January 2022

From yesterday's WSJ:

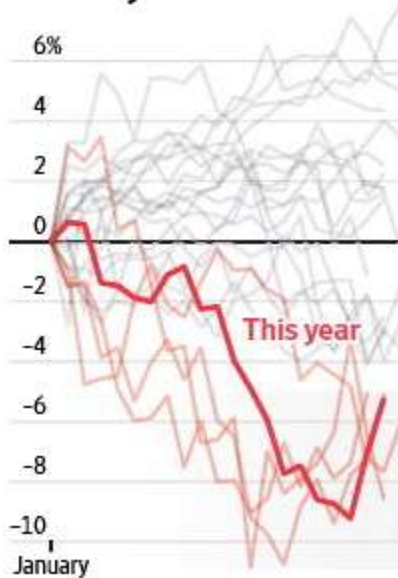
S&P Ends Worst Month in Years

BY KAREN LANGLEY AND CAITLIN OSTROFF

The S& P 500 rose Monday but closed out its worst month since March 2020 as expectations for higher interest rates erode enthusiasm for stocks.

The broad U.S. stock index retreated 5.3% in volatile trading in January, as investors wrestle with the question of how tighter monetary policy would influence equity valuations. High inflation and a strong labor market have led Federal Reserve officials to accelerate plans for unwinding support for the economy.

S&P 500 performance in January since 2000



S&P 500 performance following a January decline of 5% or more

Year	January	February	End of January to end of year
1939	−6.9%	+3.3%	+1.5%
1960	−7.2	+0.9	+4.5
1970	−7.7	+5.3	+8.2
1977	−5.0	−2.2	−6.8
1978	−6.1	−2.5	+7.7
1990	−6.9	+0.9	+0.3
2000	−5.1	−2.0	−5.3
2008	−6.1	−3.5	−34.5
2009	−8.6	−11.0	+35.0
2016	−5.1	−0.4	+15.4

Sources: FactSet (performance); Dow Jones Market Data (performance after January decline)

The central bank last week signaled that it would begin steadily raising rates in mid-March. Adding to investors' anxieties in recent weeks: the possibility of a Russian invasion of Ukraine and the surge of the Omicron variant of Covid-19.

The suite of concerns has led to declines across the stock market, with 10 of the S& P 500's 11 sectors retreating in the new year. Only energy stocks have bucked the downward trend. ...

The Fed's shift unsettles an important support for stocks. Investors credit the central bank's near-zero short-term interest rates and program of bond buying with helping fuel the stock market's run from its lows of March 2020. Even after pulling back in recent weeks, the S& P 500 is trading at about double that month's closing low. ...

Technology stocks slumped in January as investors consider how rising interest rates could weigh on the group's pricey valuations, which are based in part on expectations for growth far into the future. ...

The Nasdaq Composite fell 9% in January, its largest one-month decline since March 2020. The Dow Jones Industrial Average fared better, losing 3.3% for the month. ...

Trading in January featured big days both up and down and sharp intraday reversals. ...

Analysts expect that profits from companies in the S& P 500 rose 24% in the fourth quarter from a year earlier, according to FactSet. About one-third of companies in the index have reported. ...

In bond markets, the yield on the benchmark 10-year U.S. Treasury note was little changed, edging up to 1.780% from 1.779% Friday. The monthly yield gain was the largest since March 2021. ...

Global oil benchmark Brent crude gained 17% for the month to $91.21 a barrel, its highest settlement value since October 2014. ...

The price of gold slipped in January, losing 1.8% to $1,795 a troy ounce.

Bitcoin fell 17% in January to $38,443.54 as of 5 p.m. in New York. ...

Morningstar's take from yesterday:

~~7~~ 6 Charts on the Stock Market's Wild January

Volatility leads stocks to their worst start since 2009

Tom Lauricella, **Lauren Solberg**
Jan 31, 2022

From start to finish, January was one wild month for the stock market.

Equities went from hitting record highs at the start of January to falling into "correction" territory of double-digit losses, only to roar back with strong gains on the final day of trading.

When the dust settled Monday:

• The U.S. Market Index lost 7.9% in January, the worst start to a year since 2009

• During January, there were 10 days where the U.S. market rose or fell 1% or more and five days where it moved 2% or more

• Value stocks outperformed growth by 15 percentage points, the widest gap since February 2001

• Large growth stocks lost 12.9% and mid-cap growth stocks dropped 14.6%

• Technology stocks slid 10%, the worst month of declines since November 2008

• Consumer cyclical stocks fell 12.4%, the sector's worst monthly performance since October 2001

• For tech stocks it was the worst January since 2008

These wild swings in the market came against a backdrop of a significantly shifting landscape for Federal Reserve policy and interest rates. With inflation surging in late 2021, investors had to recalibrate their expectations for the Fed. Rates are now expected to rise higher and faster this year.

With stocks starting off the year at relatively lofty valuations, the market was vulnerable to the kinds of declines seen over the course of the month. That was especially true of many technology and consumer cyclical names that had led the market higher in 2021. ...

After a strong 2021 , where stocks were bolstered by surging corporate profits and a strong economic recovery from the pandemic recession, the U.S. Market index hit a new high within days of starting the year. However, things quickly turned south.

With that decline came a noticeable spike in volatility and a white-knuckle ride for investors. To some degree measuring the market's swings by the close of trading each day didn't do it justice. For example, on Monday, Jan. 24, stocks collapsed by some 4% in the morning only to finish the session little changed.

Two of the biggest trends in January were the rolling over of technology and consumer cyclical stocks, and the collapse of growth names in general.

Within the Morningstar Style Box, the performance gap among stocks was stark and driven by where they landed on the value vs. growth style spectrum. That contrasted with 2021 performance where the market value of a stock had a greater link to performance than whether it was undervalued (Value stocks are not necessarily "undervalued". It depends on their current valuation relative to their future growth, which is why PEG is our preferred valuation metric.) or a fast-grower.

U.S. Market Barometer

January 2022

	Value	Blend	Growth
Large	0.46	-6.11	-12.91
Mid	0.11	-5.99	-14.61
Small	-1.94	-7.73	-14.37

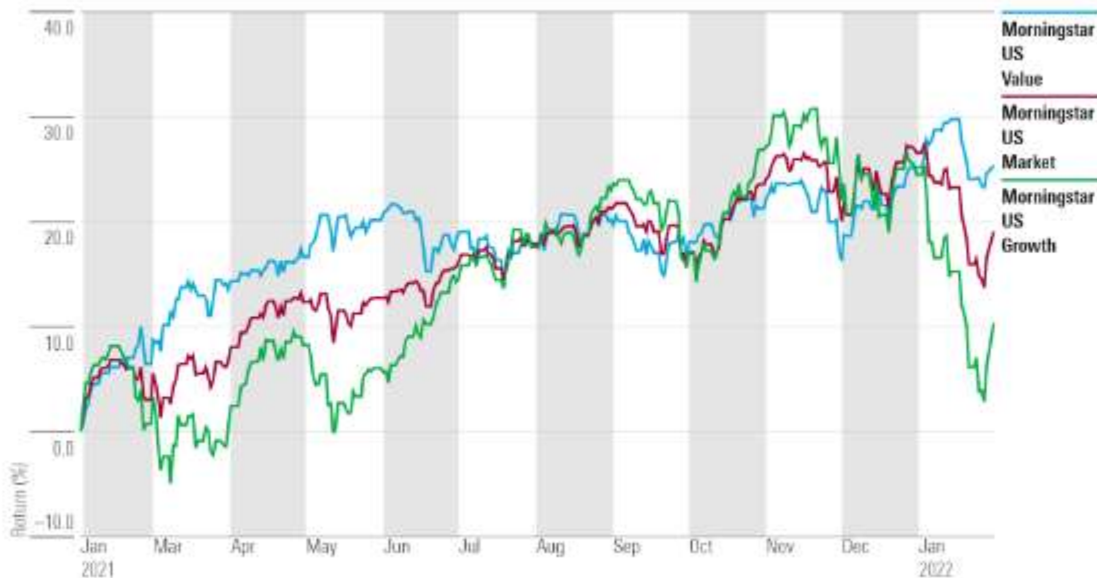
2021

	Value	Blend	Growth
Large	21.49	29.32	21.47
Mid	29.02	27.81	14.97
Small	31.79	21.17	-1.00

Source: Morningstar Indexes. Data as of January 31, 2022

For growth stocks, January's steep declines reversed a substantial portion of 2021's gains.

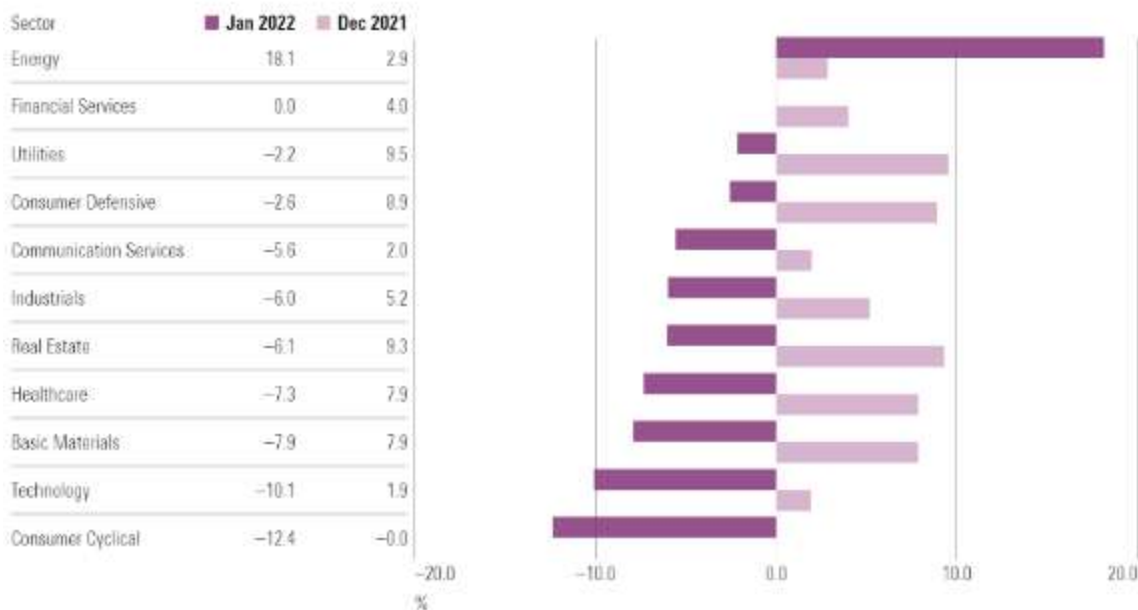
Growth vs Value



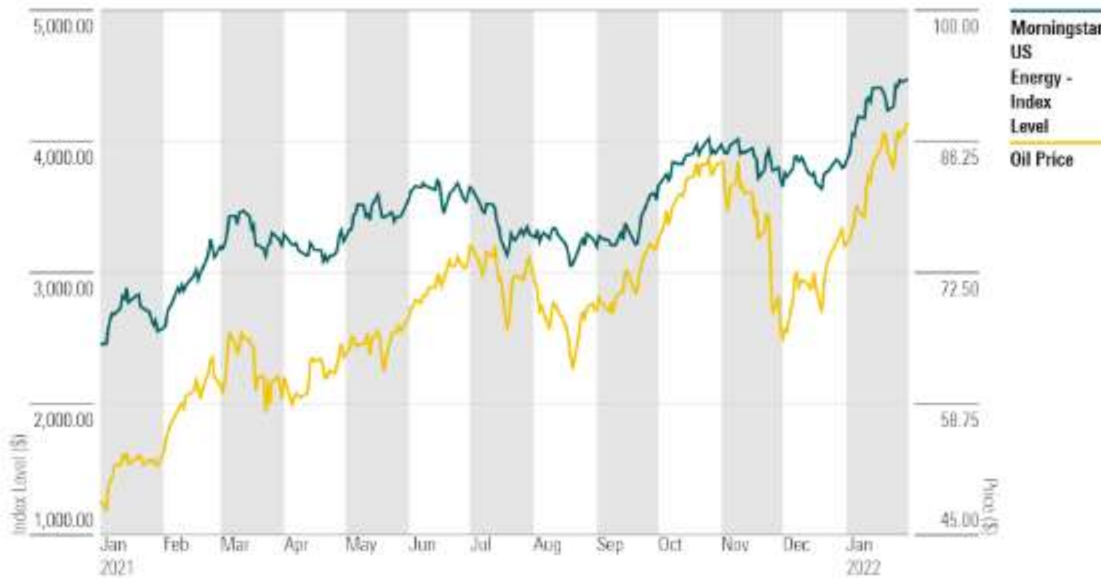
Source: Morningstar Direct. Data as of January 31, 2022.

But over longer time frames, growth and blend stocks still generally hold a substantial advantage over value. That's in part due to value's woes in 2020 when growth outperformed value by record margins. Large- and mid-cap growth stocks in particular remain far ahead compared to value stocks and smaller companies.

The other big trend in January was the collapse of technology and consumer cyclical stocks. These sectors had been major drivers of the market's 2021 rally and many of these stocks were trading at lofty valuations. The tech sector's declines have come as investors adjusted to an outlook of higher interest rates and moderating economic growth for this year.

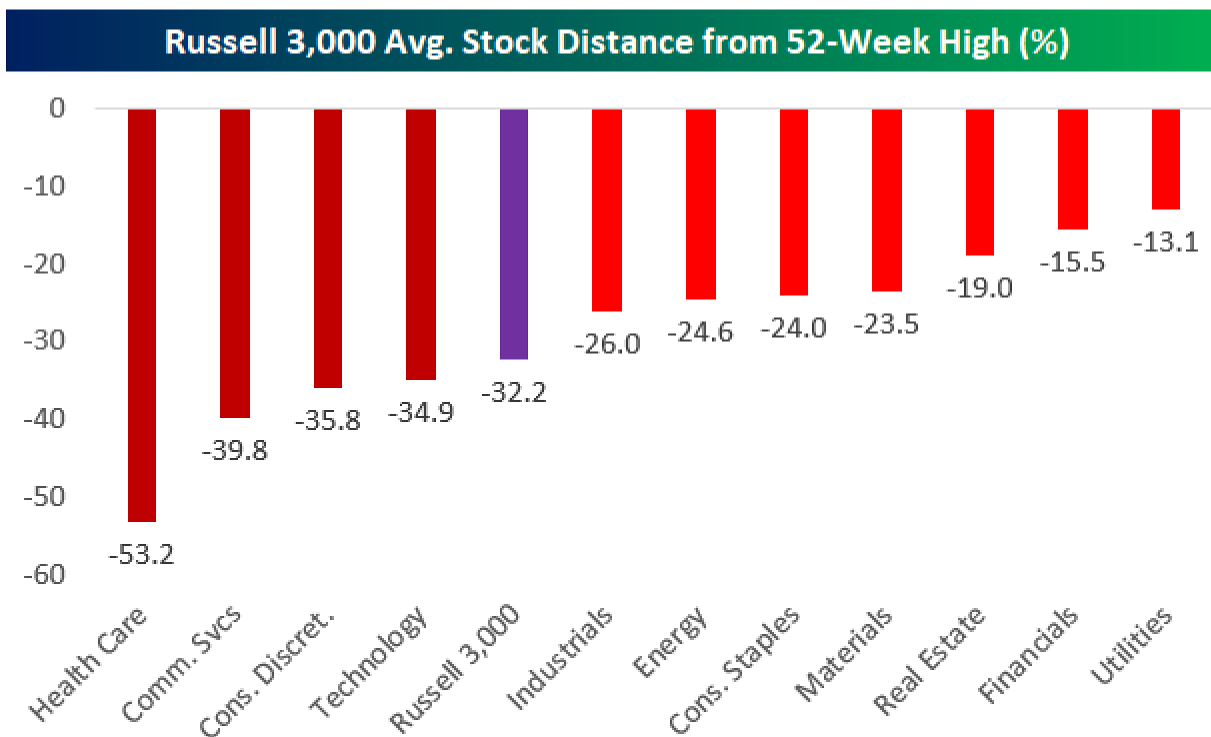


Energy stocks have seen a significant reversal of fortune, rallying strongly in 2021 and again to start off 2022 on the back of rising oil prices. (Our clients whose primary focus is Capital Appreciation, and whose portfolios include individual stocks are overweight Energy stocks.)



