Hutchinson
CAPITAL MANAGEMENT

July 2020

Investing vs. Speculating

"Men, it has been well said, think in herds; it will be seen that they go mad in herds, while they only recover their senses slowly, and one by one." Extraordinary Popular Delusions and the Madness of Crowds by Charles Mackay (1841)

An ancient Chinese curse, which translates into English as, "*May you live in interesting times*," was meant to wish upon another person a life of turmoil and uncertainty. As we grapple with the ongoing effects of the COVID virus, we face personal challenges, as well as financial. When it comes to investing, we believe that the one consistency that carries us through any period of heightened uncertainty is the ability to adhere to rational thought amid a sea of chaos. Part of this is experience, but it is also having a process that applies thoughtful research to each investment decision. In this *Investment Perspectives* we will explore some of the behavioral factors we are observing (and avoiding) and highlight how our process contrasts with the more speculative activities we are witnessing.

Investor behavior is a topic that academics struggle to explain because it's inconsistent and mostly unscientific. As investment practitioners, perhaps we have a better understanding of market psychology in the real world. When economists explain markets, one might expect a calm, predictable environment, "In a world of market efficiency, share prices would always reflect intrinsic value, and speculators would simply be rational economic agents intent on optimizing their wealth; there would be no animal spirits, no crowd instincts, no emotions of greed or fear, no trend-following speculators, and no 'irrational' speculative bubbles."[1] As everyday observers of markets, we see something entirely different.

Each market cycle is unique, but investor behavior always seems to move between extremes, and the actions that investors take are surprisingly consistent across cycles. These behaviors are most apparent at the peaks of fear and greed. Still, it's amazing to us that market observers seem to look back at each cycle in incredulous surprise at the reckless behavior perpetrated by the masses. During the heat of the last technology-stock frenzy, 20 years ago, Warren Buffet was asked by an interviewer, *"Why is it that smart people sometimes do such dumb things?"* In response, Mr. Buffett said, *"What interferes with rationality? It's ego. It's greed. It's envy. It's fear. It's mindless imitation of other people. There are a variety of factors that cause the horsepower of the mind to get diminished dramatically before the output turns out. If Charlie [Munger] and I have any advantage it's not because we're so smart, it is because we're rational and we very seldom let extraneous factors interfere with our thoughts. We don't let other people's opinion interfere with it. We try to get fearful when others are greedy, and greedy when others are fearful."*

Speculative behavior and market bubbles are fascinating to watch, but as it's primarily a social science, the investment implications are tough to specify. Since we do not seek to directly profit from the follies of speculators, our focus is on preserving capital and winning by first not losing. This means staying out of the wake of speculative blow-ups that periodically roil markets. This is usually not too difficult for us, but we must admit that this current environment of managed markets is a genuine challenge. We have experienced multiple bubbles in our investing experience and have studied those that occurred before our time. Some of the localized episodes that snared investors in speculative frenzies include: Conglomerates (late 1960s), Computer Software and Services (1969-70), Nifty-Fifty (1973-74), Oil Stocks (early 1980s), Biotech (early 1990s), Tech, Media, Telecom (TMT, 1998-2000), Housing/Credit (2008). Each of these episodes involved different products, but there were similarities between them. The most prominent characteristic is the behavioral influence, and that is the focus of this paper.

[1] Edward Chancellor, *Devil Take the Hindmost* pg. xiii New York, 1999

Investing is Not Entertainment

"The aim of investment is the preservation of capital while that of speculation is enhancement of fortune. Speculation is an effort, probably unsuccessful, 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." [2]

Whenever we commit capital to an investment idea there is a risk of loss, no matter how careful we are. While our principal goal is to protect our clients' wealth, we also expect our investments to generate growth. A significant element of our research process is determining what we are willing to pay for the growth we expect. In simple terms, we will pay a bit more for higher levels of profitable growth, but never at the expense of our margin of safety. We expect a return on capital, but also a return of capital. By some definitions, the distinction between investing and speculating is narrow, but in practical terms, at HCM, the activities are starkly different.

