Are There Still Any Market Timers Out There?

There's no doubt about it: attempting to time the market is incredibly tempting. Every rational person at some point during this pandemic has said to him- or herself, "Wow, this is really bad. This time it's definitely different. We've never been through this as a nation, and I think maybe it's time to play it safe and pull our money out of the market until things are more normal." That is a perfectly rational, if not overtly logical, thought process. The problem, however, is that it is a terrible investment strategy. Here's why.

Let's say that on January 1, 2020, we called and told you we had perfect knowledge that the following would transpire in the year 2020:

- A pandemic would sweep through the U.S., claiming hundreds of thousands of lives.
- Iran would launch missiles at a U.S. base in Iraq.
- Impeachment proceedings would begin against the president.
- March Madness would be cancelled.
- Disney World would be closed.
- Oil price futures would turn negative.
- Many professional sports would be cancelled or delayed, with games played in empty stadiums.
- The stock market would fall by 34% before the end of the first quarter.
- Unemployment would hit 14.7% — the worst figure since the Great Depression.
- Stay-at-home orders in 27 states would affect 225 million people.
- Widespread societal unrest would follow in the wake of George Floyd's death.
- Johns Hopkins University would report over 12 million COVID-19 cases in the U.S.
- A wildly divisive presidential election would unfold.
- The Fed Funds rate would be cut to zero.
- The president would test positive for COVID-19.
- GDP would fall 4.8% in a single quarter.

Let's assume we could have told you in advance with unerring certainty that all these events would unfold, and we said, "Dear Rockwood Client, given that we know for sure that all of these terrible things will happen, do you think stock prices will be higher or lower at the end of the year?" Every sane person among us would respond, "Obviously stocks will be lower by year-end! Why are you wasting time asking me questions? Sell all my investments now so I can bury the cash in my backyard!"

Well, surprisingly enough, even after all those events, the stock market delivered above-average returns to investors who were disciplined enough to stay invested.

And that is precisely why the stock market can be so humbling — short-term price movements are unknowable. They are unknowable even for the well informed (heck, even for those who wield perfect knowledge of future events). Even if one can predict what will happen geopolitically, one still cannot predict how the stock market will react. 2020 is perhaps the best example of this phenomena in the history of capital markets.

Behavioral finance experts will be writing about the year 2020 for decades — it will be in the behavioral finance textbooks that your grandchildren read in business school.

As we've said before, "Friends don't let friends time the market."

Game…Stop.

The founder of Vanguard, John Bogle, would roll over in his grave if he knew that in this past calendar quarter, 28% of investors traded a "story stock" of some kind. We define a story stock as one of the companies — including GameStop, Nokia, and Blackberry — that rose to infamy with wild price fluctuations fueled by collusion among investors loosely organized via internet forums.

That means roughly one in four of us took time out of our busy lives and picked up our phone or other trading device and placed a speculative bet on a risky individual stock. That statistic is a terrible indication that at least one-quarter of the investing public failed to either comprehend or respect the boundary between strategic long-term investment planning and wanton speculation.

Folks buying these stocks are relying on the "greater fool" theory: they know that prices will rise and fall dramatically. All they need to do is find a person who is a somewhat greater fool than they are to whom they can sell the stock for a higher price.

For those of you fortunate enough not to have followed the recent events, the archetypical example of a story stock is GameStop (ticker: GME). GameStop is an obviously struggling, definitely boring, midsize retailer stuck in a stale business model — selling physical video games, while most games are downloaded these days.

The fact that everyone is talking about GameStop is less a reflection of the company itself and more symptomatic of the dangers of speculative trading.

The sob stories are already starting to trickle in. They are as heart-wrenching as they are predictable. Some "retail traders" (otherwise known as small individual investors) made a little bit of money betting on a story stock. Emboldened by that small "success," they bet a lot more than their previous wager and lost money they simply couldn't afford to lose. Wash, rinse, repeat … and millions of "investors" learned very expensive lessons that will haunt them financially for decades to come.

Oddly, the financial media is acting as if this phenomenon is something new. Perhaps they have forgotten that only last year the speculative trading bug caught hold of shares of Hertz and Kodak — two companies essentially in the throes of bankruptcy. How did that work out for investors? Spoiler alert … not well.

There is a deep and well-documented pattern of speculative bubble stocks whose share prices became wildly disconnected from their fundamental values. Many of us are too young to recall the speculative bubbles in so-called story stocks in the late 1950s. During that era, uranium-related stocks soared, followed a few years later by bowling stocks (yeah, bowling) and then recreational vehicle stocks. In the 1960s, a company called Skyline Homes saw its shares rise 20x — only to crater shortly thereafter. Most of us do remember all too well what happened to internet stocks in the late 1990s.

