# Market Speculation on the Rise

## Stay-at-Home Speculators Contribute to Stock Market Volatility

- A new wave of investors, many of whom are millennials, are throwing caution to the wind in search of outsized returns.
- Frequent trading and easy access to leverage have enabled these amateur investors to contribute to stock market volatility more than is generally acknowledged.
- This rise in risk-taking is unlikely to last indefinitely; thoughtful stock selection based on fundamental company analysis remains the best way to navigate erratic swings in stock prices.

Millions of new investors have piled in to the stock market in 2020. Being stuck at home without the usual distractions like traveling on vacation, socializing at bars, or watching sports (and related gambling) has caused many to look for excitement elsewhere. The brokerage giant Charles Schwab Corporation added over 1 million accounts in the first half of 2020, while the popular millennial-focused trading app Robinhood added over 3 million new accounts[1]. The Robinhood client base in particular serves as an informative sample because the company provides more granular account level data than other brokerage firms and the average user skews younger. The average Robinhood investor is only 31 years old, and half of its users are investing for the first time[1]. Could these new investors have a proclivity for speculation that is contributing to stock market volatility and distorting market prices?

The meteoric rise in Tesla's stock price this year provides a clear, albeit isolated, example of how novice investors may be especially prone to speculation. The electric car manufacturer is up over 400% in 2020, including a gain of over 40% in early July. While the company did release positive quarterly results, the relentless rise in the shares appears to be more related to general investor enthusiasm than any particular data point or news story. In fact, the number of Tesla investors on the Robinhood platform more than doubled to over 500,000 in only three months[2]. In a telling sign of investor psychology, the number of accounts grew in lockstep with the price—the bigger the gains, the more investors sought to buy Tesla for the first time. While it is true that even a few hundred thousand new investors is probably not enough to dictate the market price for a more-than $300 billion company like Tesla, it is likely that these investors are influencing prices to at least some degree. Robinhood users reportedly trade as much as 40 times more frequently than investors on the Schwab platform (which generally caters to more traditional "buy and hold" investors), so they are almost certainly having a larger impact than the dollar amount of their assets alone might suggest[1]. However, it is not clear if Robinhood is just an anomaly that serves as an isolated haven for aspiring day traders or if these statistics provide a peek into a broad increase in speculative, risk-seeking behavior. In either case, it is reasonable to conclude that these volatility-seeking investors are influencing stock market prices over the short term in certain stocks. Nevertheless, Tesla is a fascinating company with an ethos that excites consumers. 1919 Investment Counsel owns Tesla in certain client accounts, primarily as part of the Disruptive Innovation Strategy, which invests in fast growing companies with long-term growth potential. Understanding the market dynamics that may influence the stock price is critical to determine appropriate position sizing and to manage portfolio volatility.

The widely publicized Hertz story provides another glimpse of the potential market impact of new investors. Shares of the distressed car rental company surged 571% in only 3 days in early June—after the company had filed for bankruptcy. The incredible rise in the share price coincided with a more than 40% increase in the number of Robinhood accounts holding the stock (bringing the total number to more than 133,000 accounts[2]). At the same time, most of Hertz's $20 billion of debt obligations were trading for less than 40 cents on the dollar. Debt holders generally must be made whole before equity investors receive any value. This bizarre disconnect between debt value and equity value prompted the company to contemplate creating more shares of stock to sell to investors in a move that would almost certainly have created a 100% loss for new stock investors and solely benefitted bond investors. Following public backlash and regulatory scrutiny, the company ultimately decided not to pursue this option. Presumably, few of the new Hertz investors conducted any research to determine if the company could repay its debt and thereby leave some residual value for stock investors. More likely, they saw a familiar brand trading at a "low" stock price and clamored to snap up a bargain. Investors typically flee from uncertainty, so one would expect holders of Hertz stock to be selling their positions in the bankrupt stock, not adding to it for the first time. Speculators, on the other hand, tend to flock to uncertainty, lured by the possibility of large gains over a short time frame. While the Hertz example is relatively small in terms of total dollar value compared to the overall stock market, it suggests that the speculative objectives of amateur investors may be influencing market behavior more than some investors generally acknowledge.