Investment activities consider the total yield (return) from an asset over its useful life, while speculation is an attempt to profit from a change in price. Philosophically, speculation has always meant an activity wherein the participant reflects or theorizes without a firm factual basis. Speculation, therefore, is always dependent on the psychology of the market. To succeed, the speculator buying today is banking on the story growing to infect new buyers who will pay even more tomorrow. "The psychologies of speculation and gambling are almost indistinguishable: both are dangerously addictive habits which involve an appeal to fortune, are often accomplished by delusional behavior and are dependent for success on the control of emotions."[3] Benjamin Graham introduced the concept of "*Margin of Safety*" when evaluating an investment whereby the principal is maintained even amid unforeseen adverse conditions. An uninformed or spontaneous investment is more speculative than one in which the investor has taken the time to investigate and assess its potential returns.

Investing should not be exciting. Charlie Munger has said that it should be like watching paint dry. When someone buys stocks for entertainment, it's not likely to work out well for them. We think the notion is ably captured in comments by one individual investor: *"It's boring watching stocks, it's not exciting, they're not making these crazy prices," said Adam Barker, a 31-year-old software engineer in Massachusetts. "You don't get a rush throwing money at Berkshire Hathaway and waiting 15 years."*[4]

	INVESTMENT	SPECULATION
TIME HORIZON	Long-term, saving for future	Generally a short timeline of less than one year
LEVEL OF RISK	Moderate	High
INVESTOR ATTITUDE	Cautious and conservative	Aggressive
DECISION CRITERIA	Based on fundamental and basic factors	Based on technical charts, market psychology and individual opinion
EXAMPLES	Stock market, bonds, mutual funds	Options, foreign currencies, cryptocurrencies

Source: U.S. Global Investors

Themes, Narratives, and New Eras

New 'New Eras' are always better than the last new era, but the central characters share similarities; they all vow to change the world, the stocks have insanely high valuations, with business models that are wildly unprofitable, and there's always a great story. Every speculative bonanza needs fuel. Investors, particularly non-professionals, love stories. The best-performing stocks are those with the most tantalizing narratives. Ben Graham pointed out during the mania of the 1920s how investors worked to justify valuations in paying the prices they were paying. The delusions worked by shifting the focus away from the high valuations being paid and rationalizing that the standard of value had been raised. Instead of

[2] Fred Schwed, *Where are the Customers' Yachts?* pg. 172 New York, 1940
[3] Edward Chancellor, *Devil Take the Hindmost* pg. xii New York, 1999
[4] Ben Carlson, *Wealth Inequality and Lottery Tickets*, A Wealth of Common-Sense Blog July 2020

judging the market price by established standards of value, the new era based its standards of value on the market price. Markets untethered from investment discipline share the notion that making money in the stock market is easy. One only must buy a good stock, regardless of price, and let nature run its normal upward course.

During the previous Tech Bubble, buyers relied on concepts like, "Eyeballs Viewed" as a metric of value when pesky things like earnings per share were nowhere to be found. Generating negative free cash flow[5] was a sign of strength because it meant a company had vast, blue-sky investment opportunities. It's easy to laugh at this folly now, but what promises of vast future wealth run through the minds of the hopeful souls paying $1,500 per share for Tesla, or $55 for Nikola Corp., or $1,000 per share for Shopify?

New eras always have FOMO. In past generations, it's been called other things like, "Keeping up with the Joneses" after a comic strip in the early 20th century. Whatever one calls it, the human desire to out-do the next guy is a powerful emotion, and it can cause us to do dumb things. When we hear someone defend speculation by saying, "*This is the next Amazon or Apple*," it's concerning. In reality, there's only one Amazon and only one Apple Computer, but the list of exciting failures is vast.