Indexes can mask the carnage within. From Bespoke on Jan. 26th:

... how far the average stock in the US is down from its 52-week highs right now. Across the entire Russell 3,000, the average stock has basically seen a third of its value chopped off from 52-week highs, while the average Health Care stock has been more than cut in half!



From Friday's Global Investment Strategy:

A Correction Not A Bear Market

FAQ On Recent Market Action

The selloff in stocks since the start of the year has garnered a lot of attention. In this week's report, we address some of the key questions clients are asking.

Q: What do you see as the main reasons for the equity selloff?

A: At the start of the year, the S&P 500 had gone 61 straight weeks without experiencing a 6% drawdown, the third longest stretch over the past two decades. Stocks were ripe for a pullback. The backup in bond yields provided a catalyst for the sellers to come out.

Not surprisingly, growth stocks fell hardest, as they are most vulnerable to changes in the long-term discount rate. At last count, the S&P 500 Growth index was down 13.7% YTD, compared to 4.1% for the Value index.

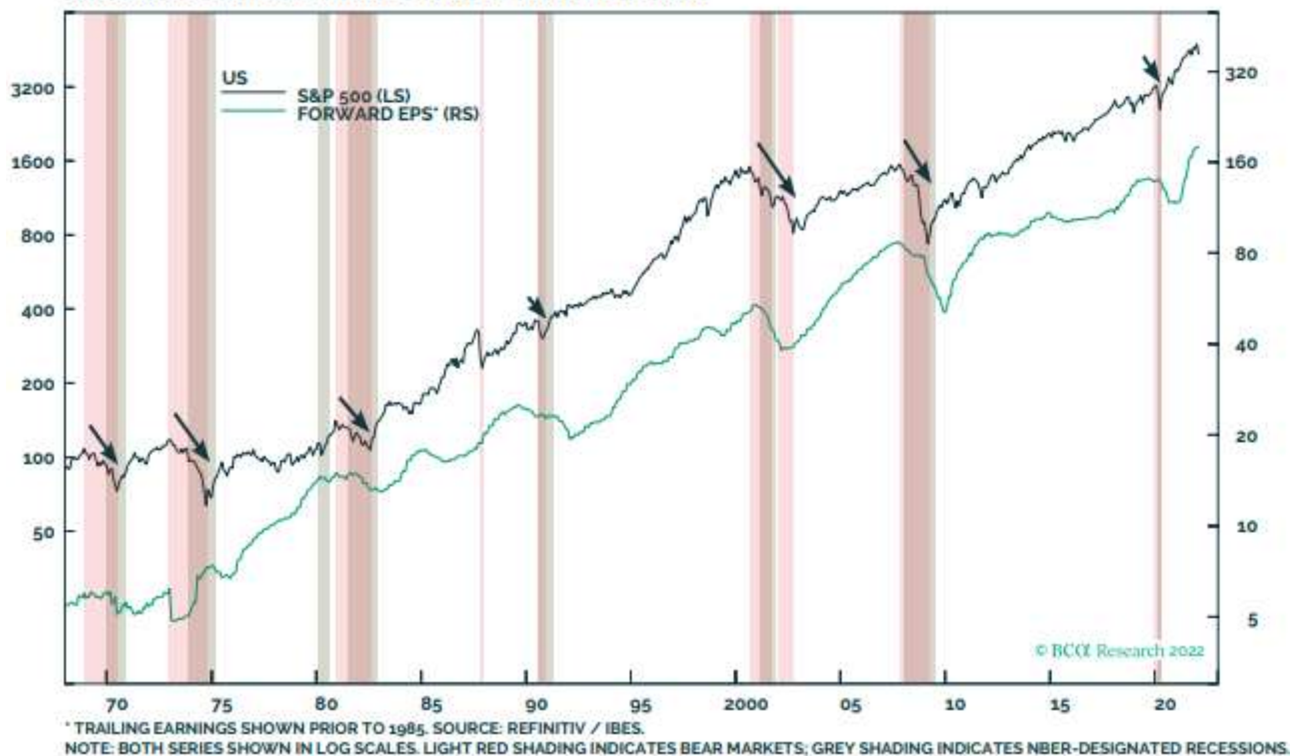
Our research has found that stocks often suffer a period of indigestion when bond yields rise suddenly, but usually bounce back as long as yields do not move into economically restrictive territory (**Table 1**). BCA's bond strategists expect the 10-year yield to rise to 2%-to-2.25% by the end of the year, which is well below the level that could trigger a recession.

TABLE 1
As Long As Bond Yields Don't Rise Into Restrictive Territory, Stocks Should Recover

		US 10-Year Treasury Yield (%)			S&P 500		
TROUGH	PEAK	At Trough	At Peak	Change (ppt)	At Trough	At Peak	Change
Oct 15, 1993	Nov 07, 1994	5.19	8.05	2.86	470	463	-1.4%
Jan 18, 1996	Jul 05, 1996	5.53	7.06	1.53	608	657	8.1%
Oct 05, 1998	Jan 20, 2000	4.16	6.79	2.63	989	1446	46.2%
Jun 13, 2003	Jun 12, 2007	3.13	5.26	2.13	989	1493	51.0%
Dec 18, 2008	Apr 05, 2010	2.08	4.01	1.93	885	1187	34.1%
Jul 25, 2012	Dec 31, 2013	1.43	3.04	1.61	1338	1848	38.2%
Jul 05, 2016	Nov 08, 2018	1.37	3.24	1.87	2089	2807	34.4%
Aug 04, 2020	Mar 19, 2021	0.52	1.74	1.22	3307	3913	18.3%

Historically, equity bear markets have coincided with recessions (**Chart 1**). Corrections can occur outside of recessionary periods, but for stocks to go down and stay down, corporate earnings need to fall. That almost never happens unless there is a major economic downturn (Chart 2). In fact, the only time in the last 50 years the US stock market fell by more than 20% outside of a recessionary environment was in October 1987.

CHART 1
Recessions And Bear Markets Tend To Go Hand In Hand



* TRAILING EARNINGS SHOWN PRIOR TO 1985. SOURCE: REFINITIV / IBES.
NOTE: BOTH SERIES SHOWN IN LOG SCALES. LIGHT RED SHADING INDICATES BEAR MARKETS; GREY SHADING INDICATES NBER-DESIGNATED RECESSIONS.

It is impossible to know when this correction will end. ... With global growth likely to remain solid, equity prices should rise.

Q: What gives you confidence that growth will hold up?

A: Households are sitting on a lot of excess savings – $2.3 trillion in the US and a similar amount abroad. That is a lot of dry powder. Banks are also actively looking to expand credit, as the recent easing in lending standards demonstrates. Leading indicators of capital spending are at buoyant levels.

It is striking how well the global economy has handled the Omicron wave. While service PMIs have come down, manufacturing PMIs have remained firm. In fact, the euro area manufacturing PMI reached 59 in January versus expectations of 57.5. It was the strongest manufacturing print for the region since August. The manufacturing PMI also ticked up slightly in Japan. The China Caixin/Markit PMI and the official PMI published by the National Bureau of Statistics also ticked higher. After dipping below zero last August, the Citi global economic surprise index has swung back into positive territory.

Markets are also not pricing in much of a growth slowdown. Growth-sensitive industrial stocks have outperformed the overall index by 1.1% in the US so far this year. EM equities have outperformed the global benchmark by 5.9%. The Bloomberg Commodity Spot index has risen 7.2%. Credit spreads have barely increased.

Q: What is your early read on the earnings season?

A: Nothing spectacular, but certainly not bad enough to justify the steep drop in equity prices. According to Refinitiv, of the 145 S&P 500 companies that have reported Q4 earnings, 79% have beat analyst expectations while 19% reported earnings below expectations. Usually, 66% of companies report earnings above analyst

estimates, while 20% miss expectations. In aggregate, the reported earnings are coming in 3.2% above estimates, slightly lower than the historic average of 4.1%.

Guidance has been lackluster. However, outside of a few tech names like Netflix, earnings disappointments have generally been driven by higher-than-expected expenses, rather than weaker sales. Overall EPS estimates for 2022 have climbed 0.4% in the US and by 1.1% in foreign markets since the start of the year.

Q: To the extent that the Fed is trying to engineer tighter financial conditions, doesn't this imply that stocks must continue falling?

A: That would be true if the Fed really did want to tighten financial conditions, either via lower stock prices, a stronger dollar, higher bond yields, or wider credit spreads. However, we do not think that this is what the Fed wants. Despite all the chatter about inflation, the 5-year/5-year forward TIPS breakeven inflation rate has fallen to 2.05%, which is 25 basis points below the bottom end of the Fed's comfort zone (**Chart 9**).[1]

1 The Federal Reserve targets an average inflation rate of 2% for the personal consumption expenditures (PCE) index. The TIPS breakeven is based on the CPI index. Due to compositional differences between the two indices, CPI inflation has historically averaged 30-to-50 basis points higher than PCE inflation. This is why the Fed effectively targets a CPI inflation rate of about 2.3%-to-2.5%.

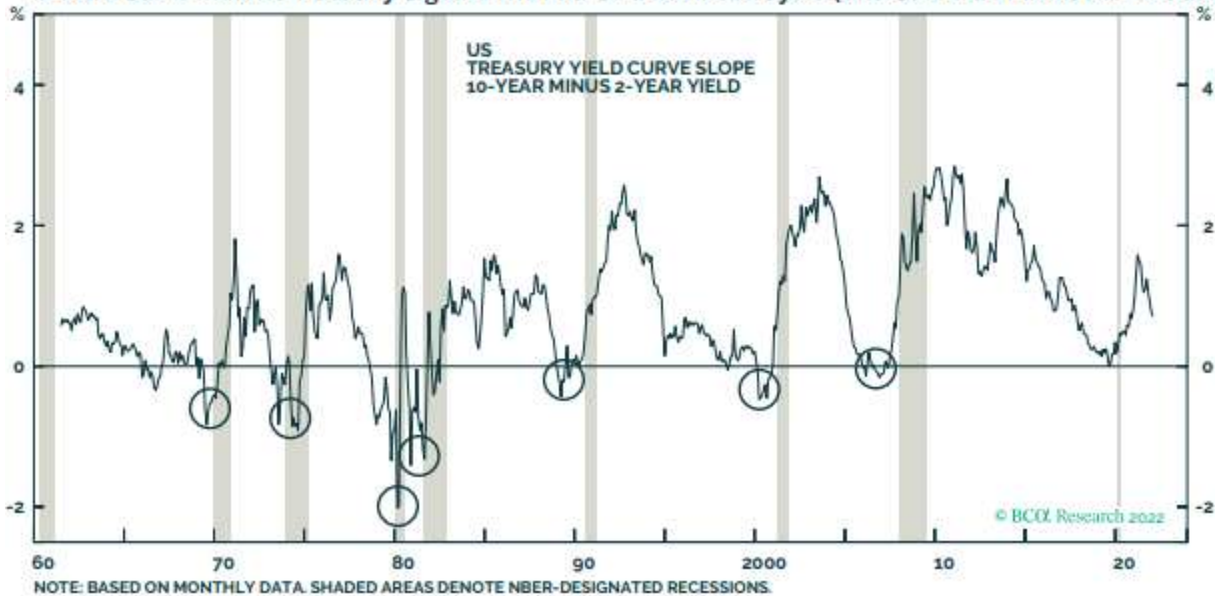
... The Fed thinks it will only be able to raise rates to 2.5% during this tightening cycle, which would barely bring real rates into positive territory. The market does not think the Fed will be able to raise rates to even 2%. The last thing the Fed wants to do is inadvertently invert the yield curve. In the past, an inverted yield curve has reliably predicted a recession (**Chart 12**).

The Fed is about to start raising rates and shrinking its balance sheet not because it wants to slow growth, but because it wants to maintain its credibility. While the Fed will never admit it, it is very much attuned to the direction in which the political winds are blowing. The rise in inflation, and the Fed's failure to predict it, has been embarrassing for the FOMC. Doing nothing is no longer an option. However, doing "something" does not necessarily imply having to raise rates more than the market is already discounting.

Contrary to the consensus view that the Fed has turned hawkish, we think that the main takeaway from this week's FOMC meeting is that Jay Powell, aka Nimble Jay, wants more flexibility in how the Fed conducts monetary policy. This makes perfect sense, as layer upon layer of forward guidance merely served to confuse market participants while unnecessarily tying the Fed's hands.

Q: How confident are you that inflation will fall without a meaningful tightening in financial conditions?

A: If we are talking about a horizon of 2-to-3 years, not very confident. As we discussed two weeks ago in a report entitled The New Neutral, the interest rate consistent with stable inflation and full employment is



substantially higher than either the Fed believes or the market is pricing in. This means that the Fed is likely to keep rates too low for too long. However, if we are talking about a 12-month horizon, there is a high probability that inflation will fall dramatically, even if monetary policy stays very accommodative.

Today's inflation is largely driven by rising durable goods prices. Durables are the one category of the CPI basket where prices usually fall over time, so this is not a sustainable source of inflation (**Chart 13**). As demand shifts back from goods to services and supply bottlenecks abate, durable goods inflation will wane.

