



Tandem Investment Advisors

Notes from the Trading Desk - May 14, 2021

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by Benjamin "Ben" G. Carew, CFA

MARKET MOVERS & SHAKERS

The month of May is off to a rocky start. The S&P 500, Nasdaq, Russell Mid Cap and Russell 2000 are all down through the first 13 days, with the Dow keeping its head just above water. While it felt like a sea of red, the carnage was confined to the recent high-flying less profitable companies. The S&P 500 did not even fall 5% from its recent high with over half of the sectors still positive month-to-date. At this time, it is seemingly just a hiccup for most of the non-Tech and non-hypergrowth names. While the S&P 500 and the Dow were relatively unbothered by the recent selloff – volatility certainly spiked. The VIX soared some 65% higher in three days. For the first time since the 2015 China growth scare, the VIX surged double digits on a percentage basis for three straight sessions. Yields have also risen higher lately. A surprisingly (relative to estimates) hot CPI print mid-week caused yields to surge higher on inflationary fears, which in turn exacerbated Wednesday's move lower.

Fred Schwed, Jr. once said "Speculation is an effort, probably unsuccessfully, to turn a little money into a lot. Investment is an effort, which should be successful, to prevent a lot of money becoming a little." Prior to the most recent bout of weakness, there was an abundance of risk-taking and speculation. According to a recent Bloomberg article, high yield spreads are the tightest they have been since 2007. Throughout the back half of 2020 and the start of 2021 there was a rapid rise in non-profitable companies. The Goldman Sachs Non-Profitable Tech Index rose more than 380% from its March 2020 low to a high in mid-January. Bitcoin, Dogecoin, and other crypto coins with names too explicit to even mention have all skyrocketed (or gone to the moon) over the past few months. There have also been

several now infamous fallouts stemming from excessive leverage or speculation. Softbank's Nasdaq whale left tech briefly reeling in the fall of 2020. Melvin Capital famously lost in its battle against a legion of Reddit and retail investors over GameStop. Greensill blew up in February from leverage issues. Archegos was reportedly levered 5:1 before it imploded. Then, there was a supposed crypto whale that was forced to liquidate Bitcoin on a Saturday in mid-April that shot the cryptocurrency lower by more than 10% intraday. European media even suggested that the recent U.S. selloff was due to forced liquidation of some hedge fund that was pushed to tap into the Federal Reserve's overnight repo window to shore things up. Excessive leverage can lead to unimagined things. Thankfully, the incidents so far have been confined (mostly to Credit Suisse's balance sheet), which has mostly left the market unperturbed. But it is clear from these events that there is a lot of leverage in the system. In fact, according to The Financial Times and London based ABP Invest, margin debt is estimated to currently be 4% of GDP – handily above the 3% number preceding the bursting of the tech bubble and the financial crisis. Moreover, call option volume, another symptom of excessive risk taking, has reached “unprecedented” levels according to Schwab. Some studies even suggest that extraordinary option activity leads to an increase in market fragility, which in turn can lead to the increasingly rapid and violent market pullbacks that have been the calling card of this bull market for the last few years.




According to Goldman Sachs' prime brokerage unit, hedge fund leverage hit a record high in April. Now, it is being reported that prime brokers are slashing the available leverage to hedge funds across the street. Lowering the available margin or leverage could be a source of selling pressure to the marketplace as firms are forced to sell to stay within their changing leverage limits. Elsewhere, we have already seen some of the unwind in more speculative corners of the market. The 20 largest holdings in the SPAC ETF (SPAK) are down on average more than 45% from their recent highs. Goldman Sachs Non-Profitable Tech Index has fallen 40% from its peak. Cathie Wood's ARKK dipped below \$100 for the first time since November – well off its high of nearly \$160. Names like Tesla, Teledoc, Roku, Shopify and Square are all down more than 25% from their recent highs. Simply put, the leverage and speculation previously outlined had gotten excessive. Perhaps we are just entering a deleveraging cycle in the marketplace. Ultimately, cleaning out the excesses and removing the surplus of speculation will be good for the market moving forward.

TRANSITION UPDATES & NEWS **

The recent pullback provided an abundance of opportunity at the transition level. We were able to add to a plethora of names including the likes of Becton Dickinson, Dollar General, Abbott Labs, Euronet Worldwide, Tyler Technologies, and Intercontinental Exchange, to name a few. Generally speaking, accounts that have been with us for one month are now a little more than halfway through their transition, while accounts that have been with Tandem for three months are closer to 85-90% of the way through their transition phase. Also, we were able to add to a bit of our existing position in Fiserv in our Equity strategy.

***The transition update describes activity taken by Tandem on the transition level, not the composite or firm-wide level. The transition update is applicable to new accounts and new money. New accounts and new money are not automatically invested on the first day. Rather, they are transitioned into our strategy over a longer time period that is dependent upon market conditions. This update describes that transition.*

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