Tesla's cars are popular, and not long ago, the stock price gyrated around the news of its ability to build and deliver cars, but as the stock's market capitalization grew to exceed the combined market values of Ford, General Motors, BMW, Daimler, and Volkswagen, a new narrative had to be crafted. A recent Wall Street research report laid out this new narrative by saying Tesla was not just a car company, but "*...the most consequential company in the mobility ecosystem, which is not likely to change for at least a decade.*" He went on to say that the only possible impediment to the stock reaching his $2,300ish price target is its ability to grow its capacity – to build cars we imagine, as part of its dominion over the mobility ecosystem. It's funny because that's exactly what we heard from a giddy analyst in 1998 when we were on a plant tour for the grocery delivery company, Webvan (bankrupt in 2001). We don't know for sure if paying $1,500 per share for TSLA is akin to buying Webvan at $25, but we have our suspicions.

Wall Street – Main Street Disconnect

If the S&P 500 index declined by 37% over 19 trading days on the fears that the virus would upend the economy, and two months later it's nearly back to even, things must be resolved, right? The economy is slowly struggling to recover, but it's challenged by a resurgence in infections. For the economy to get back to pre-virus levels, we need to return to more normal social behavior. Many businesses cannot function in a world of social distancing. The relevance to this discussion is the role that human behavior and expectations have played in this disconnect between economic strength and stock prices. Firstly, not all stocks are back to previous highs. The rally in the market-cap-weighted indexes is incredibly narrow, led by a small group of very large companies. The average stock in the S&P 500 is still down 12% this year. Small-cap value stocks, as captured by the Russell 2000 Value Index, are down 27% year-to-date. Granted, economic data are backward-looking, and stock prices reflect future expectations, but we know from experience that the market's ability to accurately forecast is highly skewed by the mood of the crowd. As the average investor embraces a higher appetite for risk, the willingness to speculate on future events increases. Over the long-term, the markets get a lot of things right, but there are speed bumps along the way that can be quite painful, and these are what we try to steer around. The same crowding into the largest technology companies was going on in the 1990s, and the mob was not too wise in late 1999, following several years of spectacular returns in tech stocks. December 18th, 1999, the average price target for the top market darlings implied an expected return of 65% in 2000. When the dust settled, they actually fell by an average of 88%.[6]

In 2020, we see similar crowding behavior, some of which is related to the effects of the virus. As longer-term investors, we mainly just observe the day-to-day conduct of stock prices, but with the moves being so significant, we cannot simply ignore it. Very simplistically, developments toward a return to normalcy, represented by vaccine news, seems to help a wider array of companies, and we see our portfolio perform relatively well. When conditions around the virus worsen, it funnels investors into a narrow set of stocks with less sensitivity to social distancing effects. This has created a strange, upside-down attitude toward risk, with the most expensive companies mega-cap growth stocks being viewed as safe due to lower exposure to distancing. Since the market rises as crowding into the largest stocks intensifies, it creates the erroneous impression that the virus doesn't matter. We built the chart below, which graphs the performance of the largest Nasdaq 100 companies and the S&P 500 against the number of new US infection cases.