Some will undoubtedly claim that what's happening with these so-called meme stocks is very different from those previous story stock fads. They will assert that in previous crazes, investors took general signals from each other — in the vein that when everyone is buying internet stocks it makes you think it's smart to buy internet stocks. Prognosticators say this time it is different because some folks are working together, via online forum collusion, to make certain stock prices rise.

They will point to self-organized campaigns with people using message boards to communicate with each other, to encourage each other, and to reassure each other so they don't lose their nerve, for example. They will cite Reddit threads with the titles "We are the captains now," "Have no fear, GME gang. We are consolidating in preparation for tomorrow's moon landing," and "GME — it never has to end."

We beg to differ. GameStop's recent stock price is utterly irrational — the company will almost certainly never make enough money to justify a $6 billion market cap. The way Redditors and others have driven its price up has been quite temporary. It will end — and it will end badly for most of the speculators. It will likely end with GameStop's share price about where it was before the trading games began.

In other words, though it may look less like a "traditional" speculative bubble, what's happening with GameStop is still speculation. One could liken it to the "bull raids" that were characteristic of the stock market in the early 20th century, when organized pools of investors plotted to drive stock prices up.

The challenge, of course, is that once the collective will begins to wane — either because people want to cash out or just move on to the next shiny object — there are going to be no economic fundamentals supporting the stock price ... and you can guess what happens next.

Tales from the Crypto: How to Think About Bitcoin

Bitcoin and related cryptocurrencies (now numbering in the thousands) are the subject of much debate and fascination. Given bitcoin's dramatic price changes, it is not surprising that many are speculating about its possible role in a portfolio.

"Everything you don't understand about money combined with everything you don't understand about computers." —
HBO's Last Week Tonight with John Oliver
March 11, 2018

In its relatively short existence, bitcoin has proved extraordinarily volatile, sometimes gaining or losing more than 40% in price in a month or two. Any asset subject to such sharp swings may be catnip for traders but of limited value either as a reliable medium of exchange (to replace cash) or as a risk-reducing or inflation-hedging asset in a diversified portfolio (to replace bonds).

Assessing the merits of bitcoin as an investment can be problematic. Adding it to a portfolio could mean paring back the allocation to investments such as stocks, property, or fixed income securities. The owner of stocks or real estate generally expects to receive future income from dividends or rent, even though the size and timing of the payoff may be uncertain. A bondholder generally expects to receive interest payments as well as the return of principal. In contrast, holding bitcoin is similar to holding gold as an investment. Even if bitcoin or gold is held for decades, the owner may never receive more bitcoin or gold, and unlike with stocks and bonds, it is not clear that bitcoin offers investors positive expected returns.

Putting aside squabbles over the future value of bitcoin or other cryptocurrencies, there are other issues investors should consider:

- Bitcoin is not backed by an issuing authority and exists only as computer code, generally kept in a so-called digital wallet, accessible through a password chosen by the user. Many of us have forgotten or misplaced computer passwords from time to time and have had to contact the sponsor to restore access. No such avenue is available to holders of bitcoin. After a limited number of password attempts, a user can permanently lose access. Since there is no central authority responsible for bitcoin, there is no recourse for the forgetful owner; a recent *New York Times* article profiled the holder of more than $200 million worth of bitcoin that he can't retrieve. His anguish is apparently not unusual — a prominent cryptocurrency consulting firm estimates that 20% of all outstanding bitcoin represents stranded assets unavailable to their rightful owners.
- Mt. Gox, a Tokyo-based bitcoin exchange launched in 2010, was at one time the world's largest bitcoin intermediary, handling over 1 million accounts in 239 countries and more than 90% of global bitcoin transactions in 2013. It suspended trading and filed for bankruptcy in February 2014, announcing that hundreds of thousands of bitcoins had been lost and likely stolen.
- The UK Financial Conduct Authority cited a number of concerns as it prohibited the sale of "cryptoasset" investment products to retail investors last year. Among them were the inherent nature of the underlying assets, which have no reliable basis for valuation; the presence of market abuse and financial crimes in cryptoasset trading; extreme price volatility; an inadequate understanding by retail consumers of cryptoassets; and the lack of a clear investment need for investment products referencing them.

The financial services industry has a long tradition of innovation, and cryptocurrency and the technology surrounding it may someday prove to be a historic breakthrough. For those who enjoy the thrill of speculation, trading bitcoin may hold appeal. But those in search of a sound investment should consider the concerns of the Financial Conduct Authority above before joining the excitement

Bit Player

Price of bitcoin for the last 10 years, March 2011 – February 2021

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