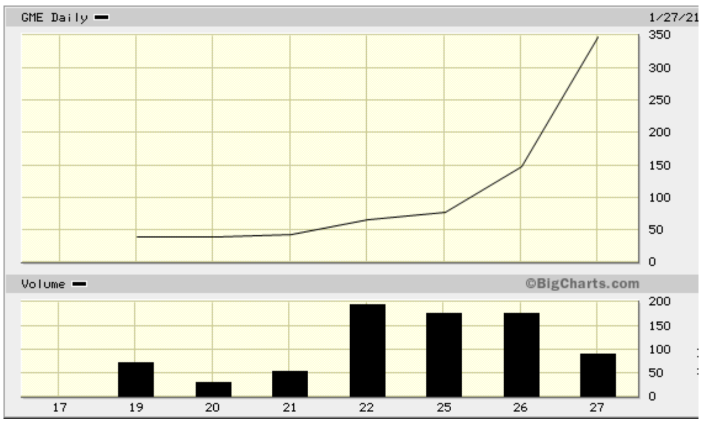
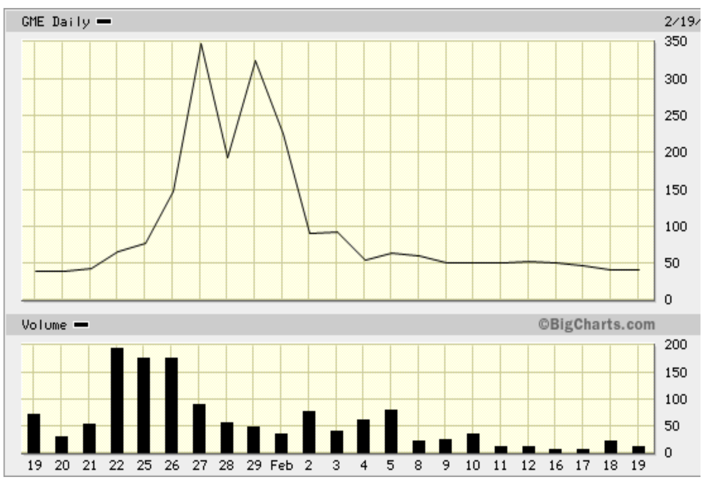
Pump and Dump





This is a good time to reflect on one of my Eternal Truths of Investing – if the left side of the chart looks like the left side of the Eiffel Tower, it will not be long before the right side of the chart looks like the right side of the Eiffel Tower. This "left side" chart shows the price of GameStop stock which began the year at $17 per share and spiked from under $50 per share to over $350 per share from January 21st through January 27th. This was not the result of any improvement in the financial outlook for the company, but the result of uneducated investors following the advice of total strangers on popular social media platforms. In other words, the blind leading the blind. Perhaps, to be kind, I should say that it was a case of the uneducated, with too much time on their hands, being persuaded by strangers that gambling in the stock market was a shortcut to riches.

This "right side" chart shows that the price of the stock collapsed to less than $50 per share over the next week. The dip and rebound in the center of the chart is instructive. Many "investors", having missed out on the run-up in the price of GameStop stock saw the decline as their chance to get in on the action and "bought the dip". This pushed the price back to over $300 per share – for about a day. These late arrivers missed much of the party but got there just in time to experience the hangover. Apparently, they were not warned that paying $300 for a $17 stock and then trying to find someone to buy it from you at a higher price is a fool's errand. Wall Street is not Mister Rogers' Neighborhood. There are many places where you can do foolish things and not suffer the consequences. Wall Street is not one of them.

A recent news item concerns Keith Gill, aka "Roaring Kitty", who used his extensive social media presence on YouTube, Twitter and Reddit to tout GameStop shares. Gill presented himself as an amateur investor whose advice would bring big profits at the expense of the hedge funds that were shorting the stock of the money-losing company. However, Gill is not an amateur investor. He is a Chartered Financial Analyst with multiple broker licenses and was working from home while employed by MML Investors Securities, a broker/dealer subsidiary of MassMutual. Gill maintains that his role at MML was to develop financial education classes for advisors, and that he had never sold securities or acted as a financial advisor. He has resigned from MML and is now the subject of a class action lawsuit which claims – *"Gill's deceitful and manipulative conduct not only violated numerous industry regulations and rules, but also various securities laws by undermining the integrity of the market for GameStop shares...He caused enormous losses not only to those who bought option contracts, but also to those who fell for Gill's act and bought GameStop stock during the market frenzy at greatly inflated prices."*