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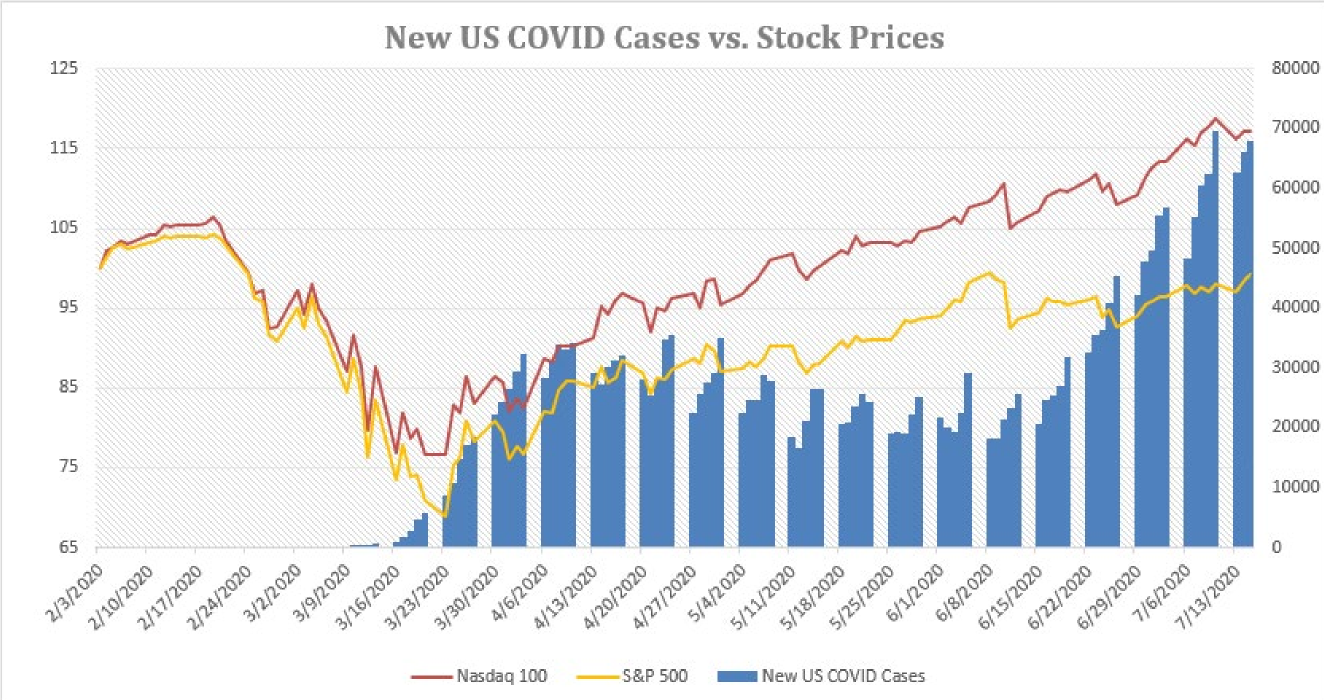
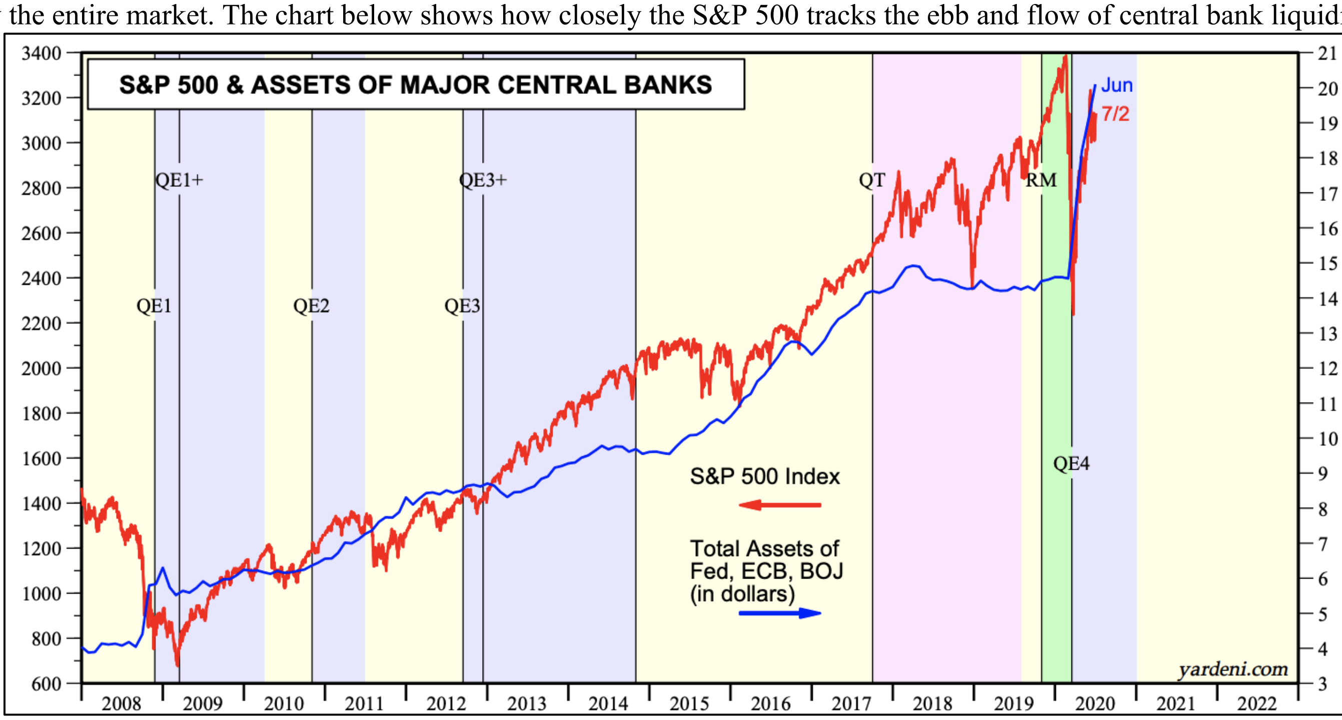
[5] Free Cash Flow is the cash available to be distributed to shareholders after paying all non-discretionary obligations and capital expenditures.