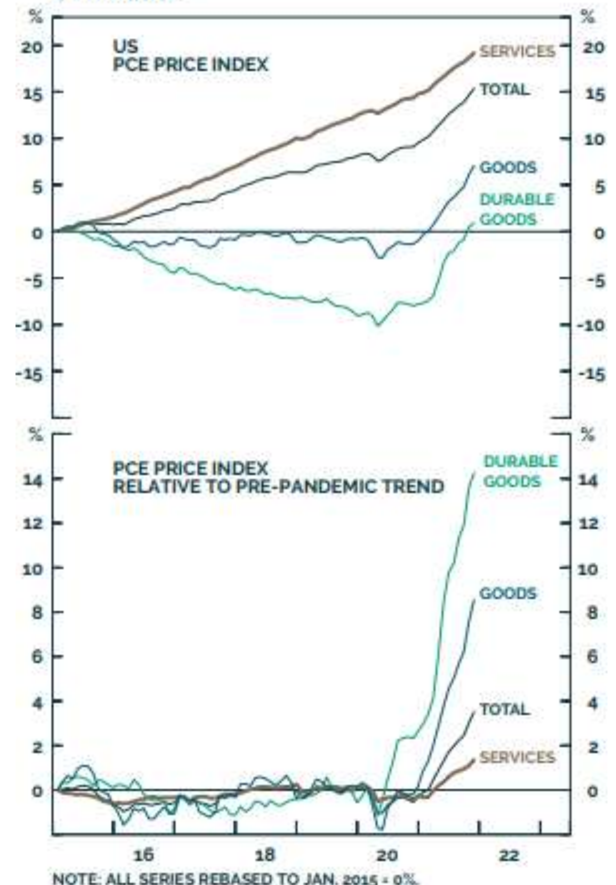
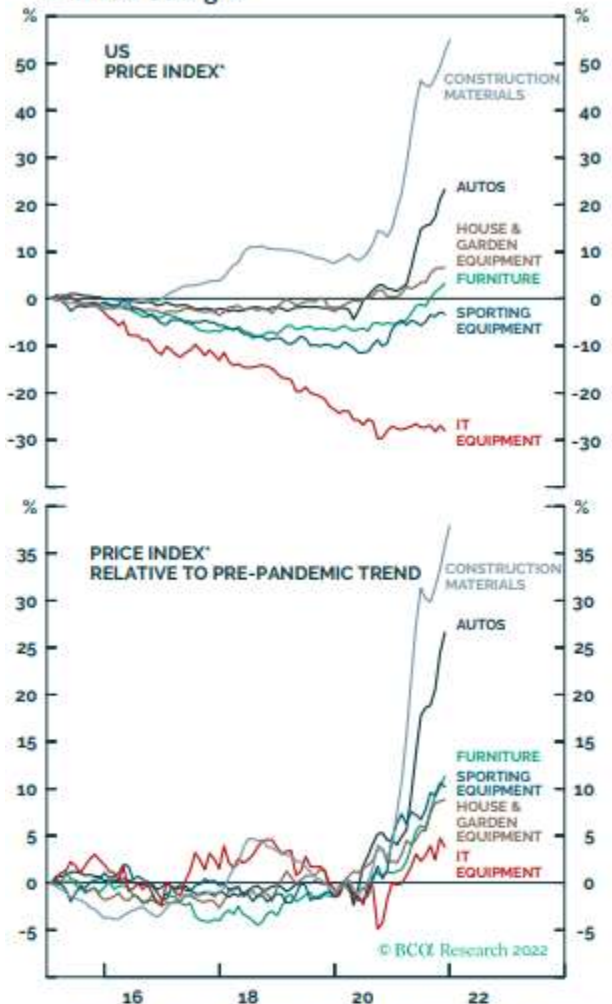
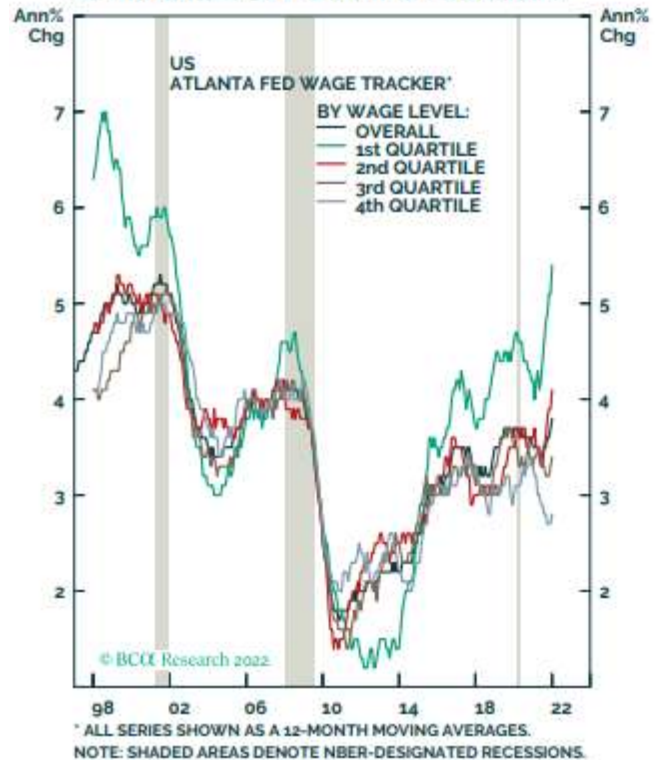
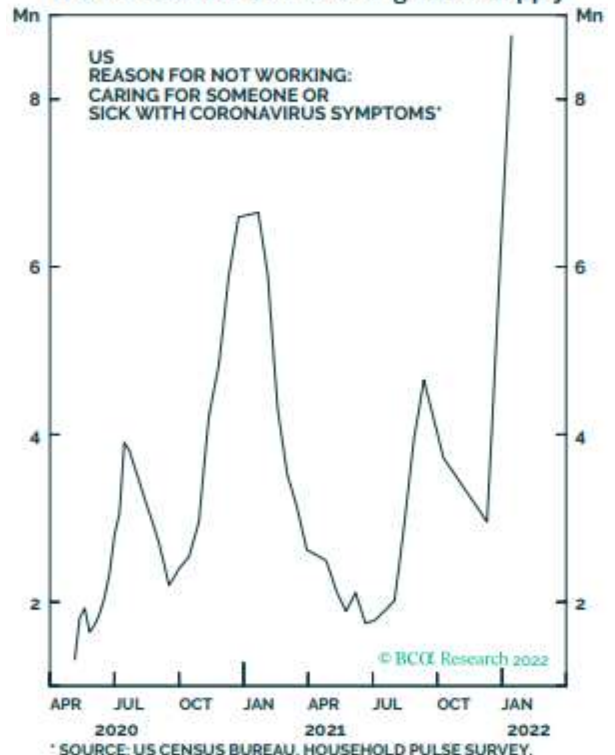


Chart 14 shows that the price indices for a number of prominent categories of goods – including new and used vehicles, furniture and furnishings, building supplies, and IT equipment – are well above their trendlines. Not only is inflation in these categories likely to fall, but it is apt to turn negative, as the absolute level of prices reverts back to trend. This will put significant downward pressure on inflation.

Granted, service inflation will accelerate this year as the labor market continues to tighten. However, rising service inflation is unlikely to offset falling goods inflation. While wage growth has accelerated, wage pressures have been concentrated at the bottom end of the wage distribution (**Chart 15**). According to the Census Household Pulse Survey, a record 8.75 million workers – many of them in relatively low-paid service jobs – were not working in the second week of January due to pandemic-related reasons (**Chart 16**). As the Omicron wave fades, most of these workers will re-enter the labor force. This should help boost labor participation among low-wage workers,







which has recovered much less than for higher paid workers.

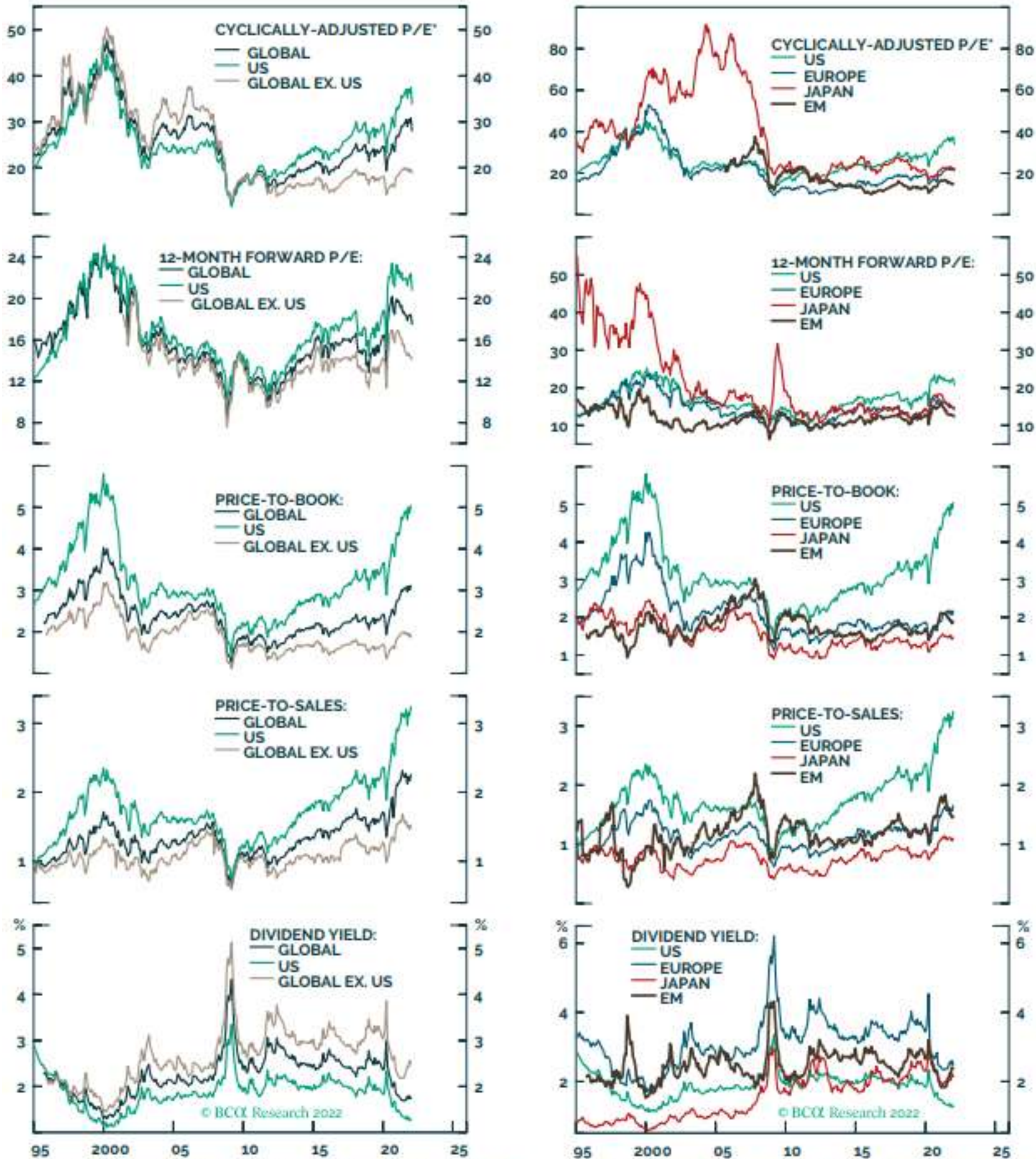
Q: Tensions between Ukraine and Russia have risen to a fever pitch. Could this destabilize global markets?

A: In a note published earlier today, Matt Gertken, BCA's Chief Geopolitical Strategist, increased his odds that Russia will invade Ukraine from 50% to 75%. However, of that 75% war risk, he gives only 10% odds to Russia invading and conquering all of Ukraine. A much more likely scenario is one where Russia invades Donbas and perhaps a few other regions in Eastern or Southern Ukraine where there are large Russian-speaking populations and/or valuable coastal territory. While such a limited incursion would still invite sanctions from the West, Matt does not think that Russia will retaliate by cutting off oil and natural gas exports to Europe. Not only would such a retaliation deprive Russia of its main source of export earnings, but it could

lead to a hostile response from countries such as Germany which so far have pushed for a more measured approach than the US has championed.

Q: Valuations are still very stretched. Even if the conflict in Ukraine does not spiral out of control and the goldilocks macroeconomic scenario of above-trend global growth and falling inflation comes to pass, hasn't much of the good news already been discounted?

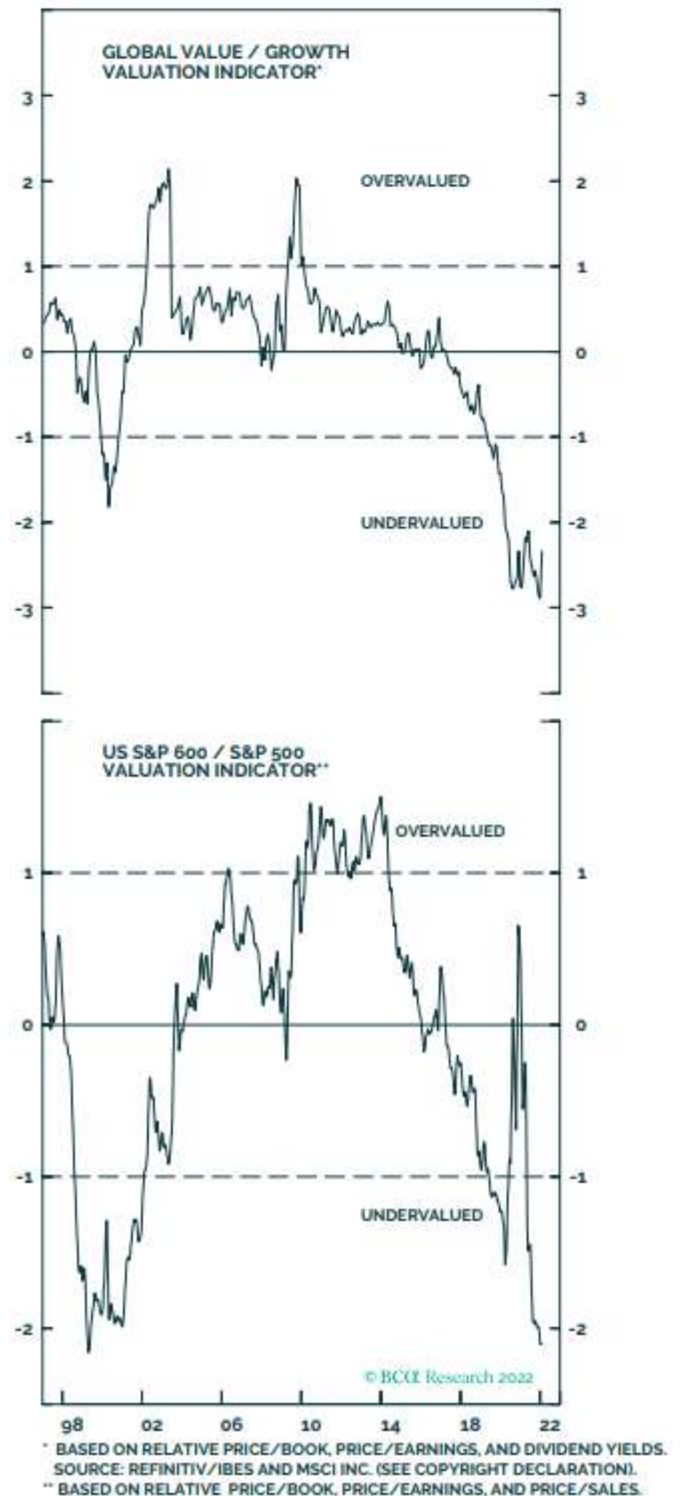
A: US stocks are quite pricey. Both the Shiller PE ratio and households' allocations to equities point to near-zero total returns for stocks over a 10-year horizon. That said, valuations are not a useful timing tool. The



business cycle, rather than valuations, tends to dictate the path of stocks over medium-term horizons of 6-to-12 months.

Moreover, stocks are not expensive everywhere. While US equities trade at 20.8- times forward earnings, non-US stocks trade at a more respectable 14.1-times. The valuation gap is even more extreme based on other measures such as normalized earnings, price-to-book, and price-to-sales (**Chart 20**).

In terms of equity styles, both small caps and value stocks trade at a substantial discount to large caps and growth stocks (**Chart 21**). We recommend that investors overweight these cheaper areas of the market in 2022.



From NYT:

These Were the Worst Predictions About 2021

Jan. 3, 2022

By Peter Coy

The cheap shot about economic forecasters is that God put them on Earth to make astrologers look good. One reason that's unfair is it's not just economists who get things wrong. As a way to say a not-so-fond farewell to 2021, I've compiled 10 of the worst predictions made about the year by overconfident people from many walks of life.

1. "With the vaccine, with mass testing and with the knowledge of how to prevent and treat this virus, I think the pandemic will end in 2021."

Former Prime Minister Leo Varadkar of Ireland said this in an interview on Dec. 9, 2020, daring to predict the course of a pandemic that has flummoxed the experts repeatedly. To his credit, he did qualify his prediction with "I think."

3. "The unemployment rate is set to remain at or above the peak level observed during the global financial crisis, reaching 7.7 percent by the end [of] 2021 without a second wave (and 8.9 percent in case of a second wave)."

This overly pessimistic forecast by the Organization for Economic Cooperation and Development, issued on July 7, 2020, applied to the jobless rate across the organization's 38 member countries. The organization's latest estimate for average unemployment in those nations as of the fourth quarter of 2021 is just 4.4 percent. And that's after several waves of the pandemic.

4. "It'll start getting cooler. You just — you just watch."

Donald Trump said that on Sept. 14, 2020, when, as president, he went to California to get a briefing on the state's wildfires. Narrowly speaking, this prediction may have been correct. According to the National Oceanic and Atmospheric Administration, the worldwide average land and ocean temperature through November this year is only the sixth highest in 142 years of record-keeping; 2020 was No. 2. Broadly speaking, though, for Trump to say the world will "start getting cooler" is quite a stretch.

5. "I wouldn't change the view that over the next year or two the dollar is going to steadily weaken."

Kim Juckes, a macroeconomic strategist for Société Générale in London, said that on Bloomberg TV on Nov. 9, 2020, when the Federal Reserve's broad, inflation-adjusted index of the dollar was at 106.1. This November it was at 109.3. That's steady strengthening, not steady weakening.

6. "We studied a range of potential risks under both normal and extreme conditions, and believe there is sufficient generation to adequately serve our customers."

Pete Warnken, the manager of resource adequacy for the Electric Reliability Council of Texas, said that in a statement released on Nov. 5, 2020. Three months later, power failures caused by Winter Storm Uri plunged millions of Texans into blackouts.

7. "I mean, this is a company trading at half-a-trillion-dollar market cap. It'll have revenue this year of $30 billion, and despite what everyone says they're still an automobile company."

The investor James Chanos said that about Tesla in an interview by Bloomberg TV that was broadcast on Dec. 3, 2020. His point seemed to be that the market value of Tesla was bound to fall because it was too high in comparison to its revenue. Since then, Tesla shares have gone from under $600 apiece to over $1,000, and the market cap is over $1 trillion. This past year Tesla sales rose an estimated 64 percent, while earnings per share jumped an estimated 169 percent. Chanos did get one thing right: Tesla is still (mostly) an automobile company.

