A Bubblicious Market

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I came of age as an equity analyst and portfolio manager in the years leading up to the bursting of the dot.com bubble in 2000. That experience and the lessons taken from that particular market crash set the foundation for the type of professional investor that I am today.

There have been numerous market crashes and financial crises since the dot.com mania ended abruptly in tears and despair. Many lessons should have been learned from that period. I know that my investing career was shaped by that storied period in the markets. I am drawn to high growth potential companies, however I am all too familiar that true wealth creation in the equity markets requires more than a good story and hope. There are always small pockets within the markets which catch investor's attention where too much money chases too few securities. Larger and more dangerous bubbles occur when a theme develops that starts with institutional investors and eventually becomes the prevalent investment of choice for retail investors who are looking to jump on the bandwagon and get rich quick.

The common denominator between all investment bubbles is a human tendency to believe that there always will be a greater fool to pay a higher price. Ultimately, too many investors crowd into too few securities without there being any tether to a fundamentally supported valuation. When this occurs, capital appreciation goes parabolic, more investors/traders crowd in to the winners, the participants become over-confident, and at some unknowable point a small unassuming catalyst brings the house of cards down. When large financial bubbles burst, they create collateral damage throughout the market. For example, by the time the dot.com bubble burst, large high quality companies with both direct and indirect exposure to the "internet" theme saw their stocks become unjustifiably over-valued. Examples from that time are Cisco Systems and General Electric. After 20 years, neither of these two mega-cap stocks have fully recovered to the levels that they were trading at in

January, 2000. Cisco hit a high of nearly $70 per share and General Electric touched $60 per share; today they are trading around $45 and $11, respectively.

Policy-makers, such as Federal Reserve Governors and politicians, have historically been unwilling to stop economic/market bubbles from inflating because they fear being blamed by the public for the financial hardship which would ensue. Instead, policy-makers have historically taken half-hearted measures to curtail identified economic/market bubbles. In some instances they enact popular policies that carry unintended consequences which end up exacerbating asset price inflation.

The dynamics that lead to dangerous economic/market bubbles are complex and rarely are fully understood prior to a bubble collapse. It is for this reason that investors need to protect against being blinded by a powerful trend of higher and higher prices that can lead to losing sight of the fundamental underpinnings of economic value. Economic value or enterprise value, when applied to operating companies, help investors determine when the price of a security, or financial asset, has moved beyond what can be economically justified by discounting reasonable future cash flow assumptions to arrive at a present value.

As we enter 2021, following a year that most of us will gladly put behind us, financial markets are pricing most securities for a perfect recovery from the massive disruptions that characterized 2020. In select areas of the markets we are seeing valuation levels that are leaving market strategists and financial pundits to invent new rationale to explain price levels that have overshot reasonable target levels set just four months ago.

From experience, when valuation discussions give way to justifying fifty and one hundred times revenues, or we see massive speculation in non-financial assets such as Pokémon cards, Beanie Babies, and now cryptocurrencies, I know that we are in a maturing bubble environment.

After the equity markets nosedived last February and March due to the fear of a Pandemic induced economic shut-down, increasing exposure to risk assets carried a significantly reduced downside risk. However, now is the time to reassess the relationship between the prices of our holdings and valuation assumptions that are based upon reasonable forecasting. It is unknowable if we are near the end of a bubble market. Given that, assessing valuation assumptions and managing exposure to those stocks that have significantly deviated from real world valuation metrics can help manage the risks associated with bursting of a financial bubble.

The poster child for speculative excesses may not even be traded stocks this time. The barometer for excessive speculation during this cycle may very well be Bitcoin. To some, Bitcoin is either the future of currency or it is "digital gold." It seems very unlikely that Bitcoin, or any other unregulated cryptocurrency, will replace the likes of the U.S. Dollar, the Euro, Japanese Yen, or Chinese Yuan. However, it is more likely that cryptocurrencies, such as Bitcoin, temporarily are seen as both a get rich quick speculation and a store of value at the same time. Gold has traditionally occupied that space during times of uncertainty or significant fiscal and monetary stimulus. For many gold investors, gold is an insurance against the risks associated with an ever expanding money supply resulting from unconstrained government borrowing. Bitcoin speculators share similar concerns.

Like gold, Bitcoin, for example, has a finite supply and its value is derived through the belief that rising demand for a scarce commodity can only push prices ever higher. Unlike gold, which has a certain amount of utility when used as a base metal in certain industrial applications, and as a collectible in the form of jewelry, Bitcoin has no inherent utility. Bitcoin is an elaborate human created digital code. In fact, Bitcoin, in substance, is practically no different than video game tokens such as Pokémon Dollars or Super Mario Bros Coins, except Bitcoin supply is capped by the digital code that creates the coins. This capped supply, along with buyer enthusiasm are the only dynamics that drive Bitcoin prices higher.

There are two blatant dangers in Bitcoin's parabolic price ascent. One is that Bitcoin possesses no inherent economic utility, and thus has zero economic value. For example, Bitcoin does not pay a dividend or have an interest rate coupon, and Bitcoin does not compound value through return on invested capital. Two, Bitcoin does not have collectible or industrial appeal like gold because Bitcoin is not tangible and was created out of thin air. Some may argue that software is intangible and is created out of thin air as well, but some software applications can have significant value. However, software only has a value because it's utility as a tool is valued by the end user in terms of return on invested capital. Bitcoin currently has no utility other than blackmail currency for hackers demanding untraceable payments or alternative currency for online gambling that cannot yet legally be transacted in conventional currency. Today, Bitcoin only has value because someone else is willing to pay a higher price based on the belief that there will always be someone else willing to pay more.

A defender of Bitcoin may point out that there are other valuable assets, which do not possess economic utility, such as art and collectibles. It is true that art and most collectibles, such as vintage automobiles, paintings, old comic books, or collector trading cards do not possess economic utility. But, in addition to scarcity, collectibles do possess artistic or nostalgic value. If you overpay for a piece of art, you can at least hang it on the wall and derive some enjoyment from its artist value. However, with Bitcoin, value is only created by predetermined scarcity/supply and speculative demand. Thus, when the exuberance supported price deflates, an owner of Bitcoin will likely see their digital asset value disappear faster than Pac Man can gobble up dots on a screen.

I will begin 2021 by admitting that Seven Summits Capital portfolios certainly benefited from the bubbly market conditions that have prevailed for the last four to five months. We acknowledge this with our eyes wide open to the risks embedded in the prices of certain securities. Although all investments subject investors to risk, financial asset bubbles are very tricky to navigate. Even when one identifies a bubble, being overly cautious too early carries the risk of significant opportunity loss. But if an investor remains too greedy, too long, he or she will very rapidly give back more gains than most people can stomach. The best way to capture gains, while protecting against the eventual bubble market deflation, is to prudently diversify and responsibly anchor investment decisions to economic or enterprise value.

Happy New Year!

Curt R. Stauffer