[6] Akami Technologies -94%; CMGI -97%; eToys -99%; Priceline -99%; WebVan -97%; Yahoo -88%

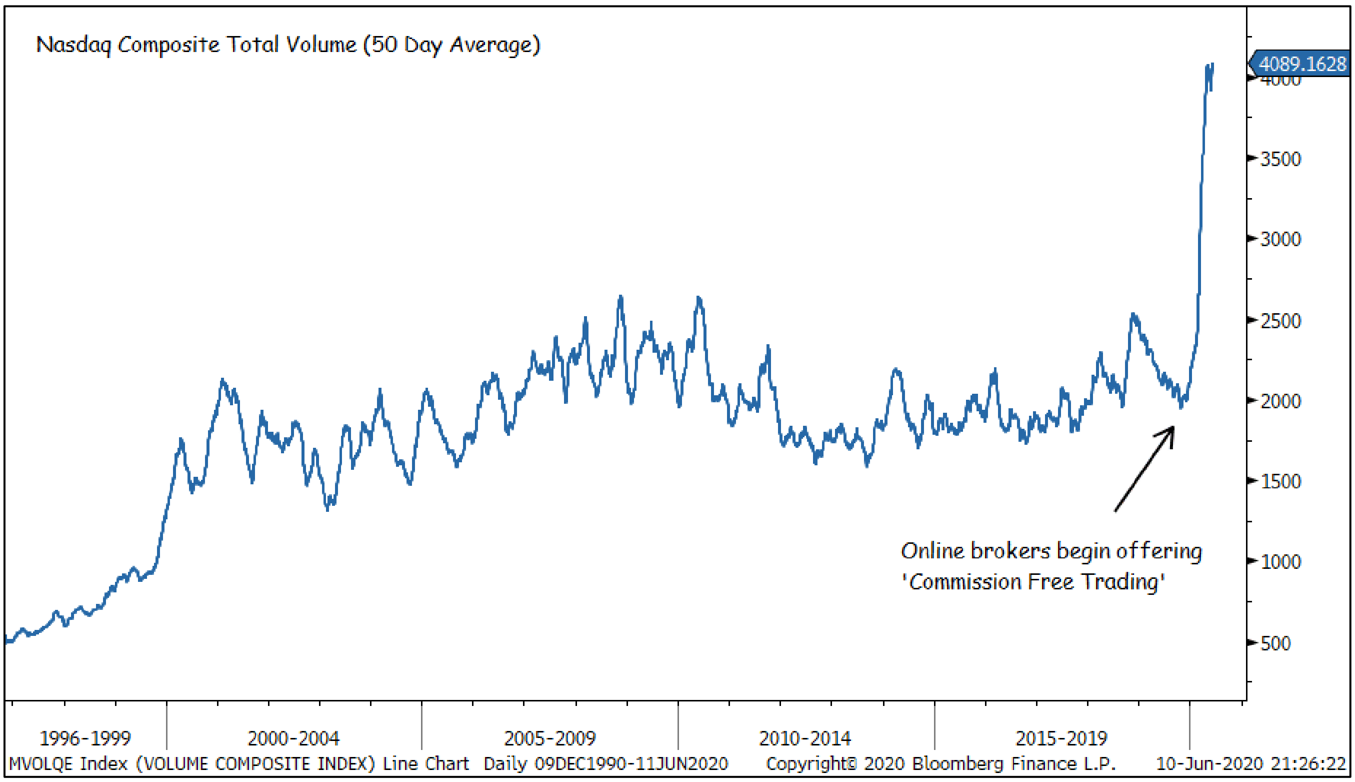


This embrace of risk in financial assets despite scant improvement in business conditions and a worsening virus situation can be attributed to the actions of the Federal Reserve. Don't fight the Fed has been a winning strategy throughout the post-Great Financial Crisis period. The Fed wants asset-inflation, and thus far, they have succeeded in conjuring it. Since March, credit investors have profited handsomely by front-running the Fed's first-ever foray into the corporate bond market. The Fed has quickly become a top holder of several credit ETFs. In March, bond markets were frozen as investors tried to sell bonds into a vacuum of mispricing. Two months later, yields are the lowest in history, and credit spreads are the tightest ever, despite record bankruptcies. It's understandable when the Fed Chair makes comments like, "*We're going to do whatever it takes*" and "*We're not thinking about raising rates, we're not even thinking about thinking about raising rates.*" In their most recent pronouncement in late June, the committee said they intend to leave Fed Funds at 0% until the end of 2022, a full two-and-a-half years from now. This is like ringing the dinner bell for a speculative feeding frenzy. We think the market is pricing in the expectation that any steep decline in stock prices will only mean that equities get added to the list of qualified Fed asset purchases. We live a world of managed markets, but we offer this warning, the Fed cannot buy the entire market. The chart below shows how closely the S&P 500 tracks the ebb and flow of central bank liquidity.



Signs of Speculation

One timeless signal of emerging speculation is rising trading volumes. Numerous empirical studies have shown that market-wide gains in stock prices lead to investor overconfidence, and with that courage comes increased trading speculation. When money is made easily with no effort, with investors getting successful outcomes without a proper process, we see overconfidence. When markets have been rising steadily for extended periods, overconfidence intensifies. Be mindful of the saying, "*Don't confuse brains with a bull market*." Market-cap-weighted indexes rise faster and more robustly than most of the stocks within the index. As it becomes more difficult to justify paying current