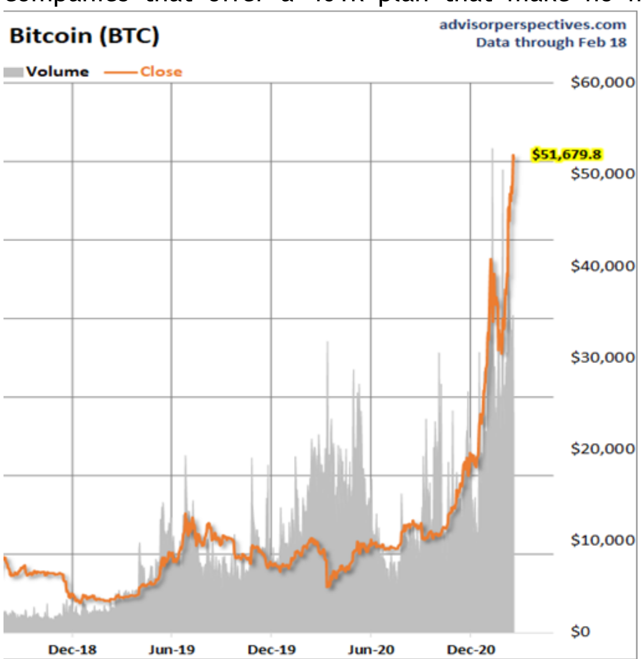
This has all the markings of a classic pump and dump scheme. This is a form of securities fraud in which an investor or group of investors promote a stock they own by making false and misleading claims about a company's business prospects (the "pump"). After the price surges because of their endorsement, they sell their shares (the "dump"), the stock price plummets, and their unsuspecting victims suffer sudden losses. For a pump and dump to work, its perpetrators must find a certain type of investor— suckers, to be blunt – who believe that they can play the stock market like a casino. One of the earliest examples of a pump and dump scheme involved Radio Corporation of America, better known as RCA, in 1929. A group of investors known as the Radio Pool bought and sold the stock among themselves to create the appearance of increasing investor interest in the stock and the share price jumped from less than $100 to more than $500. After the dump, the stock price crashed to under $10 a share. At the time, there was nothing illegal about this type of stock price manipulation, but pump and dump schemes were outlawed by the Securities Act of 1933. The Financial Industry Regulatory Authority (FINRA), a self-regulatory agency that monitors participants in the U.S. financial markets, advises investors to be on the alert for these warning signs of a pump-and-dump scheme -

"Be skeptical of press releases, spam emails and promotional materials such as newsletters and blogs from unknown senders, which often come from paid company insiders or promoters…Be wary if you are flooded with information over a short period of time, especially if the communications only focus on a stock's upside with no mention of risk."

You can invest in almost anything these days with the click of a mouse. But whenever investors seek quick riches instead of allocating their capital to productive uses, they get into trouble. Successfully navigating through all the investment options available today requires wisdom and perspective. Social media sites supply endless information but little wisdom or perspective. Charismatic social media pundits with huge followings can influence millions of investors' actions. Social media posts containing unverified claims of quick riches lead to copycat investing – a type of herd behavior that often leads to trouble. Fear of missing out – FOMO - along with the greed, envy and regret that accompany it, is a major factor behind much of the trading frenzy that we have seen recently. "It's not fair that they are getting rich instead of me. I'm just as smart as they are!" Social media offers pump and dumpers access to millions of potential marks, a goldmine opportunity that would make their predecessors green with envy. It comes as no surprise that the SEC recently halted trading on 15 stocks whose prices it believes have been manipulated by social media posts.

In the News

Tesla made headlines last month when the company announced that it placed $1.5 billion of its cash into Bitcoin. The company had its best year in 2020 – a profit of $5.8 billion, up from $3.0 billion in 2019. Yet, it is one of the 4% of companies that offer a 401k plan that make no matching contributions to employee salary deferrals. How can a supposedly "enlightened" company looking for a productive use of an extra $1.5 billion sloshing around in its checking account roll the dice with a speculative bet on Bitcoin rather than invest in the welfare of its employees?



We tend to overestimate the wisdom of smart, financially successful people. Unfortunately, smart, financially successful people often overestimate what they know in areas beyond their expertise. When it became known that Elon Musk put that much money into Bitcoin, his social media lemmings quickly followed, pumping up the price, enriching him and his company, but doing nothing to help those who work on his assembly line.