10. "Such an argument would suggest that this move could potentially peak in December 2021, at the high of the channel, suggesting a move to as high as $318k."

That's what Tom Fitzpatrick, a Citibank analyst who predicts markets by analyzing historical price movements, wrote about Bitcoin in a note to clients that someone posted on Twitter on Nov. 13, 2020. Actual price last month? About $50,000. True, Fitzpatrick said "could" and "potentially." But you can bet that he'd be bragging now if Bitcoin were trading around $300,000. (We continue to hold the opposite view.)

Wait, I have one more:

11. "The hawks may still turn out to be right, but for now, the preponderance of evidence is that today's high inflation is anomalous and transitory."

Who wrote that howler? I did, on June 2, 2021, in one of my last articles for Bloomberg Businessweek before I came to The Times. Then again, if James Altucher can argue that "forever" can be a very short time, maybe I can argue that by "transitory" I meant a very long time ….

Follow-ups

As a follow-up to our most recent Worth Sharing "Moving from Growth to Value?", this from January 26th's WSJ:

Russell 2000 Sags as Profitless Firms Fade

BY KAREN LANGLEY

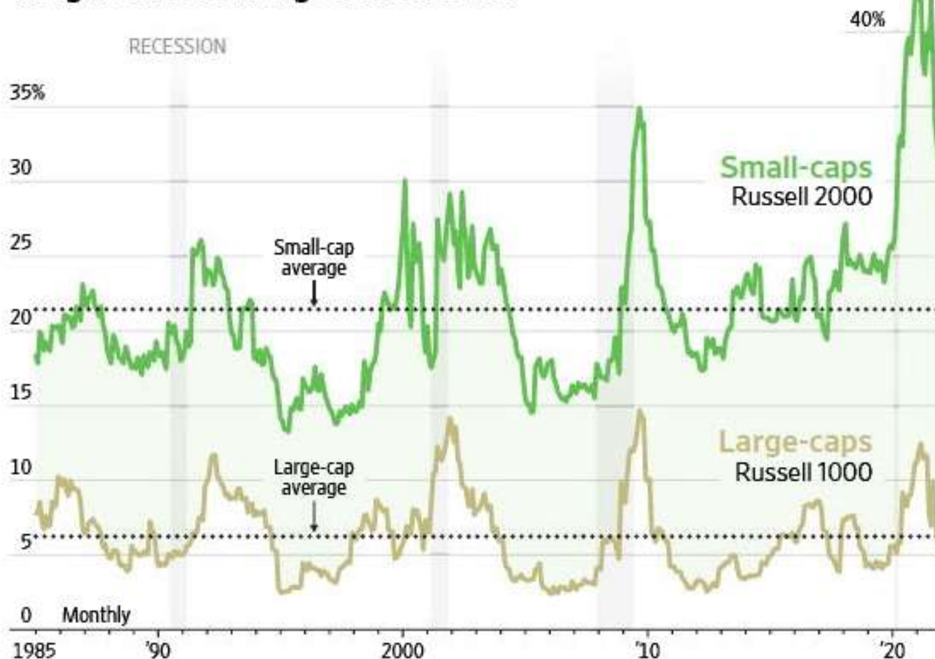
The prospect of rising interest rates has been especially hard on the Russell 2000 small-cap index, in large part because of the high proportion of small-caps that aren't making money.

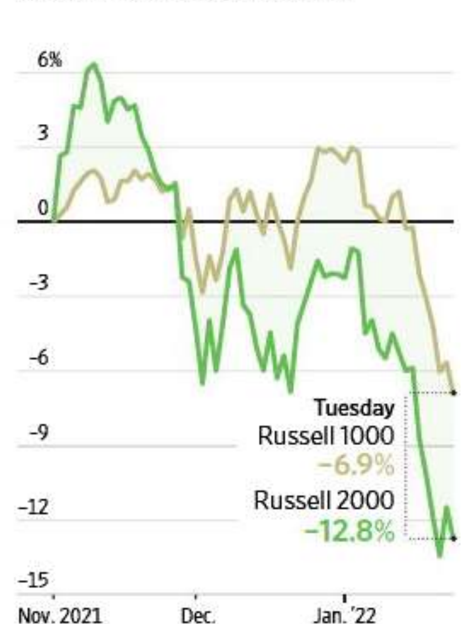
During the market selloff of recent weeks, investors have been shedding speculative investments from tech stocks to cryptocurrencies.

Speculative investments with their promise of higher returns thrived in the ultra-low rate environment of 2021. Now that the Federal Reserve ~~may~~ will raise interest rates as soon as March to combat inflation, investors are less comfortable with risk.

The companies in small-cap index funds tend to have less-diversified business lines and more of a chance of not turning a profit.

Companies making up 31% of the Russell 2000 were unprofitable as of the end of 2021, according to an analysis from Jefferies of earnings over the previous 12 months. By contrast, 5.7% of the Russell 1000 index of larger firms was made up of companies without earnings.





That disparity has been apparent in the performances of the indexes in recent weeks. Even with a stronger start to the week than other major U.S. stock indexes, the Russell 2000 has dropped 18% since its record close in November. The Russell 1000, by contrast, is down 9.6% from its record, according to FactSet. ...

Shares of companies that promise high future growth have also lagged behind the broad stock market year to date. The Russell 1000 growth index, for example, is down 14% in 2022, while the Russell 1000 value index has dropped just 4%. Growth stocks are losing out to value stocks among the small-caps as well.

While we have repeatedly warned against IPOs in general, and Robinhood in particular, the combination has proven especially deadly to financial wellbeing. From https://www.readmargins.com/p/robinhood-and-ipo-access :

Robinhood and Democracy Promotion

Opening up the IPO club

Ranjan Roy
Jan 21

In March 2021, Robinhood announced they *(Note 1)* would be building a platform to give everyday investors access to IPOs. It really was the perfect 'democratizing finance' story. Until they pushed this, the IPO allocation process was the poster-child of clubby, insider-y, and banker-y. The stereotype was of investment bankers pulling out their Rolodexes (for the younger ones, this is a Rolodex) and calling up their golf buddy money managers to decide who got the juicy access to buy into an IPO that always pop on the open. It was so easy to conjure up images of backrooms with oak furniture and cigars.

When Robinhood announced the news, we were back in a world with endless headlines about IPOs shooting up after ringing the bell. It was the easiest of money. Why should the everyday investor be left out? So Robinhood came up with a system where companies would allocate some portion of the equity to be raised to Robinhood users. Those users would be able to reserve their own shares to be purchased at the IPO price. They wouldn't be left out of the inevitable gains.

In May 2021, the product officially launched. The hip medical scrubs company, FIGS, was the first to be offered. The company had genuinely good numbers (it was profitable - good piece from Sid Jha at the time) and everyone could now share in the wealth creation.

I started receiving emails in June announcing upcoming IPOs. The first one I received was for Outbrain. ... The second email was the really buzzy one - it was for the Robinhood IPO itself (how meta. Not Meta). The emails slowly trickled in over the following months. ... and the emails looked innocent enough ...

Every time one of these emails were sent out, it'd spark inevitable conversations *"are you buying into the XX IPO?" "I might pick up a few shares."* Because of course it did. Robinhood is explicitly avoiding any recommendation, but implicitly has curated this offering. And in some ways, it felt like Cathie Wood's genius in just

Outbrain Inc. (OB) is now on IPO Access

Hi Ranjan,

Outbrain Inc. (OB) plans to go public. You can now find OB in the IPO Access list and review the prospectus.

View list

You can also learn more about investing in IPOs and the allocation process on Robinhood Learn and in our Help Center.

– The Robinhood Team

publishing ARK's daily transactions. The act of informational communication is the recommendation and has the downstream effect of catalyzing conversation and purchase interest. It's even more acute in this situation because this is a one-sided conversation. You can only buy the IPO, and you've just introduced a vast new population of buyers.

And it worked….

And it worked and it was non-stop. Sweetgreen opened at nearly double it's IPO price. Allbirds surged 90% after the open. Nubank 'only' traded up 15% after it's 'blockbuster IPO'. I will note, Robinhood, itself, was a bit different. The shares traded slightly down on IPO day, and then shot up 100% on the 4th day of trading.

Overall, things appeared to be going according to plan. Finance, democratized.

But, of course, that's not how things have ended up. ...

I promise you, I'm not cherry-picking. I went through my inbox and every single stock chart that was being marketed through the IPO Access program looked like that. (Note: These are all the emails I got - I'm not sure if they had other IPOs where I didn't receive an email):

	Ticker	Current Price	52 week high	52 week low	% off high	% above low
Sono Group	SEV	6.81	47.5	6.5	-86%	4%
Robinhood	HOOD	13.69	85.0	13.7	-84%	0%
Riskified	RSKD	6.6	40.5	6.2	-84%	6%
Vaxxinity	VAXX	7.94	22.8	5.1	-65%	55%
Backblaze	BLZE	13.11	36.5	12.1	-64%	8%
Nerdwallet	NRDS	12.84	34.4	12.1	-63%	6%
Iris Energy	IREN	11.4	28.3	11.0	-60%	3%
Cue Health	HLTH	9.1	22.6	8.5	-60%	7%
Figs	FIGS	20.53	50.4	20.5	-59%	0%
Allbirds	BIRD	13.44	32.4	12.6	-59%	7%
Sweetgreen	SG	24.83	56.2	22.8	-56%	9%
Vita Coco	COCO	9.82	18.6	8.5	-47%	16%
Expensify	EXFY	27.05	51.1	25.8	-47%	5%
Argo Blockchain	ARBK	11.19	21.0	10.4	-47%	7%
Braze	BRZE	55.29	98.8	54.9	-44%	1%
Brilliant Earth	BRLT	12.02	20.4	10.6	-41%	13%
Nubank	NU	7.95	12.2	7.4	-35%	7%
Outbrain	OB	14.38	21.0	13.0	-31%	11%

I'm the first to recognize that there are endless momentum-y, meme-y stocks have collapsed (this is me in mid-December on CNBC saying the ‘era of the story stock is over'), but this is brutal. So many of these stocks are 60-80% off their high ....

It doesn't matter whether you're a Brazilian fintech, a fancy salad chain, a cloud backup company, a German solar company, a fantastic expense management SaaS (I love Expensify), something-something-blockchain, coconut water, a biotech claiming to cure chronic disease, a fraud detection company, an Australian energy company, a COVID-19 testing maker, a wallet for nerds, or whatever else. It didn't matter whether you IPO'ed in May or July or November. Other than the jewelry company BRLT Brilliant Earth ... every single company comes out incredibly strong or has a spike early on, and then it slowly dies. Sometimes, like SEV or SG or HLTH, it's brutal. Other times, like ARBK or NRDS, you see glimmers of hope and then goodbye. Seriously, take a look again.

Correlation or Causation

... When I was in trading, there was a running meme. Whenever someone inquired about a market move up, and no one had a clue what happened, someone would yell "more buyers than sellers!" I know a lot of stocks have lost a lot of value over the past few months, but the mechanics specific to Robinhood's IPO Access offering feel like it had to contribute to this exact scenario. It literally created....**more buyers than sellers**.

And then maybe people lost interest, or the company really wasn't great, or the valuation was stupid, it would collapse. Especially if it were predominantly retail investors, you could imagine the initial moves down would be amplified by investors who never cared too much for the company and moved on to the next thing. It's happened over and over, almost universally (Note 4). ...

Finance, democratized?

A lot of people have now lost a lot of money. I have no way of knowing what percentage of them were retail investors, but back in July 2020, when I wrote about Robinhood users being ‘the gravy', this is the kind of stuff I worried about. Even more, this feels exactly like the woo-woo Silicon Valley doublespeak of democratizing finance that has always grated on me. In that original Robinhood post, I had written:

I hadn't processed just how perfectly Robinhood has silicon valley-ified financial markets until I started writing this post. Robinhood is Facebook is Google is everything else. Just look at the story:

- Stanford (or insert other top-level school here) grads head out to disrupt a market that genuinely needs to be disrupted.
- The great disruption is things will become free. Everything is couched in the language of democratization. The Robinhood founders even push the origin story that the idea was born amidst the Occupy Wall Street protests.
- As with most "free" products, the real business model is based on engagement. The more time you transact and interact on the platform, the more money the platform makes.
- The product is built to trigger every possible dopamine receptor in a user's brain. In the early years, terms like gamified UX are considered a positive.

- The company grows to an incredible size and the founders and investors and lots of people working there get incredibly rich.
- We slowly start to see a litany of unintended consequences, but for the most part, it's too late and the cultural impact has already taken place.

....and we're at that stage about unintended consequences. It's yet another example of the language of democratization being deployed without any thought of how to build up the newly democratized world. It feels like Dick Cheney and Paul Wolfowitz's idea of the democracy they would bring to Iraq and Afghanistan. Access without a plan can be a bad thing.

... I recognize there is plenty about the traditional IPO process that could be improved. But this effort gave people a ticket to a process with specific mechanics that made it much more likely to result in a quick rush followed by intense pain. Sending an email to millions of users with no additional analysis or context is probably correct from a regulatory perspective (it's *not a recommendation)*, but it is a nudge to buy. This is another situation where the SEC should've looked a bit deeper at how things were done. ...

From January 19th's WSJ:

Investors Bail Out of Unprofitable Startups

BY DAVE SEBASTIAN AND HARDIKA SINGH

Moonshot stocks are coming back to Earth.

As the Federal Reserve moves closer to raising interest rates, investors are repricing their bets on one of the riskiest corners of the market: shares of companies that don't make money. Cash-burning technology firms, biotechnology companies without any approved drugs and startups that listed quickly via mergers with blank-check companies—some of which soared during the pandemic— have dropped sharply.

A Wall Street Journal data analysis shows that, as Fed officials' signals and continued high-inflation readouts made it clearer that rate increases were looming, shares of unprofitable companies in the Nasdaq Composite Index have skidded while their profitable counterparts have traded nearly flat. On average, loss-making companies in the analysis slid 28% from the market's close on Sept. 30 through Tuesday. Profitable companies in the index edged down 0.7% on average for the same time frame.

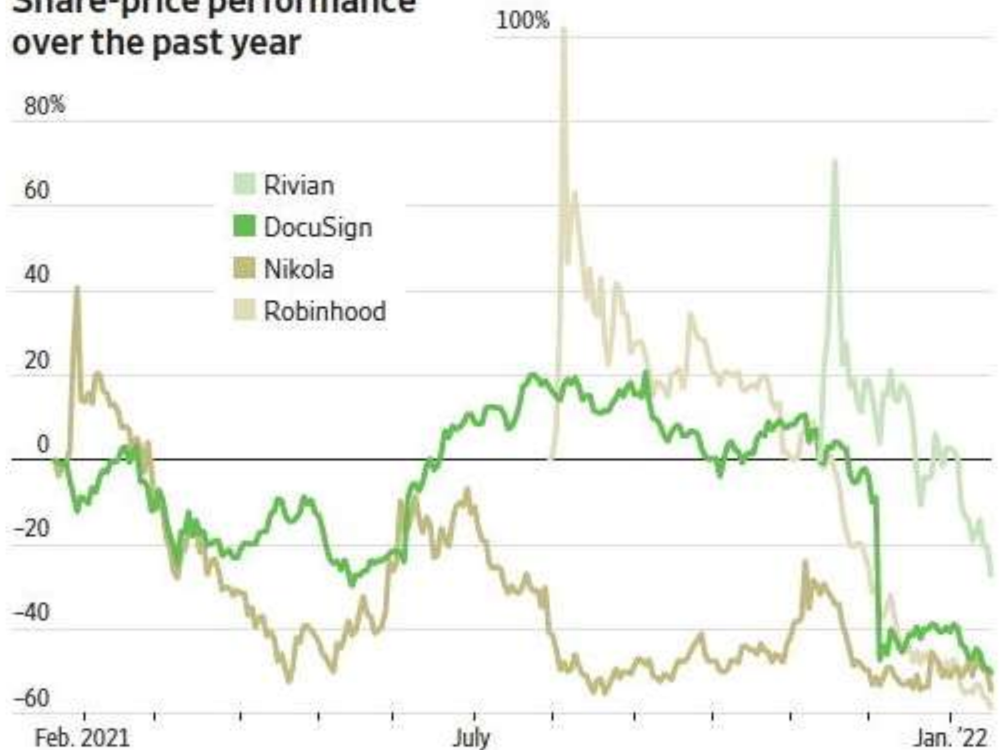
The Journal's analysis identified loss-making firms as having earnings per share below zero for at least the past four quarters combined. It excluded blank-check companies that haven't merged with a target and some companies for which FactSet didn't identify earnings-per-share figures for the most recent four quarters.