prices, and retail investors increasingly enter the market, we witness a shift in focus. Instead of paying attention to the price being paid relative to value, the mob is focused on whether the market is apt to go higher soon. In such environments, thoughtful research and financial analysis are denigrated as individual stock selection methodologies struggle to match the returns generated by the market-cap-weighted indices.



Trading volumes give us an empirical signal, but much of what we rely on to evaluate speculation is anecdotal. We sense overconfidence in the mob when we start hearing criticisms of Value investing and its most famous prophet, Warren Buffett. We see comments from the newly emboldened that the old guard just doesn't get it. In 1999, after missing the Tech boom, Buffett was said to have lost his touch. In 2020, Dave Portnoy, founder of online gambling site, Barstoolsports.com, and poster-child of the Robinhood trading cohort, said that if Buffett worked for him, he'd fire him.

The stock market can be seductive to newly initiated investors. During the latter phases of bull markets, the rewards can be so far beyond the effort expended to get them that it can feel like picking the right Lotto numbers every day. In another similarity to the speculative environment in the late 1990s, we have the Robinhood phenomenon. We've not seen any TV ads by Robinhood yet, but listening to their founders pitch their product, we are reminded of the terrific ads targeting a new class of investor twenty years ago: the day trader. After the SEC did away with fixed commissions, there was a frenzy to attract these new, inexperienced speculators. The ads all catered to the Get-Rich-Quick mentality, with fanciful notions of owning your own island and commuting to work in your helicopter. But, perhaps the most entertaining was a series of ads by Ameritrade in 1999, staring a mailroom clerk named Stuart. Stuart was tech-savvy, so his help was elicited by the company's head honcho, Mr. P, to get into the online trading game. Stuart excitedly encourages his boss by saying, "Let's light this candle!" Mr. P admits to having no knowledge about the stock in question (Kmart), so Stuart advises him to "Research it." One click later, the five-second research process complete, Mr. P concludes that it's a good company and wants to buy it. [We have provided a link to the ad below for anyone feeling nostalgic].[7]