The Hertz and Tesla examples are telling, because in both cases investors seem to be attracted to the heightened volatility – up or down – in a risk-seeking behavior more akin to gambling than prudent investing. But how are these investors making financial decisions if not through rigorous company research? Digital and social media sources seem to play an increasing role. For example, David Portnoy has become a digital sensation by broadcasting high-energy day trading tactics to his 1.7 million Twitter followers. David founded the sports and pop culture website Barstool Sports, which Penn National Gaming recently acquired a 36% stake in for $163 million. David's style makes even the popular CNBC personality Jim Cramer seem stale and boring. As an example of his often absurd advice, upon waking up to a live deer outside his residence, David tweeted that he bought half a million dollars of the heavy equipment company John Deere based on the logic "you see a deer, you buy DE [John Deere]." Despite a Twitter profile that states "I'm not a financial advisor. Don't trust anything I say about stocks," he continues to post videos about stocks on a daily basis, with his followers eagerly watching.

Beyond these isolated examples, it is difficult to quantify broad measures of risk-seeking investor behavior. One place to look for clues is the options market. Options contracts can provide a leveraged bet on whether a given stock will be higher or lower than a certain price at a specified date in the future. Multiple stories are surfacing about unsophisticated investors recklessly trading options, resulting in substantial losses that not only wiped out their accounts, but actually left the investors owing hundreds of thousands of dollars in some cases. While sad on their own, these devastating losses appear to be a symptom of a broader trend. According to Goldman Sachs, the daily value of options traded has surpassed the daily value of stocks traded for the first time[3]. In other words, more money is now "bet" on which way stocks will move, and less money purchased in direct stock investments. While managers can legitimately use options to hedge a portfolio, the rapid increase in activity suggests there is more speculation than hedging. Furthermore, trades for a single options contract now account for 13% of the total market volume–a sign that much of the activity is coming from individual investors as opposed to institutions. Multiple large hedge funds actually pay to see what options Robinhood users are buying and selling, presumably because they can profit from this information. It is easy to imagine a feedback loop whereby speculators buy options, which causes hedge funds to buy the stock, which drives prices higher, which lures more speculators to buy the options and the stock, and so on.

Further evidence of an increase in the use of leverage can be found in the growing popularity of mutual funds and exchange traded funds (ETFs) that provide two or three times the exposure to popular market indices. One of the largest funds in this category, the ProShares UltraPro QQQ Fund, provides three times the exposure to

the daily price movement of the technology-dominated Nasdaq 100 Index. Despite high annual fees of nearly 1%, investors added over $2 billion to this fund in the first four months of 2020. Institutional investors can easily replicate such a strategy at a lower fee in the futures markets, so most of the added assets are likely inflows from less sophisticated individual investors.

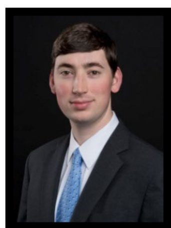
Whether because of demographic shifts, falling trading commissions, or virus-related lockdowns, it is highly likely that millions of new speculative investors entered the market in 2020, and that their high trading activity and access to leverage contributed to stock price volatility in certain cases, and perhaps overall market volatility. However, history and logic both indicate that over longer periods, these anomalies are likely to dissipate as slower-moving but vastly larger pools of institutional capital respond to prices that may appear to defy common sense. The question is not if these distortions will continue, but for how long. One of the most prudent methods for navigating the landscape of wild price swings is through thoughtful selection of individual stocks. 1919 Investment Counsel devotes vast investment resources to finding quality companies with valuations supported by rigorous fundamental analysis and research. As long as investors or managers closely understand a company's investment merits, then fluctuating stock prices can actually provide attractive opportunities to buy undervalued securities or sell overvalued securities.

Footnotes:

[1] https://www.nytimes.com/2020/07/08/technology/robinhood-risky-trading.html

[2] https://robintrack.net/ (Robinhood ceased disclosing account statistics so this website is no longer updated)

[3] https://www.cnbc.com/2020/07/24/options-volume-hits-record-with-bullish-sentiment-at-extremely-high-levels-goldman-sachs-says.html



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Miller entered the financial services industry in 2008 as an equity trader in New York. Prior to joining 1919, Miller was employed at Sterne Agee where he built custom portfolios for financial advisors to use with their high net worth clients. Miller was also responsible for the due diligence on third-party investment managers.

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