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The Fear of Stock Market Failure

Dear fellow investors,

The stock market is a big place with thousands of investments that you can make as an investor. It's a frustrating place. There is a myriad of investing disciplines that you can seek out. As a millennial, my generation is learning this for the first time. Don't kid yourself for one second: they will destroy wealth.

This element of speculative risk was underlined by an article in *The New York Times* on July 8, 2020, *Robinhood Has Lured Young Traders, Sometimes With Devastating Results*. The author, Nathaniel Popper, writes about Richard Dobatse, a husband and father, who signed up for Robinhood through credit card advances. As he repeatedly lost money, Mr. Dobatse took out two $30,000 HELOCs to get more money involved with the trading platform with more speculative stocks and options, hoping to pay off his debts. His account value shot above $1 million in value, but as of the article, his balance was $6,956.

To digest this for Smead Capital Management clients and investors, we call this stock market failure. Many investors never find an investment discipline which provides them long-term stock ownership. What Mr. Dobatse experienced is not uncommon. Investors who share these experiences look at the stock market for years after this type of failure as a place that is big, frustrating and very confusing. Most investors can empathize with these emotions.

The other way investors experience stock market failure is by just being human. This causes them to feel excited at high points and depressed at low points in overall stock prices. Mr. Market is good at this. As Dalbar and many studies have shown over the years, most investors never attain the returns they seek in stocks.

As an example of Dalbar's work, the investors in the crash of 1987 did far worse than they should have:

> *In October 1987, the average investor lost 20% of their account value. Although buy and hold would have yielded a gain for the year, there was a net withdrawal of funds in 10 out of 12 months. And the investors stayed out of the market for the most part until March 1990.*[1]

The investors produced stock market failure in their activity within the stock market. They poured far more money in at the top and pulled it out at low points. Baby Boomers poured money in like you couldn't believe in 1999!

> *Investors are not born to buy into bubbles; their recent experiences lead them to see future gains as being irrationally more probable because those are the memories most available to the average investor's brain," according to the study. "Leading into the dot-com bubble of 2000, the average investor was drawing on 5 years' worth of memories in which the*

S&P saw 20% or greater growth!" In fact, investors contributed 20% more per month in the 24 months leading up to March 2000 than historical data shows they had done previously.[2]

The reality is that this manic activity that produces stock market failure doesn't just lower returns. It destroys wealth.

As Richard Bernstein, a former chief investment strategist at Merrill Lynch who now runs his own firm, told me, "What's shocking is that simply by investing, most people actually made themselves poorer." He added, "They're just shooting themselves in the foot, over and over."[3]

We belabor this point to advise investors where we are at in the pendulum of stock investing. We believe there is a euphoria present in markets, not unlike 1999 or particularly 1972. Jeremy Grantham of GMO highlighted where we are in light of price to earnings ratios from a historical context today:

Everyone can see and feel that this is different and can sense the bizarre nature of the market response: we are in the top 10% of historical price earnings ratio for the S&P on prior earnings and simultaneously are in the worst 10% of economic situations, arguably even the worst 1%![4]

Why do the millennials of America have newfound interest in the stock market at a time like this? Today, the Robinhood trading platform is their friend, helping guide their newfound interest. In 1999, it was Ameritrade, E*TRADE or any other discount brokers that wanted to "help" you get involved in what the stock market offered. This element is timeless and will take place as long as capitalism and democracy reigns in a free country.

If you put these two problems together, you'll find a white-hot investment strategy heading into an era where the stock market is likely to cause a lot of disappointment in the future. This is the worst-case scenario for investors and the biggest risk to investors today.

Was the investor buying Coca Cola in 1972 going to hold through thick and thin? The Nifty Fifty was raging. It was exciting! What wasn't exciting? Waking up at the end of the 1970's with your stock value declining 53.54%.

Was the investor buying Microsoft at the end of 1999 going be a buy and hold investor? The dot-com bubble was raging. It was once again exciting for a whole new generation of investors. At the end of the 2000's, Microsoft had declined 47.79% during that decade.

Did it matter whether Microsoft and Coca Cola were truly great American companies? Did it matter that they produced very high profitability? Did it matter that they had a lock (or a monopoly) on their customer?

Our clients are investors that fear stock market failure and are advised by a low turnover, differentiated, value discipline seeking great businesses to build wealth. The discipline continues to focus on companies that benefit from the economy normalizing. To put it frankly, it's the kind of thinking that very few can visualize because stock market investors are so dour on the economic future!

We continue to advise our clients to remain excited about the prospects of the homebuilding business in the U.S. NVR (NVR), Lennar (LEN) and D.R. Horton (DHI) have rebounded from shutdown lows, but we believe the resilience and demand will continue to shock investors. We have witnessed our subprime auto lender Credit Acceptance Corp. (CACC) survive a credit market that was supposed to ruin them. Instead, the lack of auto manufacturing has caused the assets that back their

financing become more valuable. If you know a friend buying a car, have the dealer call Credit Acceptance. They'd love to help. We have seen travel-related stocks like Booking Holdings (BKNG) bounce pretty close to where it was before the shutdowns. Most investors that are unknowingly set up for stock market failure have feeble views of these businesses. They believe the small reversion in these businesses and their stock prices have run their course.

We advise our investors to eschew this view. We believe we are at the beginning chapters of a wonderful economic era globally where the consumer and economy will have slack to build upon for years. With rates this low and many stocks so cheap, it seems illogical to us that investors are so unaware that stock market failure could transpire out of today's circumstances. The problem is that logic has nothing do with what is going on. As James Grant wrote in his 2019 book *Bagehot*, "Logic is as poor an argument against a boom as it is against a love affair." Our parting advice: be logical and avoid stock market failure!

Warm regards,

Cole Smead, CFA

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