The Vortex of "Buy at Any Price"

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Price agnostic investing, the action of buying securities at any price, without regard for what a security price represents, has taken center-stage over the last month with the crowd-sourced short squeeze in the stock of video game mall retailer, GameStop. However, price agnostic trading has been increasingly distorting stock and bond markets for a very long time, driven by both passive and quantitative investing.

There have always been short-term traders and larger investors who try to "game" the markets. However, for most of the history of our modern markets, these non-fundamental market participants have not had a meaningful influence on the price dynamics of the broad markets.

The most common form of price agnostic trading occurs every month when millions of investors have funds withheld from their paychecks to invest in their 401K. This money flow into predominately market cap weighted passive index funds, target date funds and active funds that largely mimic an index is systematic price agnostic investing. These money flows are on automatic pilot and these indiscriminate purchases serve to perpetually inflate the largest and most popular stocks of the recent past.

Stocks are not the only asset class that benefit from automatic pilot investing via retirement accounts. For many middle age or older investors using target date funds, these types of preset portfolios will hold between thirty and forty percent in broad bond investments. Today, these bond investment are mostly yielding less than the rate of inflation, thus providing a negative "real" interest rate yield. However, automatic, price agnostic investing provides significant money flow into these unattractive investments, only serving to bolster their price and make them more unattractive.

Why are we so concerned about price agnostic investing? Simply put, markets only work as intended when there is "price discovery." Price discovery is market terminology describing a market mechanism in which buyers and sellers who have differing assessments of the value of a particular security vote with their trades, thereby moving the price ever closer to approximating the intrinsic value of the underlying company. This process is the very essence of the capital markets. Capital markets are supposed to act as a source of capital for businesses who desire to sell shares to the public and a mechanism for valuing companies whose shares are currently trading in the market.

Today's markets do not resemble what is described above. In today's market, money flows, algorithmic and high frequency trading, passive asset allocation, gamified option betting, and most recently, crowd sourced short squeezing of "meme stocks" dominate daily trading. One has to wonder where investors fit into a market environment dominated by price agnostic investing. On June 13, 2017, in a CNBC online artlcle written by Evelyn Cheng, JPMorgan estimated that just 10% of trading is derived from fundamental discretionary investors. JP Morgan's Marko Kolanovic, head of Macro Quantitative and Derivatives Stategy, stated "the majority of equity investors today don't buy or sell stocks based on stock specific fundamentals." It is no wonder many people today see investing in stocks as a game or treat it as just another form of gambling. If all one focuses on are the movement of prices disconnected from what the price represents, buying and selling stocks is no different than gambling.

If only 10% of stock buying and selling is transacted by investors who connect a price to an estimate of value, price discovery cannot possibly have any material influence over the price of a stock in today's market environment. The result of this breakdown of price discovery in capital markets is that stock prices of popular stocks grow ever higher as prices are inflated by indiscriminate money flows fueled by speculation, hype, and price momentum. This breakdown in markets is how Zoom Communications, a company with an expected $2.37 billion in revenues for 2020 currently has a stock price that values the company at $122 billion. This compares to Viacom/CBS, which is expected to have nearly $24 billion in annual revenues in 2020 and currently has a market value indicated by its stock price of $33 billion. Similarly, Peloton has a stock price currently which equates to a $42 billion value for a company whose 2020 revenues totaled $1.8 billion. Whereas Lululemon apparel, a company which is growing rapidly and reported $4 billion in revenues for its 2020 fiscal year, has a stock price which equates to a value just one billion dollars higher than Peloton. The most egregious example of dominance of price agnostic trading in our markets is Tesla. Tesla is a fantastically successful company that deserves a premium valuation because of its ability to out innovate its competitors to date in the rapidly growing electric vehicle and battery technology marketplace. However Tesla, which reported 2020 fiscal year revenues of $20.79 billion, currently has a stock price that has risen over 700% within the last twelve months and values the company at $808 billion. By comparison Toyota, the largest automobile company by revenue at $278 billion for fiscal year 2020, has a stock price that values the company at just $210 billion. In fact, Tesla's $808 billion market value exceeds the summation of the value of every other publicly traded automobile company in the world combined.