Fed officials have indicated they are speeding up their timetable for raising interest rates, potentially as soon as March, to combat burgeoning inflation. Many investors value stocks based on the present value of companies' future earnings. When interest rates rise, eating into that future value, it becomes less appealing to make high-price bets on companies that might not be profitable for years to come. ...

The performance of riskier growth stocks, which aim to deliver sharp profit growth in the future, also lagged behind broader indexes in the latter part of 2021. The Nasdaq CTA Internet Index, for example, has fallen 18%

from Sept. 30 through Tuesday. The Nasdaq Composite gained 0.4% for the same time frame, while the S& P 500 added 6.3%. ...

Some unprofitable companies' stocks had soared earlier in the pandemic, when their businesses got a boost from lockdowns and social-distancing measures. Shares of e-signature software maker **DocuSign**, which surged early in the pandemic as businesses adapted to remote and paperless environments, hit a closing high of $310.05 on Sept. 3 but have fallen 59% since then. DocuSign has posted a loss every quarter it has reported as a public company since its initial public offering in April 2018.



Note: Robinhood and Rivian started trading July 2021 and November 2021 respectively

Shares of electric-vehicle maker **Rivian Automotive**, which went public in November and posted revenue of $1 million and a loss of $1.23 billion for the third quarter, topped out at $172.01 in mid-November but have fallen 57% since.

Robinhood Markets, which became popular among individual investors during meme-stock mania, maintains a loyal fan base and its shares have been volatile since their debut. After its IPO in July, shares shot up to $70.39 in August, but they have dropped 80% since then.

The global race to vaccinate the world against Covid-19 sent shares of biotech companies rallying during the beginning of the pandemic. But in the biotech world, where clinical trials and regulatory decisions can make or break a company's value, firms can lose money for years while they wait for treatments to move through their pipelines. Many may never make money at all. The Nasdaq Biotechnology Index has fallen 17% since Sept. 30.

Easy monetary policy has partly fueled growth stocks' run, making it easier for companies to borrow cash at low rates. ...

Source: FactSet

The rout has also particularly pushed down companies making debuts in the public market through special-

purpose acquisition companies, also known as blank-check companies, which raise money with the purpose of seeking a target to merge with and take public. Though one of Wall Street's hottest trades during early 2021, SPACs have fallen from their highs.

Electric-truck startup **Nikola** Corp., which went public through a SPAC, declined 35% last year and has pulled back 13% since Sept. 30. The **Defiance Next Gen SPAC Derived ETF ,** which tracks companies that have gone public through SPACs along with SPACs that have yet to do deals, fell about 26% in 2021 overall and is down 17% since Sept. 30.

"For some of them, it could be poor fundamentals; some could be pre-revenue companies that just aren't profitable yet," Sylvia Jablonski, cofounder and chief investment officer of Defiance ETFs, said of the forces driving selloffs in shares of some growth companies. Some investors who drove up those companies' prices, such as retail traders, have also taken a pause in SPAC investing and shifted to other assets like cryptocurrencies (another "asset" to be avoided as we have repeatedly shared), Ms. Jablonski added.

Unprofitable traditional IPOs also delivered lower first-day returns in 2021, according to an analysis by Jay Ritter, a finance professor at the University of Florida. About three-quarters of the more than 300 operating companies tracked by Prof. Ritter that went public in the U.S. had earnings per share below zero, and they delivered an average first-day return of 30% in 2021, compared with 45.3% among a smaller pool of companies in 2020.

With valuations still frothy, the bar is high for unprofitable companies to deliver the results they promised, said Tim Murray, a capital-markets strategist in T. Rowe Price Group Inc.'s multiasset division. Investors are likely going to be more selective in investing in growth companies, profitable or not, in 2022 amid a more challenging economic environment, Mr. Murray added. ...

Eight from Morningstar:

The Stock Market's Dominoes Are Falling

The first one to fall was ARKK.

John Rekenthaler
Jan 27, 2022

The Speculators

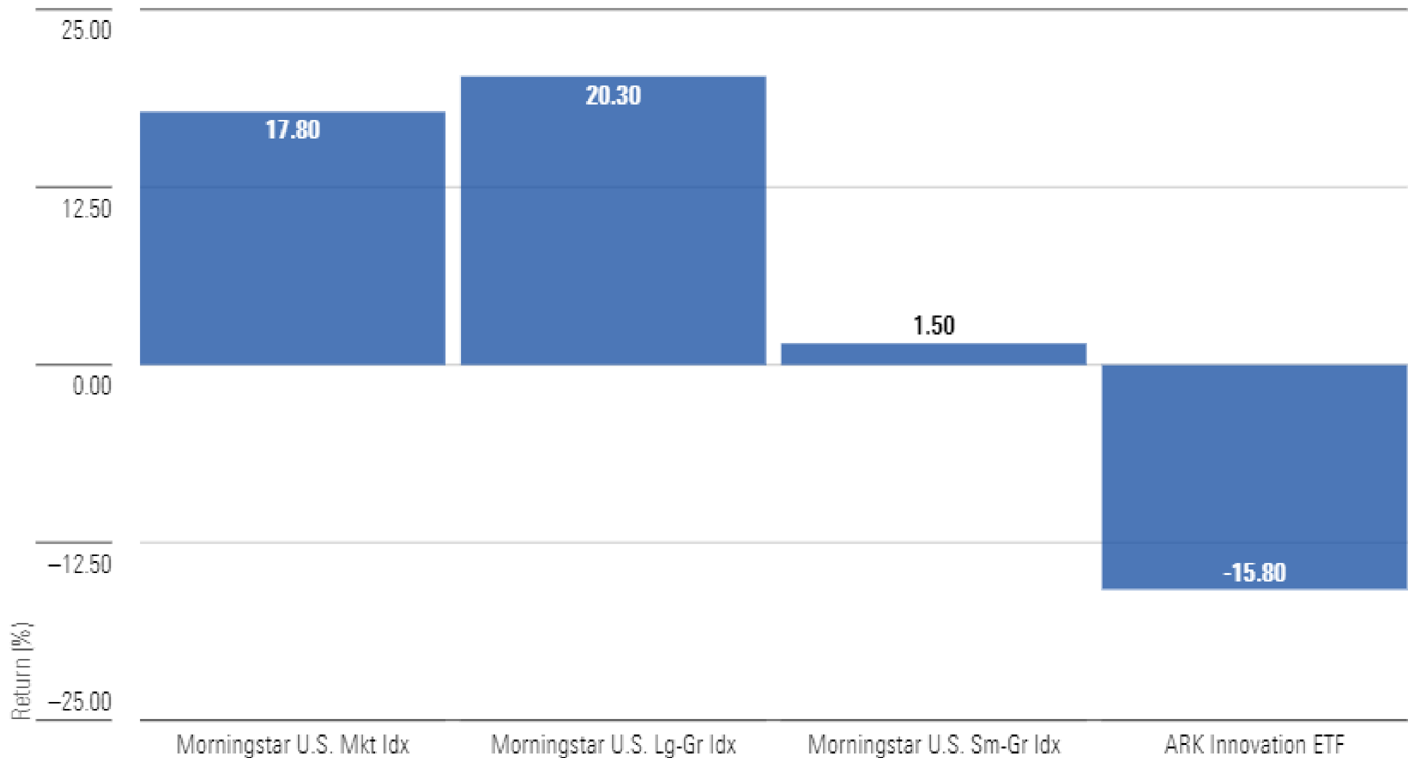
The first domino to topple was ARK Innovation ETF (ARKK). The most celebrated fund of the previous year, having scored a 156% return, ARKK began 2021 where it had left off. By Jan. 25, it had already gained another 18%. The sky was the fund's target. That day marked the fund's peak. Manager Cathie Wood would garner further headlines, but the fund has been retreating for a full year now.

The same week also marked the top for meme stocks. Based largely on social-media enthusiasm, such issues boomed during late 2020. As with ARKK, those stocks started 2021 with a bang but quickly fizzled. Bed, Bath, & Beyond (BBBY), Peloton Interactive (PTON), and most notably GameStop (GME), posted their all-time highs in January. (AMC Entertainment (AMC) lasted for a few more months, but it too subsided.)

A slew of recent articles have buried meme-stock investing, but the truth is that those securities have long been dead on their feet.

Also struggling have been special-purpose acquisition companies, or SPACs. Although new SPACs continue to be launched, most notably Digital World Acquisition Corporation (DWAC) (covered last week in this space), SPACs that completed corporate mergers have crumbled over the over the past year. From February through September of 2021, reported Goldman Sachs, an index of SPACs trailed the S&P 500 by 49 percentage points. Now that's a bear market!

The common link shared by SPACs, meme stocks, and the companies owned by ARKK was abundant hope for the future accompanied by negligible (or nonexistent) current earnings. In a word, those investments were speculations--the stock market's granciest securities. And when other stocks continued to rise, the speculations slipped. The following chart omits SPACs and meme stocks, for which I possess no index data, but it does depict how ARKK fared from late January through early November 2021 against other stock-market segments.



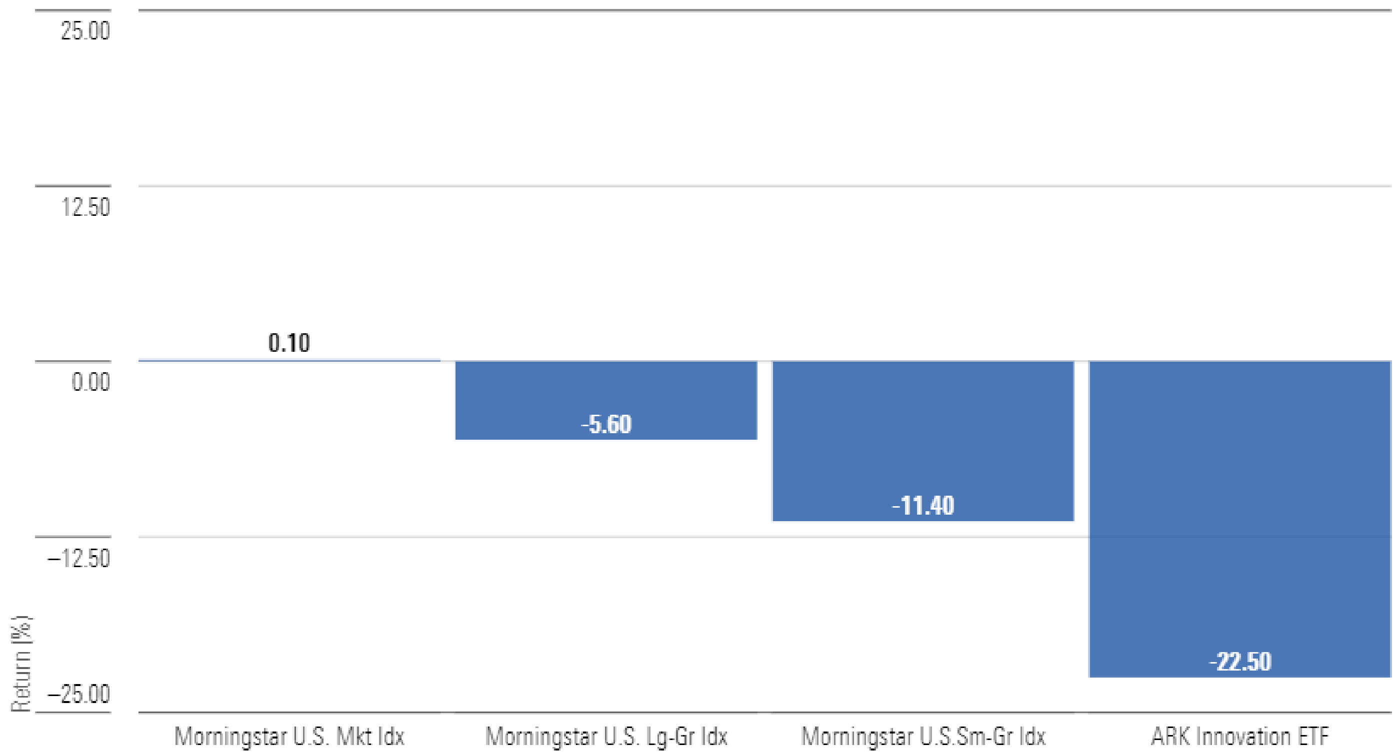
Two More Dominoes

Unsurprisingly, small-growth stocks placed closest to ARKK. Meme stocks, SPACs, and ARK's fund are the first rung on speculation's ladder. The second is the broad group of small-growth companies, as represented by the Morningstar U.S. Small-Growth Index. Such businesses are steadier than those that occupy the initial rung, but their stock-market fortunes nevertheless depend greatly on investor optimism. When buyers become wary, these typically suffer.

That began to occur in early November. To be sure, ARKK performed worse yet (as did meme stocks and SPACs, though once again their returns are not shown), but small-growth companies nevertheless underwent a

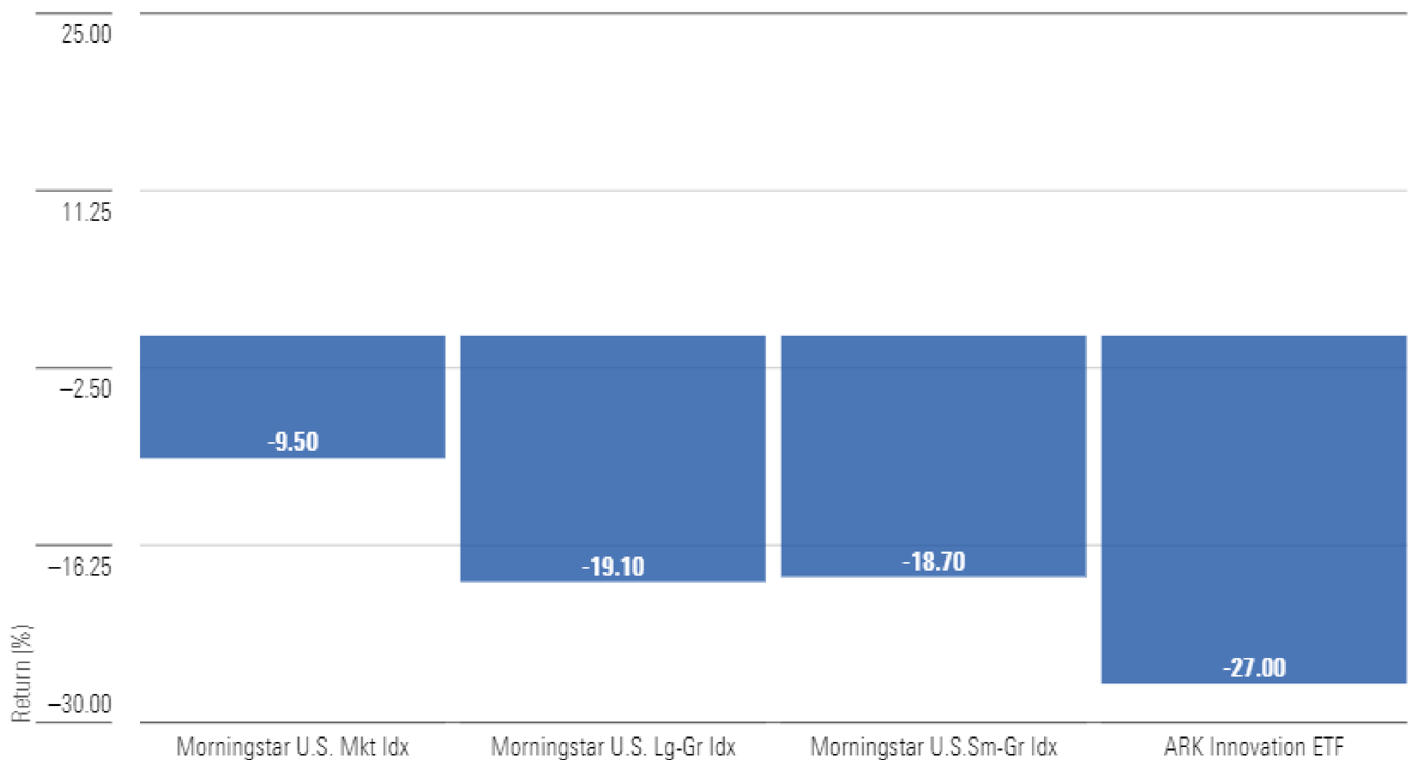
correction through year's end, shedding 11.4% of their value. Large-growth stocks suffered a modest decline through that period, while the U.S. stock market overall was flat.

