OBSERVATIONS

Tandem Investment Advisors | William "Billy" Little, Jr., CFA

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Financial Markets Review

"Nothing so undermines your financial judgement as the sight of your neighbor getting rich."
– J.P. Morgan

Did you know that the Federal Reserve met this past week? Yeah, they really did! It was the first time since probably the Financial Crisis that the financial news media did not wait with bated breath to parse through the Chairman or Chairwoman's every word searching for that one hidden clue signaling the FOMC's next move. I am not going to lie; it was pretty nice not to hear some financial pundit opine on the increased probability of the Fed tapering or further expanding their balance sheet because the FOMC's statement was six words less than their previous statement. Nope, no one had time for this type of in-depth analysis. Instead, all effort and attention were given to one thing – the FOMO to YOLO.

If you had never heard of Reddit and a community called WallStreetBets (WSB), I am sure you have now. At first, I set out to write about the events of this past week, but you can just as easily turn on the TV or open The Wall Street Journal to catch up on the battle between the WSB community and certain hedge funds. What I find more interesting and useful are the potential unintended consequences and risks in the market moving forward.

It is not possible to experience a near collapse of the global financial system and expect everything to just go back to "normal". The events that transpired this past week are a culmination of monetary and fiscal policy decision making since the Financial Crisis. The pitting of individual retail investors versus the "establishment", or hedge funds, did not happen out of nowhere. The WSB members are looking to lead a financial revolution, just as the BLM movement seeks a social revolution. These frequent and ongoing uprisings have one thing in common – inequality and a widening of the wealth gap.

For several years now, we have written extensively about the consequences stemming from the unprecedented monetary policies adopted by global central banks. In short, ultra-low interest rates inflate financial assets, which are primarily owned by the wealthy. This, in turn, allows the rich to get richer and the poor to get poorer. As the gap increasingly gets wider, volatility in all aspects of life – financial, political, and social – increases exponentially. Just two months ago in the December 2020 edition of Observations, we looked back at the ever-increasing volatility in financial markets over the past few years and had this to say…

"What does this ultimately mean for you – the investor? Expect the unexpected and stick with an investment strategy that can control your emotions. Emotions get in the way of sound decision making, because in the moment, extreme fear is never more frightening and extreme greed is never more euphoric. As always, the truth lies somewhere in between."

Over this past week, the unexpected was not a mob of retail investors banding together to squeeze the shorts or impose their will on the "establishment". It all just came to a head this week. What was truly unexpected and an enormous risk to stock prices in the very near term is the instability of the market structure and clogging of the financial plumbing. In fact, it was the backing up of the market's pipes that caused many brokerage firms to restrict trading in several names. These trading restrictions threw fuel on to the fire and conspiracy theories were running amuck. We may never know the full truth behind the trading restrictions, but one thing is for certain, the surge in volumes and crowding into a select few companies created a systemic risk.

Technology and the movement to zero commissions has made it easier and more accessible than ever to trade stocks and options. It has also created an environment that has shifted from ownership in a business to just outright gambling. According to Felix

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Salmon of Axios, "almost never does a stock trade more than twice its market value in a single day. It never happened in 2001 or in 2003, and only happened once in 2002. It has happened 7 times this week already, and 20 times this month. In the past 12 months, it's happened 84 times, which is more than all of the previous occurrences going back to November 1998." The issue with the surge in common stock and option volume is that the underlying system designed to keep track of the ownership changes is being overwhelmed. And, the brokerage firms allowing their clients to trade these companies, on margin no less, are losing control of their risk management systems.

For the stock market to function smoothly, there must be confidence that all parties will meet their financial obligations in a timely manner. I think it is imperative that everyone involved in the stock market has a basic understanding of how the process works. To place a trade, you must initiate that trade through a broker who then sends it to an exchange for execution. The trade gets executed and you will see the shares immediately show up in your account or the cash raised if you are selling. However, those shares, or the cash now available in your account, is not technically yours for another two days, which is called the settlement period. Over fifty years ago, the time between execution and settlement was for the brokers to swap the physical certificate. Today all records are kept electronically, and the trade details go to the Depository Trust & Clearing Company (DTCC). The DTCC is the clearing house for processing and keeps record of the ownership transfer in the shares. Probably the most important role of the DTCC is to guarantee settlement, as to avoid systemic risk if brokers are unable to deliver the shares or the cash. For the DTCC to guarantee settlement of the trade, they require brokers to post collateral, which is calculated based on the volatility and value of the trades. If the volatility of the underlying company is high, more collateral is required of the brokerage company and vice versa. And just to add in one more layer of risk is the broker's propensity to allow their customers to trade on margin, which is simply money loaned to the client. So, if the trade is executed on a margin loan, the DTCC requires even more collateral, because it is not even the client's capital being used for the trade. To sum it up, a brokerage firm's collateral that needs to be put up to allow the DTCC to guarantee settlement is largely based on volatility and the use of margin. And guess what we have a lot of right now? You guessed it – heightened volatility and a record amount of margin debt!

This perfect storm is causing brokerage firms to post an increasing amount of collateral every day, which puts a strain on their capital levels. If a brokerage firm does not have the capital to meet the collateral call, then it is pretty much game over for that firm. And therefore, you see many of these brokerage firms restrict trading in the most volatile names right now, because it is one of the only ways for them to control their risk. Markets need liquidity to function and bad things happen when liquidity dries up. Trade restrictions inherently reduce the liquidity in certain names, which in turn creates more volatility. It can be a vicious cycle that ends up spreading to other areas of the market.

For the most part, volatility has stayed in the WSB battleground stocks. However, it should not come as a surprise that volatility has begun to spread a little bit. Last week, all three major indices (DJIA, S&P 500 and NASDAQ) fell more than 3% with two-thirds of the weekly loss coming on Friday alone. This was the worst weekly loss for the indices since October. We have routinely mentioned that when valuations are stretched, as they are today, the risk to a correction in stock prices is very high. The cause and catalyst for the correction is usually not valuations alone, but something almost no one saw coming. The retail participation in many of the smaller cap companies, SPACs, and popular investing themes such as renewable energy and electric vehicles is nothing new. However, the recent explosion of retail activity to the point of clogging the market's plumbing is not what most people saw coming. As market structure risks mount, it would not be the worst thing in the world to steer clear and let your neighbor bask in all of their glory.

Tandem Strategy Update

It should not come as a shock to anyone that we do not own GameStop (GME), Blackberry (BB) or AMC Entertainment (AMC). These companies do not make it through our quantitative model based on their deteriorating fundamentals. And since we are

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a long-only investment manager, it is not part of our strategy to short stocks. We will either be an owner of a company or not.

In last month's edition of *Observations*, I discussed the process and our philosophy regarding cash in our clients' portfolios. Well, that cash is still there waiting to be deployed. If this past week is a precursor of what is yet to come, then there will be plenty of opportunities to invest that cash. And I suspect those opportunities will likely come sooner than later.

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Billy Little is a shareholder, Vice President and Portfolio Manager for Tandem Investment Advisors, Inc. Mr. Little began his career in the investment industry in 2004, as a Financial Advisor with Ameriprise Financial in Baltimore, Maryland. Mr. Little joined Tandem in 2006 where he directs Tandem's quantitative research. He is a regular member of the CFA Institute and past President of the CFA Society South Carolina. Mr. Little graduated from the College of Charleston with a Bachelor of Arts in Business Administration with a concentration in Finance.

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