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Quarterly Point of View
Play Your Own Game

January 11, 2021

Rarely have so many wished so earnestly for a turn of the calendar and a sense of hope that this year will be better than the last. As we all know, the act of flipping the date doesn't mean anything has actually changed, and though we can look forward with hope to the possibility it will, last year's issues still remain. The appalling events in our nation's Capitol the first week of the new year reminds us, however, that there's rarely a shortage of additional things to worry about. As far as 2020 is concerned, it will likely go down in history as the year of COVID-19, yet we remain right in the thick of that battle. As the vaccine rollout kicks into gear though, the hope we do hold for a better 2021 is not baseless, so Happy New Year!

The past 12 months was a period of seeming contradiction for markets. In mid-February the S&P500 was enjoying an all-time high when the reality of the novel Coronavirus began to rapidly unfold and with it the fastest ever fall into a bear market – a nearly 35% decline in a single month's time. March was the most volatile month in history for the market, besting prior records set in 1929 and 2008, with an average **daily** move one way or another of 4.8% for the S&P500[1]. Further, reflecting the grave economic outlook (as well as storage issues), crude oil futures experienced a never-before-seen collapse, when the price of West Texas Intermediate (WTI) for April delivery traded in *negative* territory – briefly hitting *minus* $37.63 a barrel.[2]

In rode the Federal Reserve, taking interest rates to effectively zero, re-establishing quantitative easing and backstopping a host of markets including municipal securities, commercial mortgages, money markets and more. On the fiscal front, Congress passed the $2 trillion Coronavirus Aid, Relief, and Economic Security Act (CARES), the largest ever stimulus package in size and scope (an additional $900 billion was added to this relief in December).

From that point, markets soared. The Dow Jones Industrials crossed 30,000 for the first time ever while the S&P500 rallied almost 70% off its lows. Most major averages ended the year at, or near, all-time highs. All of this within a nine-month period when unemployment hit 14.7%, the highest level since the Great Depression and earnings for the S&P500 declined. Again, it was a year of contradiction for markets.

In last quarter's letter, *History Rhymes, #1999,* we analyzed the state of the current market from a valuation perspective and offered a view that conditions are looking eerily similar to the late 1990s' Technology Bubble. Led by a group referred to as "Disruptors" (including the likes of Tesla, Netflix, Amazon, Google and Facebook, amongst others), heavily weighted subsets of this market have become remarkably expensive.

Additionally, due to their perceived immunity from economic hardship and the massive market capitalizations investors have bestowed upon them, the Disruptors have had an incredibly outsized impact on market averages, camouflaging the challenges currently facing most companies.

Looking for historical context we also examined similar valuation episodes of the past half century: the Tech Bubble of the late 1990s and the Nifty Fifty of the early 1970s. For both of those prized groups of their eras, ten-year subsequent returns were poor, if not disastrous.

In addition to our concern for stretched valuation in meaningful corners of this market, we are also becoming uneasy about market psychology and the amount of risk the average participant appears willing to take (or inadvertently assuming). The following are keen examples:

SPACs

The proliferation of Special Purpose Acquisition Companies (SPACs), or 'blank-check' companies, skyrocketed in 2020. A SPAC is an empty investment vehicle led by a person (or "sponsor") who creates the structure to raise money via an initial public offering (IPO) of sorts. Once the SPAC's capital raise is complete, it has up to two years to use those funds to buy a private company – which then 'magically' becomes a public company without having to undergo the regulatory process that accompanies a traditional IPO. In these cases, 'investors' are buying an IPO that skipped the due-diligence process and furthermore are allocating capital without first knowing its intended purpose. Though many more SPACs were on the docket to be completed the last two weeks of December, there were already $74 billion worth of them completed in the year, through mid-month. That compares to $43 billion done in the previous seven years, combined.[3]

Below is an excerpt from investment house GMO's October letter, written by Ben Inker, that encapsulates the sheer madness of some of this type of risk-taking behavior (emphasis ours).

> *… But Tesla isn't the craziest thing that happened this year, and that is true even if we restrict ourselves to looking only at electric vehicle companies named after Nikola Tesla. This spring a would-be Tesla called Nikola went public via a reverse merger with a SPAC at a valuation of $3 billion. In the 2020 EV frenzy, it rose 10-fold to a market cap of about $30 billion.* ***This company is a rare bird in the stock market, a pre-revenue manufacturing company. In fact, Nikola is not only pre-revenue, having never sold any vehicles it has produced, it has also never produced a vehicle. Further, it has not even built the factory in which it aspires to build the trucks that it has yet to sell.*** *This summer, a report came out detailing allegations that almost all of the claims of Nikola's Elon Musk wannabe founder over the few years of its existence were lies. That founder, Trevor Milton, was forced to resign and the company has yet to meaningfully refute any of the claims made in the report. The stock duly fell, but even after information came out showing that pretty much everything the company has claimed to accomplish in its history was a lie, it still has a market cap more than three times its value at its public debut less than a year ago – a valuation that was presumably predicated on the company's claims actually being true.*

Options Trading

Options are used for a variety of purposes, including portfolio protection from market downturns for example, through the purchase of put options. The purchase of call options (financial contracts allowing the buyer the right to buy a stock or index at a specified price within a specified time), however, profit when the underlying asset increases in price. This year has seen a frenzy of aggressive call option trading, predominantly by smaller, retail investors. In December, the 20-day moving average for call option volume exceeded 22 million contracts, roughly 150% higher than the previous 10-year average.[4] Jason Goepfert, president of research firm Sundial Capital said, "Since mid-July, trades for 10 contracts or fewer have consistently accounted for more than 60% of all opening call purchase premiums, massively dwarfing larger trade sizes." Further, Anthony Denier, CEO of online broker Webull Financial, referring again to the smaller retail trader, went on to say, "They are not doing it to hedge a position. These are naked, purely speculative plays that we're seeing."[5]