Exhibit 2 The Second Domino: Small Growth Stocks (Nov 9-Dec 31, 2021)



Source: Morningstar Direct

Exhibit 3 The Third Domino: Large Growth Stocks (Dec 31, 2021-Jan 26, 2022)



Source: Morningstar Direct

This year we are seeing a third domino (Exhibit 3): large-growth stocks. From the new year through this past Wednesday, large-growth companies have joined the party. Once again, ARKK led the way down. (If you sum the losses for the fund that appear in this article's three charts, the total loss is 65%. Fortunately for the fund's shareholders, the math works otherwise. The fund's cumulative drop is 49%.) This time, however, large-growth stocks slid along with their small-growth rivals.

Canary in a Coal Mine?

On Jan. 5 of this year, my former Morningstar colleague John Coumarianos published a highly prescient article. Noting that that the small-growth indexes were drooping, with the most aggressive of such indexes performing the worst, John wondered whether such behavior was the proverbial canary in the coal mine. The last time small-growth companies so badly trailed other stocks, he points out, was early 2000. Shortly thereafter, blue-chip growth stocks also turned belly-up.

As they have since done. Now that's market-timing!

The critical question, of course, is whether this month's carnage completes the process or merely jump-starts it. That depends heavily upon corporate earnings. Although the 2000-02 technology downturn is largely remembered today as being the inevitable outcome of an investment frenzy, the valuations were only half the story. The other half was eroding profitability. From February 2000 through February 2002, the earnings reported by the companies in the Morningstar U.S. Technology Index dropped by 50%.

Today's blue chips do not appear to face a similar future. Of course, as Yogi Berra perhaps said, it's tough to make predictions, especially about the future. But it's difficult to foresee what could torpedo the operations of the major growth companies such as Amazon.com (AMZN), Apple (AAPL), or Microsoft (MSFT). After all, the developed countries seem to be early in their economic cycles, rather than late. Maybe a collapse in the Chinese economy? But that is the sheerest of guesswork.

Risk Off

To some extent, the stock market's current behavior can be explained by the precept of "risk on, risk off." By that framework, speculative investments--such as the ones mentioned in this column, or emerging-markets equities--thrive when central banks are accommodating and investors are ebullient. However, when money becomes tighter and investors warier, a flight to quality occurs. Aggressive securities wane, safer investments appreciate.

With the Federal Reserve signaling that money will soon be harder to come by, aggressive securities have indeed waned. Besides growth stocks, cryptocurrencies have also sunk since early November. That said, risk is not entirely off, nor is safety entirely on. During that period, the traditional havens, Treasuries and gold, haven't exactly blossomed, with Treasury prices weakening (albeit modestly) and gold being roughly flat. Further complicating the analysis is the continued success of that most experimental of marketplaces, transactions in non-fungible tokens.

In summary, today's equity downturn is alarmingly reminiscent of what occurred 22 years ago, when a sell-off in speculative stocks presaged far greater losses. However, the historical comparison will be complete only if growth-stock earnings also stumble.

John Rekenthaler (john.rekenthaler@morningstar.com) has been researching the fund industry since 1988. He is now a columnist for Morningstar.com and a member of Morningstar's investment research department. John

is quick to point out that while Morningstar typically agrees with the views of the Rekenthaler Report, his views are his own.

Performance matters when it is the result of a valid Process; otherwise you're chasing returns which you will rarely catch:

ARKK's Claims of an Anti-Innovation Market Ring Hollow

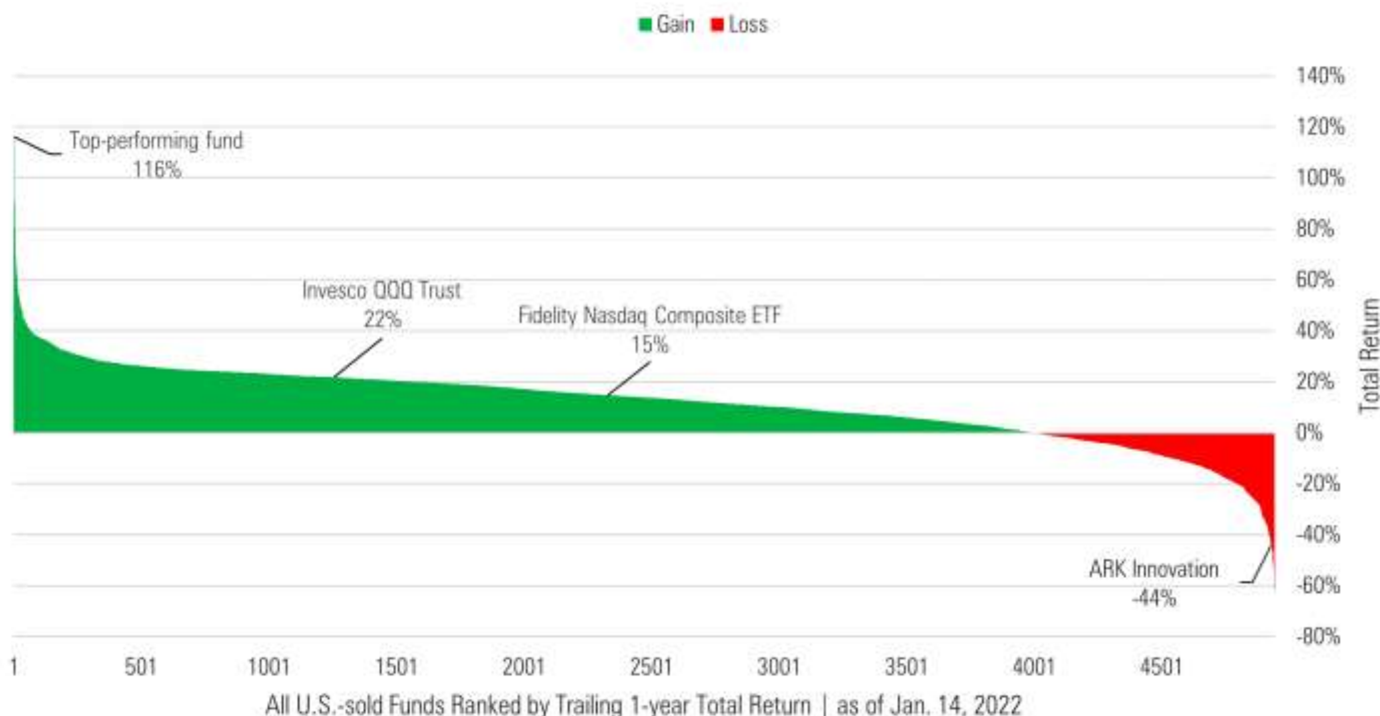
The fund's style does not explain ARK Innovation ETF's steep losses over the trailing year.

Robby Greengold, CFA

Jan 24, 2022

Since its meteoric rise in 2020, ARK Innovation ETF (ARKK) has been one of the worst options among more than 5,000 U.S. open-end and exchange-traded equity funds. Its 44.3% loss over the trailing year through Jan. 14, 2022, wasn't just poor compared with the Russell Midcap Growth Index's modest decline, it was wretched versus the tech-heavy Nasdaq Composite and Invesco QQQ Trust's (QQQ) respective 14.3% and 21.6% gains.

Exhibit 1: Only a Handful of U.S.-Sold Funds Performed Worse Than ARK Innovation Over the Past Year



Source: Morningstar Direct.

ARK's portfolio manager Cathie Wood has taken to the airwaves and penned a blog to say the strategy's merely out of favor. Investors have punished "innovation stocks" amid steep rises in consumer prices and other signs that the Federal Reserve's ultra-loose monetary policy will quickly tighten. They've fled to their benchmarks'

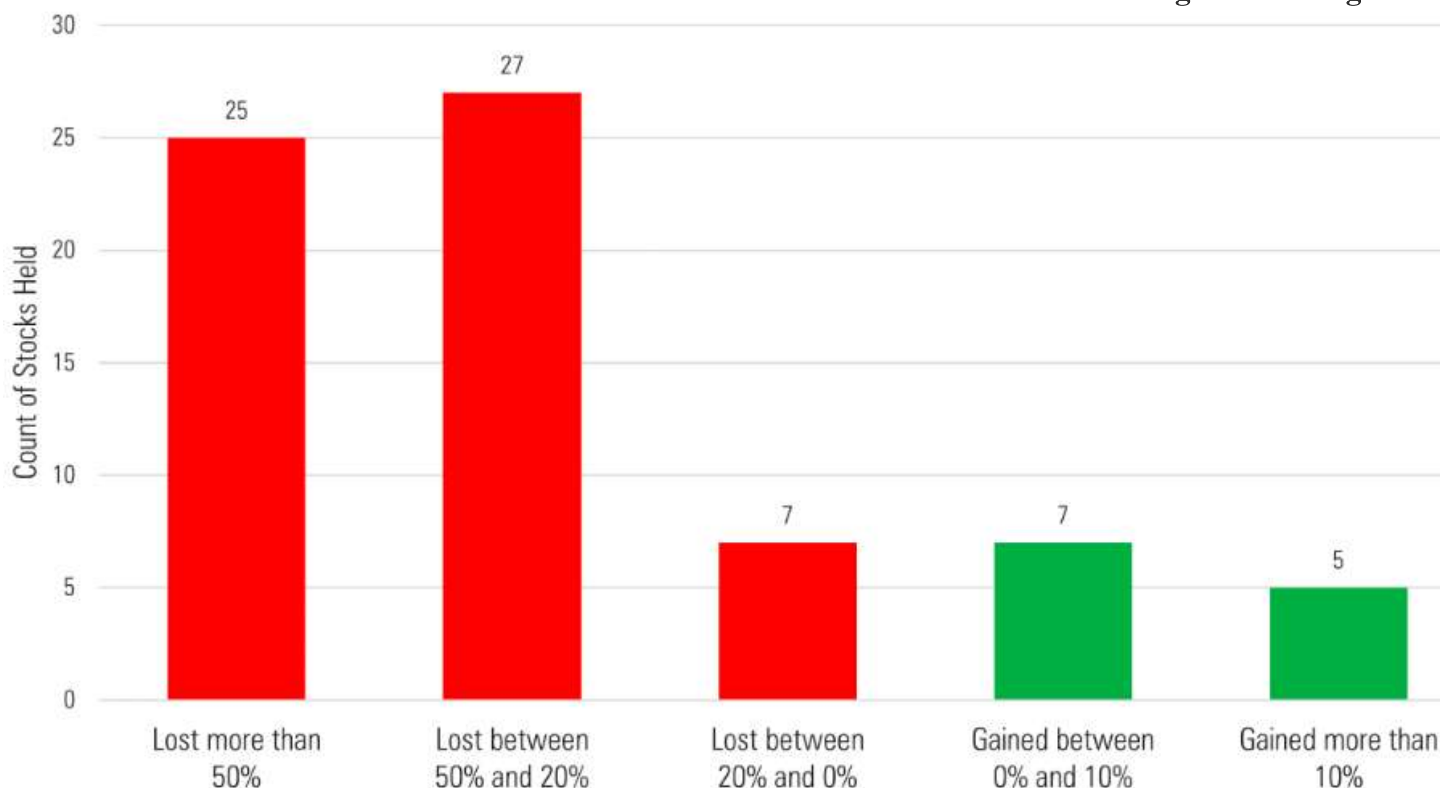
holdings, she says. ARK Innovation has embraced the abandoned nonindex holdings to build a distinctive portfolio--a source of pride for Wood.

It's hard to find data that support these points.

ARK Innovation's Relatively Few Unique Holdings Have Been Resilient

Only around one fourth of ARK Innovation's holdings aren't in the Russell 3000 Index--a popular and sweeping equity-market tracker--and these out-of-index positions have not driven the strategy's underperformance. They amount to a minority of the strategy's assets and have mostly held up better than the broader portfolio. Rather, 50-plus of the 70 or so stocks owned at some point over the past year have done most of the damage, with each falling 20% or more while held.

Exhibit 2: Performance of the Stocks That ARK Innovation Held at Some Point During the Trailing Year



Source: Morningstar Direct. Data as of Jan. 14, 2022.

Signs of an Anti-Innovation Bias Are Hard to Find in the Market

Did a marketwide fire sale of innovation stocks burn ARK Innovation? Not quite, judging from the MSCI ACWI IMI Innovation Index. Recently developed in collaboration with ARK Invest, this index gained 7% in 2021 thanks to constituents such as graphics chipmaker Nvidia (NVDA), which more than doubled in value. Wood had held Nvidia but sold it in April 2020. Wood's investments in the FAAMG stocks--Facebook (now Meta Platforms) (FB), Apple (AAPL), Amazon.com (AMZN), Microsoft (MSFT), and Google (now Alphabet) (GOOG)--tell a similar story. Wood had owned each in recent years, but not over the past year when all but one gained at least 35%.

The Strategy's Aggressive Posture Has Hit Headwinds, Not the Typhoon That ARK Claims

Cathie Wood also believes that algorithm-driven strategies have reacted to the market's macroeconomic concerns by "simplistically" selling stocks trading at high prices relative their earnings, sales, or book value. That theory is difficult to confirm or disprove. But it also seems a minor point to her important observation that rising interest rates typically disadvantage the stock-price performance such companies, whose profitability often isn't expected for years. The kind of aggressive-growth stocks Wood favors are an example.

Indeed, across all funds in the large- and mid-cap growth Morningstar Categories (two segments that ARK Innovation emphasizes), the poorest performers tended to be those with the most exposure to stocks with high price multiples, low dividend yields, and rapid long-term earnings-growth prospects, as reflected in their portfolios' high value-growth scores. So, given ARK Innovation's aggressive-growth posture, it is reasonable for it to have underperformed its peers over the past year.

Exhibit 3: Portfolios With the Highest Value-Growth Scores Have Posted Negative Returns, on Average

Source: Morningstar Direct and author's calculations.