The preceding paragraph is just a sampling of the insanity that price agnostic investing has created in our markets as we begin 2021. Trading without consideration of what a stock price represents has very real consequences for the underlying businesses in the real world. For instance Zoom Communications, at its current stock price, could issue stock equivalent to just 27% of its current shares outstanding and purchase Viacom/CBS outright increasing Zoom's revenues by a multiple of seventeen. Tesla could issue new stock equivalent to 10% of its current shares outstanding and buy every share of General Motors, having enough money left over to buy both Harley Davidson and Mazda outright.

We take this all very seriously. We understand how and why it is happening. We see silly speculation, whether in stocks, the proliferation of online gambling, or Bitcoin. Every American today has the ability to trade stocks, place bets, and speculate on cryptocurrencies using a few finger swipes on their smartphone screen. Speculation has been democratized, commoditized, and digitized. An unintended consequence of technological innovation, which we celebrate and invest in, has been a blurring of reality whereby smart phone apps have gamified various forms of financial actions that were not intended to be treated as a game. Public markets were intended to bring informed buyers and sellers together in order to continually discover an efficient price given known public information.

We begrudgingly conclude that investors, retail and professional, over time have reduced investing down to an elaborate game where investors play price movements in securities without regard for derived value. This has occurred as the average holding time of an equity security can now be measured in seconds and minutes as opposed to months and years. Value has little to no consequence when security ownership is brief and purely transactional in nature. Equity investment in particular has become more akin to a one-night stand as opposed to a courtship. The vast majority of today's equity investors are only interested in superficial qualities, such as price and momentum. These superficial qualities can be sized up within seconds for a person and within milliseconds for computer. No longer can active discriminating investors move markets. In today's gamified markets, an active discriminating investor must either seek out small corners of the market that are not within the purview of indexers and short-term traders, or this type of investor must capitalize on the price-to-value variances that price agnostic investing will inevitably produce.

Our process, as discriminating active investors, has evolved as the markets have become more price agnostic. We have both attempted to seize on the gross inefficiencies that result from price agnostic investing and additionally we have sought out securities representing companies whose shares are not pulled into the "buy at any price" vortex created by the sheer size of the daily passive money flow, the volatility that is created by the institutional quantitative trading strategies, and the massive price chasing dynamic created by momentum traders.

Our clients are very used to hearing us talk about market cap instead of stock price, expected future cash flows rather than backwards-looking financial ratios, and fair or intrinsic value range versus 50- and 200-day moving averages. We love talking about companies, not the market and technical indicators. In fact, market levels are a distraction that we prefer to minimize or even ignore. Value is created by future company performance, free cash flows, and capital allocation decisions. These corporate metrics are what we focus on. We do not choose this process to be different or contrarian, we choose this process to be responsible. Responsibility means anchoring the decisions that we make in client portfolios on those metrics that are at the center of how value is created.

The more disconnected from reality that the markets get, the more opportunities that are created for us to build wealth for our clients using the growing disconnect between price and value to our advantage. The effectiveness of our approach was put on full display last year when price agnostic selling sent our markets plunging nearly 30%, with many individual stocks falling more sharply in late February and March. We are always on the lookout for unusual variance between price and value that can be exploited for outsized gains for our clients.

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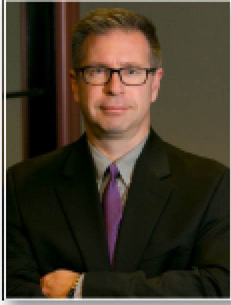

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Disclosure:

Advisory services offered through CS Planning Corp., an SEC registered investment advisor.

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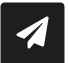
Share: 

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