So, we see in this chart the left side of the Bitcoin Eiffel Tower. How much of the recent rise is related to Musk's social media influence? At what point will the board of directors of Tesla, acting on behalf of its institutional shareholders, insist that Tesla dump its Bitcoin investment and pocket the exceptional gain? How many people will learn the hard way that investing in something you do not understand on the advice of someone you don't know, for reasons you can't explain is one of the dumbest things you can do with your money?

This chart from Scott Grannis' blog shows that despite adding $4 trillion of debt in 2020, the interest payments needed to finance the federal debt, as a percentage of GDP, is as low (2.5%) as it was in the 1960s. This even though federal debt equals 100% of GDP, a level not seen since the days of WW II. The low interest rates Uncle Sam is paying to borrow all these new trillions will lower the interest burden of the debt by about $35 billion every year for the foreseeable future. Federal debt burdens could become problematic in the future, especially if interest rates rise and federal deficit spending continues. But few of the politicians voting for all this deficit spending will still be around to face the political backlash that will come from the economic fallout of their profligate spending. Thus, the party rolls on.

Each new generation of investors starts out by ignoring the lessons of history and repeating the mistakes of prior generations. On February 19, 2020, the S&P 500 Index made its last pre-Covid all-time high before dropping 34% over the next month. The following 12 months provided investors the opportunity to make three big investing mistakes. The first was to panic sell stocks, hide in cash and miss the unexpected, sharp rebound in stocks over the past six months. The second big mistake was to put politics ahead of their investment strategy. People on both sides of the political divide fled the stock market, fearing that a victory for the other side's candidate would usher in the end of America. The third big mistake was to chase past performance. For most of 2020, the large tech companies were the only stocks yielding positive returns and many investors succumbed to the temptation to overweight the tech giants in their portfolios.

The world is constantly breaking. Diversification provides the most dependable way to survive the unexpected and it is just as important for retirees as it is for those in their accumulation years. If your goal is to own a portfolio that will yield substandard returns over the long-term, then shun diversification and overweight your portfolio to the best performing asset of the past few months, let your political beliefs direct your investing and sell stocks after they go down. But if you had a plan driven, diversified portfolio a year ago, avoided these three investing mistakes and stuck with your plan, you should be happy with your portfolio's performance over the past year.

A Stock Market Bubble?

There seems to be a speculative frenzy among investors that we haven't seen since the dot-com bubble. This has led many commentators to claim that the stock market is in a bubble. A Google search of "Is the stock market in a bubble right now?" produced 41 million results in 0.5 seconds. Investopedia defines a bubble as *"an economic cycle that is characterized by the rapid escalation of market value, particularly in the price of assets. This fast inflation is followed by a quick decrease in value, or a contraction, that is sometimes referred to as a "crash" or a "bubble burst."…During a bubble, assets typically trade at a price, or within a price range, that greatly exceeds the asset's intrinsic value."*

Manias are the irrational emotions that inflate a bubble. Manias result from unrealistic optimism about the future price of an asset by assuming that recent price increases will continue. Those who are caught up in a mania go through three phases. The first is instructing doubters as to why future price increases are inevitable. Soon thereafter, they bolster their argument by bragging about their big profits. Finally, they deride those advising caution - "You pessimists are all the same. This time it's different!" But valuations far exceeding an asset's fundamental value cannot be sustained in a free market. Eventually, all bubbles are exposed as irrational and burst in spectacular fashion. There is nothing new about this, it has nothing to do with social media – it's been happening for centuries.

Unfortunately, stock market bubbles are almost impossible to identify, except with 20/20 hindsight. Wise investors understand that no one knows what is going to happen, that analysts, economists, forecasters and portfolio managers are just guessing. No one knows if stocks are in a bubble, when the next bear market will occur, how steep the drop will be, or how long it will last. We can speculate, calculate or estimate, but we can never be certain. Focusing on your own goals frees you from the need to know if the market is going to be higher or lower a year from now. After the recent gains, your annual rebalance and review with your financial advisor is the perfect time to determine if it's time to take some of your gains off the table.

The big lesson of 2020 was that trying to time the market is a fool's errand. A forecaster may be right about the next big move in the stock market but that's not good enough. The timing also must be right – getting in or out at the right time. This chart shows the danger of missing just a few of the best days in the S&P 500 over the past 26 years. For long-term, goal focused investors, the time to invest in stocks is when you have money to invest. The time to sell is when you need the money for something else. And that's all that needs to be said about that. Is the stock market in a bubble today? Today's prices should be compared to what you believe they will be a decade or more in the future, the minimum holding period for any prudent investor's stock investments. Ignore the market prognosticators and let time and compound growth work their magic on your behalf.