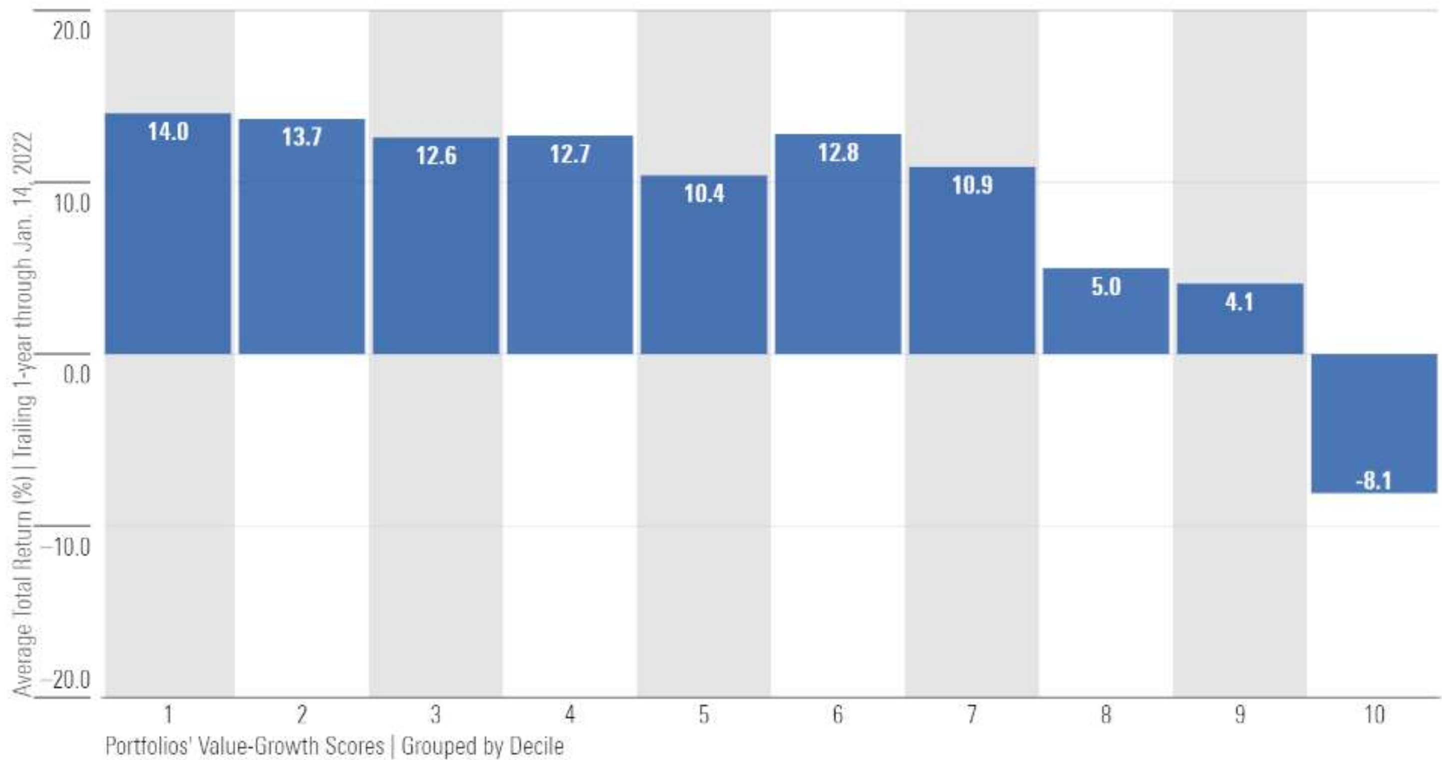
But investment style doesn't explain the magnitude of ARK Innovation's losses. Growth funds with value-growth scores in the broader cohort's top decile--those deserving of the aggressive growth label--fell by around 8% (Exhibit 4), on average--a far cry from ARKK's 44% loss.

Cathie Wood's Assurances

Describing herself as more comfortable today than in mid-February 2021, when shares in ARK Innovation were double their current value, Wood derides the public equity market's understanding of innovation and exponential growth. The fund is now at a bargain price, she suggests by depicting ARK's holdings as deep-value stocks. She advertises big rewards for fund investors who stick with her: Over the next five years, she expects ARK Innovation to deliver a nearly 40% annualized total return.

Among her most consistent messages in recent months has been that the prices of innovation stocks have not been irrationally high as technology and telecom stocks became in the late 1990s.

Exhibit 4: Average Total Returns Over the Past Year for Funds With Similar Value-Growth Scores



Source: Morningstar Direct and author's calculations.

By historical standards, Wood's return forecast is possible but improbable. Less than 2% of U.S. funds (alive or dead) have achieved such a feat over any rolling five-year period since 1980. Many did so during the late-1990s bubble.

How to Lose Money: Buy Digital World Acquisition Corp.

The odds are stacked against public shareholders.

John Rekenthaler
Jan 20, 2022

This Year's Model

Last January, the big news was GameStop (GME). Today, it is Digital World Acquisition (DWAC), which over the past eight weeks has surged from $10 to $77 per share. Digital World is a special-purpose acquisition company, or SPAC, that is scheduled to merge into a new Donald Trump organization, Trump Media & Technology Group. (Those unfamiliar with how SPACs operate may wish to read the Jan. 6 article, "Why SPACs Are a Racket." which we have shared below.)

Donald Trump has been the draw, not Digital World's founders. In fact, when Digital World raised its initial cash, through the usual SPAC method of soliciting institutional investors (mostly hedge funds), the company slightly scaled back its offering. Digital World had hoped to sell 30 million shares coming out of the gate, but it settled for 28.75 million. (Each two shares were accompanied by a warrant.) If Digital World's principals knew

in advance that the company would buy a stake in a Trump property, as has been alleged, it seems they did not tip their hands.

After going public, the stock sat at its opening price of $10 a share for three weeks. Then, on Oct. 20, Trump Media announced its existence, along with the fact that Digital World would be providing the company with its capital. Two days later, Digital World's stock commanded $118 per share. The seed investors fared very well! (Imagine the regret of the hedge fund managers who were approached by Digital World's promoters, but who decided to pass on the opportunity.)

A Big PIPE

Although Digital World's stock had skyrocketed solely because of Donald Trump's brand--Trump Media possessing no history, no financials, and only the vaguest of business plans--by early December the company could point to something more tangible: a $1 billion commitment from so-called PIPE investors, which increased the company's cash to $1.25 billion. For Digital World shareholders, this appeared to be doubly good news. First, Trump Media became that much better capitalized. Second, in exchange for their money, PIPE investors accepted convertible securities that could be exchanged for common shares at a price of $33.60.

That seemed to be a powerful vote of support. Not only had institutions pledged $1 billion to the new entity, but they did so while paying more than three times Digital World's initial value. True, the conversion price was below Digital World's market price. If PIPE investors converted their shares, they would dilute public shareholders' equity. But at least the bargain had set a floor. Unless the smart money had erred, Digital World shares were worth at least $33.60.

Smoke, Not Fire

Only that's not what the transaction indicated. The $33.60 represented the *most* that PIPE investors will pay for their shares, not the least. If the average daily price of Digital World's stock during the 10 days after the merger (rumors are it will occur in late February) surpasses $56, then the conversion price is the official figure of $33.60. If not, then the conversion price declines, becoming 60% of the average daily price, with a minimum value of $10. That is, PIPE investors could pay as little as $10 per share--scarcely a vote of confidence in Digital World's prospects, given that the stock traded at $45 when they bartered their terms.

Therefore, the PIPE investment did not signal what the smart money thought about Trump Media & Technology. It was instead a short-term trade of Digital World shares. Because PIPE investors may sell their shares as soon as the merger commences, their arrangement all but guarantees them a quick, fat profit. Even if Digital World's stock were to lose two thirds of its value from when the PIPE investors struck their deal, falling to $15, PIPE investors will earn a 50% return.

Five Investor Rungs

Nice work if you can get it. But unless you are a Wall Street insider, you cannot. The ladder of SPAC investors contains five rungs, four of which are occupied by institutions. On top are 1) the SPAC sponsor and 2) the underwriter, which put up little money. Further down the ladder are 3) the investors who deliver the seed capital and 4) PIPE investors. Those two parties supply the merger's cash, while receiving volume discounts. Finally comes the public, which buys its shares on the secondary market. It obtains no special favors.

In other words, public shareholders pay a SPAC's way. It must be so. If each of the other four parties collect fees from the SPAC or receive discounted shares, then the fifth party must foot the bill. The math insists. That

holds particularly true with Digital World, for two reasons. One, the company's PIPE investors received unusually favorable terms. Two, its acquisition target is a shell that brings no assets to the bargain. Thus, public shareholders are twice diluted--once by the SPAC's insiders, and then again by Trump Media & Technology's ownership stake.

Running the Numbers

The return prospects for Digital World's public shareholders are bleak. Just how bleak may be witnessed by the following chart, which depicts the estimated total returns for three tiers of Digital World's investors: 1) the IPO investors who paid $10; 2) the PIPE investors who will pay between $10 and $33.60; and 3) public investors, who paid $70 if they bought their shares at this week's opening price.

The returns are calculated for four scenarios:

1) Bear (the company becomes worth 100% of the cash contribution)
The market capitalization of the post-merger entity becomes solely the $1.25 billion dowry that Digital World brought to the marriage.

2) Neutral (300%)
Trump Media & Technology delivers $2.5 billion of value, making the company worth $3.75 billion.

3) Bull (700%)
Trump Media & Technology creates $7.5 billion of shareholder wealth, so that the company's market capitalization becomes $8.75 billion.

Exhibit 1 Prospective Returns: Three Classes of Digital World Shareholders, Four Scenarios

	Bear (100%)	Neutral (300%)	Bull (700%)	Strong Bull (1400%)
Market Capitalization (Millions)	**$1,250**	**$3,750**	**$8,750**	**$17,500**
Number of Shares (millions)	224.7	244.6	193.4	193.4
Value Per Share	$5.56	$15.33	$45.24	$90.49
Returns to Shareholders				
Initial	-44%	72%	521%	1200%
PIPE	-44%	53%	67%	169%
Secondary (at $70 per share)	-92%	-78%	-35%	29%

Source: Digital World Acquisition Corp. filings, author's calculations.

4) Strong Bull (1400%)
Thanks to a $16.25 billion contribution from Trump Media & Technology's business, the new entity carries a market capitalization of $17.5 billion.

(Note: These projections are oversimplified because SPAC investors have the right to tender their shares back to the company, at the $10 issuance price, before the merger occurs. Presumably, such redemptions will not occur, since Digital World's stock price is so far above that level. But the possibility should be mentioned. Also, the profit for initial shareholders is greater than would be suggested by their $10 per share purchase price, because they also received warrants)

I have no idea which, if any, of these scenarios is likely. Nor does anybody else. Trump Media & Technology is a shell company that resists investment analysis. However, given that Fox Corporation (FOXA), which owns more than just Fox News, is worth $23 billion after decades of operation, my Strong Bull case of $17.5 billion must surely be regarded as that.

Here are the estimates for future performance of the three investor tiers, taking into consideration that the number of shares outstanding depends upon the stock's future price:

The Outlook

If they haven't already cashed in their chips, the initial public offering investors will do so shortly. For their part, PIPE investors can't legally sell their positions yet (although they can hedge their positions by shorting), but barring a collapse in Digital World's stock price, caused by public shareholders suddenly agreeing with the Bear assessment--an event that seems highly unlikely--they also will record a handsome profit. However, public shareholders will only come whole if Trump Media & Technology performs something of a business miracle.

Or, of course, one can ignore such computations, and buy Digital World's stock in the hope that somebody else will pay more. That sometimes works, as annoyed GameStop shareholders informed me 12 months ago. ("Informed" is the politest of euphemisms.) And sometimes it doesn't. The day that my GameStop article was published, that stock closed at $325. Today, you can buy it for $108.

Four weeks from now, Digital World shares might trade above today's price. That wouldn't surprise me. But I expect its price to be lower, probably substantially so, by one year from this time.

In Closing

Two amusing tidbits. First, Digital World's underwriter is EF Hutton. No, your memory does not fail you; the company was absorbed by Shearson Lehman decades ago. However, in 2021 the EF Hutton brand was resurrected, becoming the old/new name of the investment bank, Kingswood Capital Markets.

Second, as I was preparing this column, I received a kindly worded email inviting me to attend The SPAC Conference 2022, as a media representative. It seems that the search engine that strung together "Rekenthaler" + "journalist" + "SPAC content" neglected a final and critical item: "conceivably favorable commentary."

From our Newsletter - December 2020:

Reducing downside risk is hard while still trying to justify a management fee, and many of the instruments designed to do so don't. In my admittedly short investing career, QMNIX remains (see below) my biggest

mistake, which we have covered ad nauseum in previous Worth Sharings. In short, QMNIX offered a Factor-based approach with 0 beta, which worked until it didn't.

AQR's Long Road Back to Average

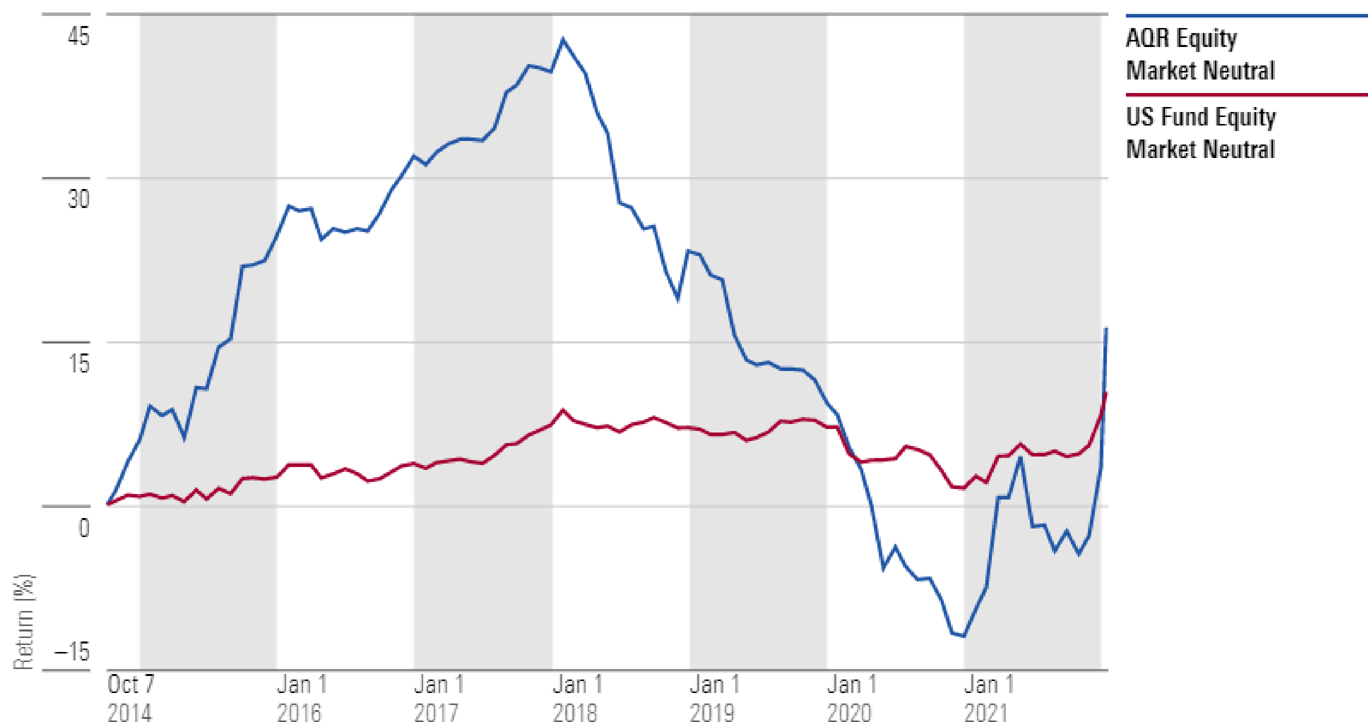
What a long, strange trip it's been.

Bobby Blue, **Erol Alitovski**
Jan 20, 2022

From its inception on Oct. 8, 2014, through Friday Jan. 14 2022, AQR Equity Market Neutral (QMNIX) returned an annualized 2.1%, edging out the average equity market neutral Morningstar Category peer's rather mediocre 1.4% gain over the same stretch.

A look at the chart over the past seven years reveals a more intriguing story. Over that period, the fund went on an incredible run from its inception to its peak on Jan. 29, 2018, returning a cumulative 43.2% versus the average peer's 8.7%. From there, it experienced a drawdown that was equally intense, losing 38.7% from its peak through its nadir on Nov. 11, 2020, and putting its original shareholders underwater by 11.8%. It has since snapped back again, capped off by a torrid 12.3% start to 2022 through Jan. 14.

Exhibit 1 The Long and Winding Road



Source: Morningstar Direct. Data as of January 14, 2022.

The strategy's wild ride provides a case study on two important points for liquid alts investors: the role of factors in their performance and the difficulty of holding a truly uncorrelated asset.

Factors Are Our Masters

AQR's quantitative approach centers around exploiting academically proven factors like value, momentum, and quality. These factors capture security-specific features--like a company's price/earnings ratio or its

profitability--that can explain the long-run risk and return of a basket of stocks. AQR's models score stocks based on how well they compare on these metrics, buying the highest-scoring stocks selling short the lowest-scoring. This description simplifies a complex process that combines the factors with neutral exposure across markets, regions, and sectors. However, the central point is that the fund attempts to produce positive returns by providing balanced exposure to these factors without incurring market risk.

The most well-known factor is value, which is simply the tendency for stocks that are cheap to outperform those that are expensive. The factor has, for long periods of time, been one of the dominant drivers of stock returns, but it can be punctuated by extended periods of underperformance. For example, over the trailing five years ending in December 2021, the MSCI World Index's 22.3% gain has squashed the MSCI World Value Index's 14.5% return over the same period.