[7] https://www.youtube.com/watch?v=WOKDK0g1Gno

The Robinhood trading platform is a Silicon Valley, venture capital darling, that is growing at a frenetic pace. Its product makes it easy (and free) for its 13 million users to speculate in stocks and options. The company makes money by selling access to its clients' order flow. Said another way, sophisticated Wall Street veterans pay Robinhood a ton of money for the ability to take the other side of Robinhood clients' trades. This practice is not new, and retail brokers such as E-Trade and Schwab also do it. But access to Robinhood's clients is much more valuable to professional traders. Professionals pay up to 15-times more for Robinhood trades than for Schwab's. According to a recent NYT article, industry research firm, Alphacution, determined that Robinhood received $18,955 for each dollar in the average RH account, for the privilege of shooting against its clients. This compares to only $195 earned by Schwab. What makes RH so unique? Most importantly, it's a do-it-yourself platform, where users make the investment decisions themselves, like our friend Mr. P. The site does a good job attracting new players and convincing them to trade a great deal. Much like Ameritrade of the '90s, RH enables investors to easily become their own worst enemy. In a 2017 interview, founder Baiju Bhatt was quoted as saying, "*The best thing we can say to those people is 'Just do it*." The platform offers easy access to options trading, which can be highly speculative without proper knowledge. In fact, unsophisticated investors are barred from trading options, but that doesn't stop Robinhood. Customers who want to trade options answer just a few multiple-choice questions. Beginners who are initially blocked because they clicked that they have no investing experience are coached by the app on how to change the answer to "not much" experience. Then options trading can begin immediately.

Services like 'RobinTrack' have popped up to allow people to monitor what the Robinhooders are doing in real-time. Much like the professional traders betting against Robinhood players, we suspect that the interest in RobinTrack's data is not to find out what the smart money is doing. It remains uncertain how much influence this legion of retail investors has on the overall market. Robinhood's growth, coupled with the sharp rally in certain stocks, does point to rising speculative behavior.

Risks

What's priced in? To get close to justifying current valuations for the expensive large-cap tech group, investors are assuming earnings growth at extravagant levels. Current implied earnings growth for the largest 75 companies is 25% per year for the next five years. Historically, only the fastest-growing 15 companies out of this group can grow at that pace, and when companies get to a certain size, the highest growth rates become harder to achieve. Sometimes it seems that valuation doesn't matter or is irrelevant, but it always matters. In environments where the conventional wisdom is that stocks only go up, and no price is too high, remember that this speculative behavior depends on a greater fool coming along behind willing to pay a higher price.

Conclusion

Ask ten investors what they believe is the most important trait held by the best investors, and you may get ten different answers, but we think it is the capacity to maintain rational thought amid all market conditions. This means winning by first not losing. We will remain level-headed, even when it appears that others are doing it smarter; frequently, the truth is simply that others are taking greater risks. The pressure to keep up, and to follow the crowd can be powerful. By building in a margin of safety for each investment we make, we ensure that a thoughtful approach has been applied whenever we allocate capital. This doesn't mean we're always right, far from it. We make plenty of mistakes. We don't always get the best price, but we never lose our discipline. Having some humility and recognizing overconfidence is a key ingredient in avoiding the disasters that often accompany speculative ventures. Our investment process works, and it does so amid market conditions that can vary widely. We may not match the returns generated by more speculative activities, but we will grow our clients' assets in a sensible fashion, never seduced by the current market fad. Sometimes we see more opportunities available to us, but our philosophy is that there's always something to do in every market. For most of our clients, we have suitable dry powder to take advantage of the easier opportunities presented during large, lengthy market declines. In the absence of easy, we continue to work hard, looking for new ideas, and we will selectively add high-quality companies to the portfolio as we find them.

