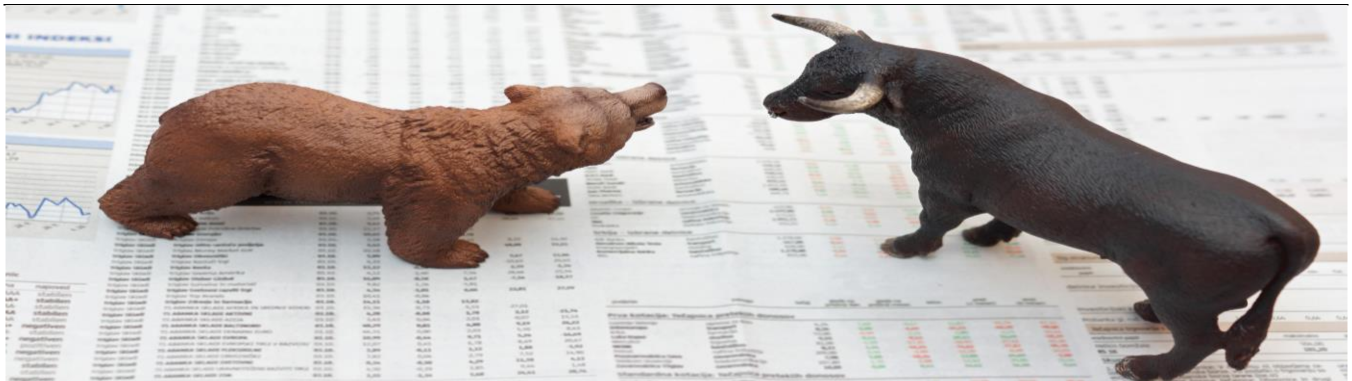

FEBRUARY 2021 MARKET COMMENTARY

Volatility picked up a bit in January with the broad equity markets slipping modestly. The Standard and Poor's 500 Index was down 1.11% while small caps led the markets with the Russell 2000 advancing 5.00% on the month. While there is plenty in the market to discuss, and plenty to remain optimistic about for the year (see our 2021 Market Outlook), we would be remiss not to address the focus of recent headlines—GameStop. This phenomenon is causing many media outlets to draw parallels to the tech boom and bubble markets. In short, we believe these short-squeezes to be a side-show to the markets and are not indicative of a broad market issue.

What is happening?

While traditional equity investing involves purchasing stock in companies that may be undervalued or have promising return potentials, there is also the ability to invest to profit on companies not doing well. This is called "shorting selling" and it involves borrowing and then selling the stock of a company that you expect will go down, so that you can purchase the stock back later at a lower price (profiting on the difference). Hedge funds have a long history of shorting stocks.

An investor and blogger in a Reddit forum called "Wall Street Bets" made his case to his fellow bloggers for value that he saw in the company GameStop surrounding some changes to management at the company and some changes to their business model. Others in the group agreed and started to purchase the stock and options contracts. Their demand for the stock pushed the price higher in the short-term.

This is called a short squeeze because as the price rises all the short sellers needed to start purchasing the shares as well to stop their losses pushing the demand and price even higher. The only problem was that Wall Street was so negative about the company that more than 140% of the available shares for GameStop had been sold short. Therefore, to close out their positions and stop losses, hedge funds needed to purchase 40% more than the number of shares available on the market. Along with media attention increasing demand there was a perfect storm of events causing the stock price to rise from around $6 to an intra-day high of almost $500 at the end of January.

This issue was not limited to GameStop. The Wall Street Bets forum identified a number of other companies that had high short-interest such as AMC, BlackBerry, Nokia, and others and turned their attention to those as well. The interest pushed those companies higher in the short-term.

What now?

During a short-squeeze investors who own the stock see astronomical returns, yet those returns are only on their statements and the stock needs to be sold to realize the returns. When the stock hits its high and the short-squeeze ends, anyone left holding their shares are only holding shares that are worth what the market is willing to pay for them. Demand can't be kept up forever. Indeed, that end to the demand may have come sooner than expected as brokerage houses made the unpopular decision to limit new purchases of shares in these short-squeeze names. Thus, artificially curbing demand.

Having seen a stock rise from $6 to an intra-day high of nearly $500 in a matter of a few weeks with no fundamental change to the business—we can only venture to guess that price will be much closer to $6 than it will be $500. While the drama surrounding these short-squeezes has been an entertaining side-show, it carries a great deal of risk and will ultimately cause a lot of pain and loss to many individual retail investors who chased a high-flying fad.

What are the implications to the market?

A lot of headlines have highlighted these short-squeezes and the astronomical returns of a handful of names and tried to draw corollaries to the tech-boom and being indicative of a broad market bubble. We do not see this as being the case.

First, the short-interest that we saw in a handful of names was very concentrated. Current short-interest in the market is the lowest it has been in approximately 20 years. The short-interest in Standard and Poor's 500 companies as a percentage of market cap is 1.6% (as of January 15, source: FactSet, Goldman Sachs Investment Research) and it hasn't been this low since 2000 (when it was 1.5%). This means that professional money manager sentiment is still long the broad market.

In addition, retail investors are generally a contrarian indicator. Typically, retail investors who invest on their own tend to sell during market downturns and reinvest towards the end of the market cycle when they are seeing the positive returns. During the market lows of February to April of 2020 over $1.1 trillion of cash was taken out of the market as evidenced by the skyrocketed value of money market funds. Since then, only about 40% of those funds have been taken out of money markets and put back into the system (source: Bloomberg, Morningstar). So the retail investors have not yet fully returned to the market and there is likely additional support available as they slowly return to markets.

Finally, we remain cautiously optimistic for the markets as extremely accommodative monetary and fiscal policies should continue to help to support markets (see our 2021 Market Outlook).

Anytime inefficiencies in the market can be identified it is a good thing. While short-selling is an important part of our free market and has a place, it is for sophisticated investors and with proper risk management. What we have seen here is extremely poor risk management coupled with a market inefficiency. We can only hope that regulators step-in to address these inefficiencies and situations which create liquidity issues and set the stage for the mania that unfolded with GameStop.

As we saw bedrock financial principles reward patience in an extremely volatile 2020, we continue to urge investors to take the headline noise out of the equation and remain committed to their long-term financial plans. While there is still political uncertainty and there will likely be additional volatility in 2021 as the world continues to grapple with COVID-19 through the winter and until there are mass inoculations, we advise clients to remain committed to their long-term financial plans. As always, please do not hesitate to contact us with any questions that you may have.

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Data sources: Economic: Based on data from U.S. Bureau of Labor Statistics (unemployment, inflation); U.S. Department of Commerce (GDP, corporate profits, retail sales, housing); S&P/Case-Shiller 20-City Composite Index (home prices); Institute for Supply Management (manufacturing/services). Performance: Based on data reported in WSJ Market Data Center (indexes); U.S. Treasury (Treasury yields); U.S. Energy Information Administration/Bloomberg.com Market Data (oil spot price, WTI Cushing, OK); www.goldprice.org (spot gold/silver); Oanda/FX Street (currency exchange rates). https://en.wikipedia.org/wiki/DeepFuckingValue News items are based on reports from multiple commonly available international news sources (i.e. wire services) and are independently verified when necessary with secondary sources such as government agencies, corporate press releases, or trade organizations.