Investing 'Gamification'

One of the characteristics of a speculative phase in markets is the idea that 'everyone should get to play' and in 2020 it looked as though everyone was starting to play. Driving the interest was a combination of factors that likely included a very long bull-market leading into 2020, an industrywide shift to commission-free trading in late 2019 and the Coronavirus spread this year that shut people at home without sports to bet on or casinos to visit. Whatever the reason, individual investors opened more than 10 million new accounts last year according to JMP Securities, a record. The most popular with new entrants, the Robinhood Markets Inc. app, reached 13 million total users in 2020 and was expected to see 500,000 downloads in December alone, according to the company.[6]

The issue of course is not the 'democratization' of the markets, which in concept is a positive, it is the 'gamification' of the markets that poses danger to new entrants and a warning sign in general. These platforms are enticing users, mostly first-time investors, to trade, not to invest. Part of the appeal are the playful interfaces akin to an online social activity. In Robinhood's case confetti animation falls to congratulate participants on their first trade, opportunities are available to win a share of a high-priced stock if they get a friend to sign up, and the ability to browse the apps 100 most-held stocks for inspiration. Like online chat rooms that were prevalent in the late 1990s' Tech Bubble, social media sites like TikTok (amongst others) have videos with millions of views under #robinhoodstocks, blending 'investing' with social media and entertainment.[7]

In December, the state of Massachusetts filed a complaint against Robinhood for these gamification tactics, accusing the company of aggressively marketing to novice investors, enticing "unnecessary trading risks" and "falling far short of the fiduciary standard." In part of the administrative complaint by the state - of the more than 71,744 residents that Robinhood identified as being approved for options trading - 68% were classified as having "limited" or "no investment experience."[8] Just one example, but this statistic is clearly alarming given the fact that options trading includes a higher level of complexity than other forms of investing, as well as substantially higher risk levels.

Exuberant Sentiment

Additional signals illustrating exuberant market sentiment include, but are surely not limited to:

- Margin debt (borrowed money to buy stocks) has soared 50% in the past 8 months, reaching a three decade high matched only in March of 2000 and June of 2007.[9]
- Google search trends for "Tech Stocks" reached highs not seen since the early 2000's.[10]
- Assets flowing into leveraged Exchange Traded Funds (ETFs) reached a peak not seen since prior to the Global Financial Crisis.[11]
- American Association of Individual Investors (AAII) sentiment indicators show bearishness at multi-year lows.[12]
- The Russell 1000 Growth Index just outperformed its value counterpart by the largest margin on record.
- Elon Musk's **personal** wealth is worth more than Exxon Mobil.[13]

The point of this evaluation is not to strike fear or promote wholesale changes in strategy, but instead to try and 'pendulum plot' as a means of preparation. In a previous letter, we referred to Oaktree Capital's chairman, Howard Marks, and his concept of the market's inevitable cyclicality and the burden investors face in understanding where they are within an economic/market cycle, describing it this way:

> *The mood swings of the securities markets resemble the movement of a pendulum. Although the midpoint of its arc best describes the positions of the pendulum "on average," it actually spends very little time there. Instead, it is almost always swinging toward or away from the extremes of its arc. But whenever the pendulum is near either extreme, it is inevitable that it will move back toward the midpoint sooner or later. In fact, it is the movement toward an extreme itself that supplies the energy for the swing back.*

Based on the evidence above, it is our view that market psychology has swung the pendulum a good distance from the midpoint and toward the extreme of the arc. Additionally, valuation and fundamentals appear to be of limited relevance currently. Though we are not predicting the market's next move, which is a dangerous and non-repeatable exercise, these are indicators to heed.

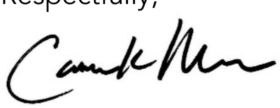
More than any other juncture in a long while, it is critical for all of us to "play our own game," resisting the temptation to chase certain 'beloved' stocks, or even compare our own strategy to market capitalization weighted indices that are now so heavily influenced by said stocks.

We will remain focused on our chief responsibility, the implementation of a strategy that is fundamentally sound, time-tested, and constructed for durability in an uncertain world. Our attention now, as always, is on owning high-quality enterprises with enduring characteristics such as strong and established competitive positions, high returns on invested capital, and thoughtful management that are able and willing to share a prudent portion of profits with us via durable and growing cash dividend payments.

Please feel free to call or email with questions you may have regarding our strategies or Martin Capital Partners in general. You can also find information on our website at www.martincp.com.

It is a sincere privilege serving those that have entrusted us with their capital.

Respectfully,



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3. The Daily Shot, SPAC Insider, December 14, 2020.
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5. How the Little Guy is Fueling the Stock Market's Wild Ride, Barron's, September 11, 2020.
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11. Morningstar, November 2020.
12. From Stocks to Bitcoin Investors Bet the Everything Rally Will Continue, Wall Street Journal, January 3, 2021.
13. Forbes, January 2021.

Statistical and analytical data provided by Factset.

If you would like additional information on how Martin Capital Partners, LLC conducts business, we can provide a copy of our SEC Form ADV part II, firm brochure.