As of June 30, 2020, the following were the ten largest holdings of HCM:

Name of Issuer	% of Equity Portfolio	06/30/20 Closing Price
Apple Inc	5.60%	364.8
Intel Corp	5.40%	59.83
Berkshire Hathaway Cl B	5.28%	178.51
Microsoft Corp	5.16%	203.51
CVS Health Corp	4.84%	64.97
Markel Corp	4.36%	923.17
Merck & Co Inc	4.20%	77.33
Cable ONE	4.10%	1774.85
Carmax Inc	4.03%	89.55
Jacobs Engineering Group Inc	4.01%	84.8

For a complete list of holdings, please see our most recent 13F filing on the following SEC website:
http://www.sec.gov/edgar/searchedgar/companysearch.html

HCM's investment decision making process involves a number of different factors, not just those discussed in this document. The views expressed in this material are subject to ongoing evaluation and could change at any time.

Past performance is not indicative of future results, which may vary. The value of investments and the income derived from investments can go down as well as up. It shall not be assumed that recommendations made in the future will be profitable or will equal the performance of the securities mentioned here. While HCM seeks to design a portfolio which reflects appropriate risk and return features, portfolio characteristics may deviate from those of the benchmark.

Although HCM follows the same investment strategy for each advisory client with similar investment objectives and financial condition, differences in client holdings are dictated by variations in clients' investment guidelines and risk tolerances. HCM may continue to hold a certain security in one client account while selling it for another client account when client guidelines or risk tolerances mandate a sale for a particular client. In some cases, consistent with client objectives and risk, HCM may purchase a security for one client while selling it for another. Consistent with specific client objectives and risk tolerance, clients' trades may be executed at different times and at different prices. Each of these factors influence the overall performance of the investment strategies followed by the Firm.

Nothing herein should be construed as a solicitation or offer, or recommendation to buy or sell any security, or as an offer to provide advisory services in any jurisdiction in which such solicitation or offer would be unlawful under the securities laws of such jurisdiction. The material provided herein is for informational purposes only. Before engaging HCM, prospective clients are strongly urged to perform additional due diligence, to ask additional questions of HCM as they deem appropriate, and to discuss any prospective investment with their legal and tax advisers.

PLEASE SEE IMPORTANT DISCLOSURES BELOW:

As of June 30, 2020, Hutchinson Capital Management (HCM) held:
48,465 shares of Apple Computer Inc. (AAPL)
2,005 shares of Ford Motor (F)
220 shares of Charles Schwab (SCHW)
143 shares of Amazon.com, Inc. (AMZN)
0 shares of Akami Technologies, Inc. (AKAM)
0 shares of TD Ameritrade Holding Corporation (AMTD)
0 shares of Bershire Hathaway Inc. (BRK-A)
0 shares of Bayerische Motoren Werke AG (BMW3.DE)
0 shares of Daimler AG (DAI.DE)
0 shares of General Motors Company (GM)
0 shares of Sears Holdings Corporation (SHLDQ)
0 shares of Nikola Corporation (NKLA)
0 shares of Booking Holdings Inc. (BKNG)
0 shares of Shopify Inc. (SHOP)
0 shares of Tesla, Inc. (TSLA)
0 shares of Volkswagen AG (VOW3.DE)

As of June 30, 2020 (Prices in USD unless noted otherwise)
Apple Computer Inc. (AAPL) closed at $364.80
Ford Motor (F) closed at $6.08
Charles Schwab (SCHW) closed at $33.74
Amazon.com, Inc. (AMZN) closed at $2,758.82
Akami Technologies, Inc. (AKAM) closed at $107.09
TD Ameritrade Holding Corporation (AMTD) closed at $36.38
Bershire Hathaway Inc. (BRK-A) closed at $267,300.00
Bayerische Motoren Werke AG (BMW3.DE) closed at $43.18 (Currency in EUR)
Daimler AG (DAI.DE) closed at $36.15 (Currency in EUR)
General Motors Company (GM) closed at $25.30
Sears Holdings Corporation (SHLDQ) closed at $0.18
Nikola Corporation (NKLA) closed at $67.53
Booking Holdings Inc. (BKNG) closed at $1,592.34
Shopify Inc. (SHOP) closed at $949.20
Tesla, Inc. (TSLA) closed at $1,079.81
Volkswagen AG (VOW3.DE) closed at $134.94 (Currency in EUR)