Quantitative factor funds--like AQR Equity Market Neutral--normally attempt to spread their exposure across a range of factors. This way, the strategy isn't beholden to the performance of any one signal or group, and the effect of one doesn't overwhelm the others. In theory, this should provide a steady ride as the uncorrelated signals and removal of market beta allows AQR's stock-selection models to drive strong risk-adjusted returns. This stability--incurred by being market neutral--allows AQR to further enhance this alpha by leveraging its portfolio up to 5 times.

Clearly, AQR's performance has been anything but steady. Value signals contributed to strong returns in 2016 but hurt performance in 2015 and 2017. In those two years, as by design, strong returns from the strategy's other factor exposures provided enough juice to overcome value's struggles. That changed in 2018, as a terrible year for value coincided with weak years for the strategy's momentum and sentiment signals. Value continued to struggle at historically bad levels in 2019 and 2020, and the firm's exposure to other factors wasn't enough to overcome the losses.

Exhibit 2 Yearly Returns

Name	2015	2016	2017	2018	2019	2020	2021
AQR Equity Market Neutral I	17.60	5.85	5.84	(11.73)	(11.27)	(19.52)	17.64
MSCI Momentum Factor	4.69	(3.16)	8.74	8.53	1.64	10.16	(6.19)
MSCI Quality Factor	4.54	(2.67)	3.79	5.20	8.90	4.82	3.29
MSCI Value Factor	(3.77)	5.01	(3.46)	(0.48)	(2.41)	(13.85)	0.39

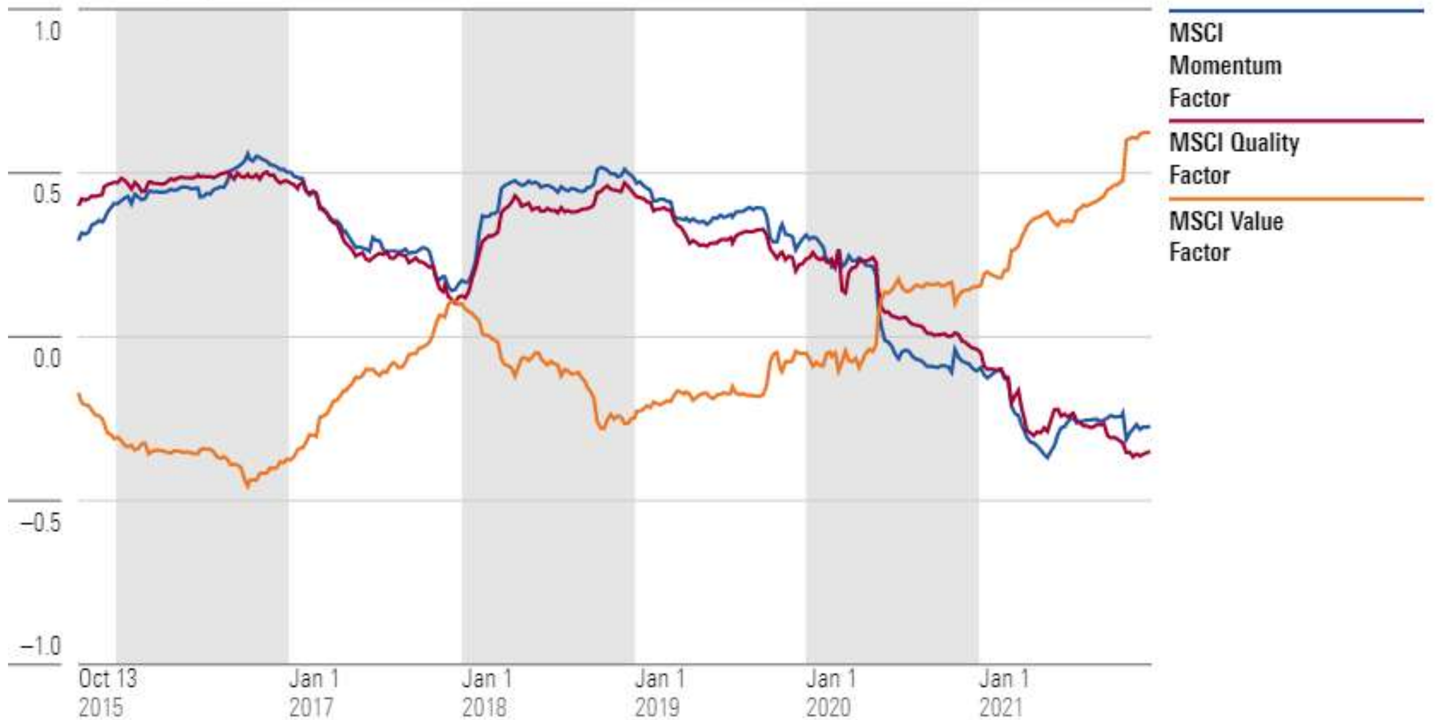
Source: Morningstar Direct

Though pain came from all parts of the portfolio, value's effects were most detrimental. Value's divergence from the rest of the market became so extreme that in November 2019, AQR's Cliff Asness[1] published a white paper saying that the firm was leaning into the factor; from there, AQR extended value's weight by 10% in the Equity Market Neutral model up to 33% of the portfolio's risk budget. It subsequently upped the weight even further, ultimately taking it to 40% in the first part of 2021.

Tilt or Dependency?

As value has regained some ground in 2021 and early 2022, so too has AQR. What has that meant for performance? Over time, AQR Equity Market Neutral's return profile has become more closely linked to the performance of a single factor: value. Part of this is attributable to AQR increasing those signals within its models, but it also owes to the value factor's unprecedented volatility. As a result, rather than offering balanced exposure across a broad array of factors, the fund has become a singular bet on value's resurgence.

Exhibit 3 AQR Equity Market Neutral Correlation to MSCI World Index Factors



Source: Morningstar Direct. Data as of January 14, 2022.

While the sizable tilt to value is within the fund's mandate, the concentration and leverage has led to increased volatility. Since November 2019 (approximately when the value tilt was implemented), the fund's standard deviation of 10.0% is significantly higher than the average category peer's 4.4%. More importantly, investors signed up to benefit from AQR's security selection and timing skills in a product where risk is tightly controlled and unintended consequences are minimized. It's safe to say that the strategy's massive performance swings are an unintended consequence.

The fund's leveraged concentration in value was particularly deleterious in 2020, when it lost 19.5%. Its 5.5% drop during the first quarter hurt, but much of the damage came in the market's snapback from the pandemic-related drawdown. Value stocks were comparatively pummeled, while expensive, growth-oriented stocks--which AQR is more likely to sell short--rallied in this stretch, exacerbating the challenges faced by the fund. The bet on value-oriented stocks closing the performance gap between growth-oriented stocks finally started to pay out in 2021, as the growth rally fizzled out and signs of value's long winter coming to an end began to show.

The fund's performance to start 2022 warrants a special callout. Its 12.3% return over the first 10 trading days of the year is its highest ever 10-day gain--the next closest being an 8.5% return in May of 2021. Three of the

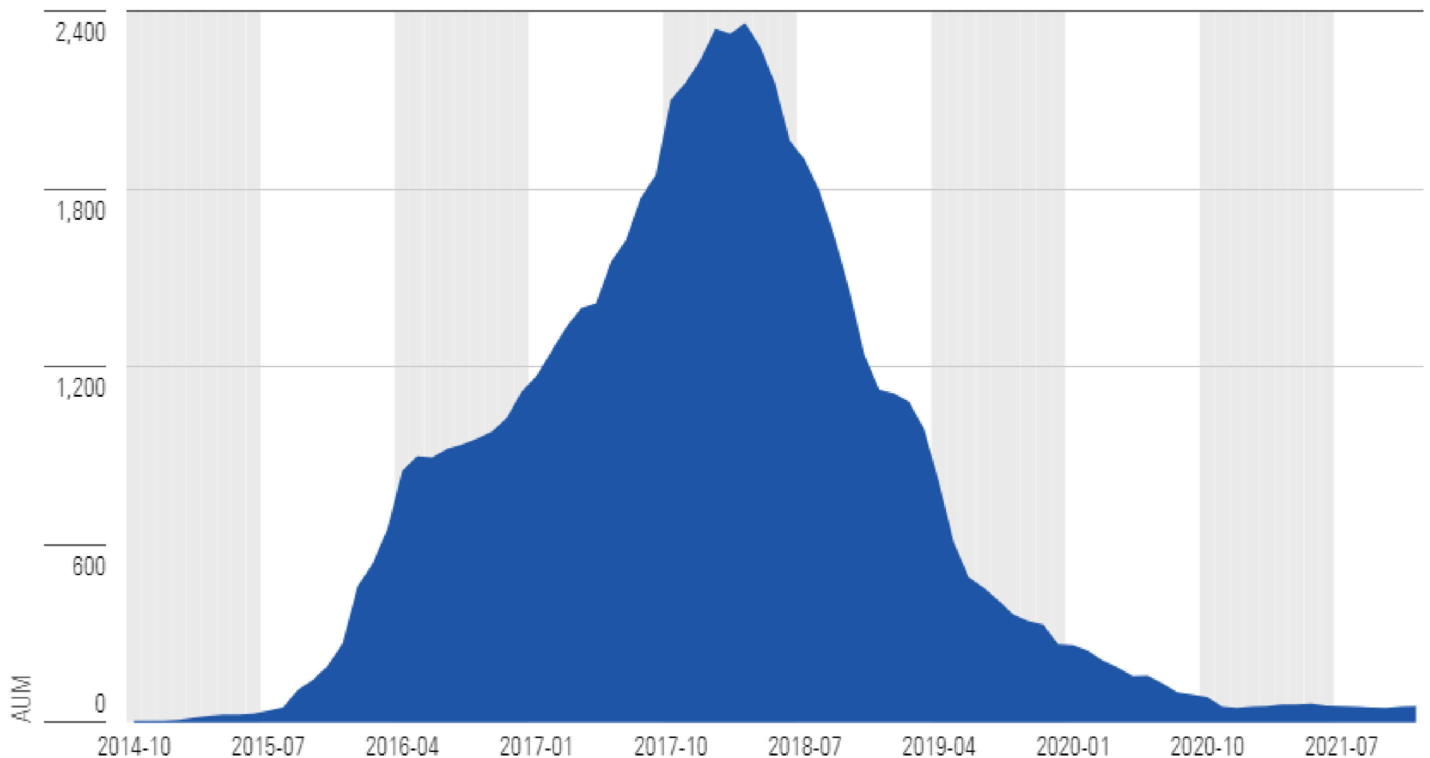
strategy's top four days ever have occurred so far in 2022, and it hasn't had a down day yet despite choppy trading in equity markets to start the year.

Exhibit 4 Approximating Returns With Leveraged Value

Source: Morningstar Direct. Data as of January 14, 2022.

This has coincided with strong performance from the value factor. AQR's performance can be approximated by

Exhibit 5 AQR Equity Market Neutral Assets Under Management



Source: Morningstar Direct. Data as of December 31, 2021.

simply taking a leveraged bet on value--which is in effect what the team has done. Though this bet has finally begun to pay off, the scars of 2019 and 2020 are still present.

Uncorrelated Does Not Mean Negatively Correlated

The recent burst of performance has been welcomed by shareholders, but the problem is there aren't many of them left. A chart of the fund's assets under management is nearly as remarkable as its performance chart, and it highlights the perils of performance-chasing.

The fund peaked at $2.36 billion in assets in March 2018, shortly after its performance high-water mark. Its bottom of $48.5 million in December 2020 coincided with its performance floor, with only a little over $2.3 million taken in since. (Exhibit 5) Investor returns--which show how much the average investor has made in the fund--were negative through the end of 2021, at negative 0.6%.

Lessons

There are lessons for asset managers, asset allocators, and financial advisors in this saga.

1. Investors love the *idea* of an uncorrelated asset but may not like the reality. Expectations are often for an uncorrelated asset to keep up in good times and act as a hedge in the bad times. Such an asset doesn't exist. Occasionally, uncorrelated assets zig when equity markets zag and provide a boost, but they may also zag along with them. A correlation of zero, which AQR Equity Market Neutral has delivered, means the results of one have no bearing on the other.

2. Asset managers must consider investor biases when designing their portfolios. It's difficult for even the most resolute investor to stick with a strategy during a nearly three-year 38% drawdown, exacerbated by the S&P 500's 30.1% return over the same stretch. Strategies that can exhibit such large fluctuations require an extreme amount of investor education, so that shareholders are informed in accepting those risks.

3. For advisors, performance-chasing is a common folly. Just as investors in ARK Innovation ETF (ARKK) piled in near the top of its eye-popping 150%-plus return in 2021 and are now underwater, many AQR investors piled in near the peak of the epic run in the early years. Investment strategies tend to revert to the mean over time, and chasing the top performers seldom leads to good fortune.

4. Market-neutral doesn't mean factor-neutral. Many offerings claim to have removed market risk, but the resulting portfolio exhibits larger style, factor, industry, or other bets. In a category where alpha generation is expected to be 2%-3% above cash, and the HFR Event Driven Index is in the same range, strategies performing outside this range warrant close inspection.

Though AQR's performance has begun to bounce back, its assets have not--yet. Investors looking to allocate to the strategy should be mindful of its sensitivity to value and be prepared for what that means for future results.

The factor indexes used in this report are custom benchmarks created by this report's author. They contain 100% exposure to MSCI World Factor Indexes and a 100% short exposure to the MSCI World Index. These long-short benchmarks serve to isolate the effects of the market factors.

[1]Asness, C. 2019. "It's Time for a Venial Value-Timing Sin."
AQR. https://www.aqr.com/Insights/Perspectives/Its-Time-for-a-Venial-Value-Timing-Sin

From our Website under OUR APPROACH - Asset Allocation:

Commodities

Many investment advisors recommend a significant allocation to commodities for returns uncorrelated with the rest of the market. And while the returns from the asset class are indeed uncorrelated, for the past few decades the roll yield on many commodity futures contracts have been negative, meaning investing in these contracts has been a losing game.

In a 9/1/16 interview titled "Why Investing in Commodities Can Be Challenging", Morningstar's Brian Huckstep, a senior portfolio manager, detailed why they finally dropped commodities from their Lifetime Allocation Indexes: "we stuck with commodities for a long time. We do have that long-term horizon and we kept waiting for roll yield to flip back to positive and it just hasn't. So because it's been negative for so long, we really have updated some of our expectations, and liquid commodity investments are just not as attractive as they used to be."

Do Commodities Have a Place in Your Portfolio?

Commodities can be a good hedge when inflation spikes. That said, trying to time episodes of inflation is a fool's errand.

Ben Johnson, CFA
Jan 18, 2022

If you've been to the grocery store or stopped at the gas station lately, you've probably noticed that your dollar isn't getting you as much milk or gasoline as it was just a few months ago. Inflation has spiked. And it's not just grocery shoppers and drivers that have taken notice. Investors have, too.

In 2021, investors added $40.4 billion in new money to Treasury Inflation-Protected Securities exchange-traded funds. This was more than 3 times these funds' prior annual record haul. Commodities funds have also seen renewed investor interest. Funds in the commodities broad basket Morningstar Category gathered $8.5 billion in net new assets in 2021. This is the largest amount of inflows the category has seen since 2009, when commodity prices surged from their postcrisis lows and inflation fears were running high.

Commodities can be a good hedge when inflation spikes.[1] That said, trying to time episodes of inflation is a fool's errand. So, is it worth carving out a permanent spot for a commodity allocation in a diversified portfolio?

The Research Says…

In their seminal 2004 paper "Facts and Fantasies about Commodity Futures," finance professors Gary Gorton and Geert Rouwenhorst (hereafter GR) outlined a compelling case for investing in a diversified basket of commodity futures.[2] They found that from 1959 to 2004, such a basket offered similar returns and a similar Sharpe ratio to stocks, was negatively correlated to both stocks and bonds, had less downside risk than stocks, and was positively correlated with inflation. The duo subsequently stood by their 2004 findings when they revisited them 10 years later, though they did note that correlations between their commodity basket and other asset classes had increased.[3] At first blush, their work appears to lay out a clear-cut case for allocating to what seems like an asset class with a magic touch.

While the research was compelling (so much so that we invited Rouwenhorst to speak at our ETF conference in 2011[4]), the real-world results for investors in commodity funds have disappointed. Exhibit 1 shows how five of the most widely followed commodity futures benchmarks have fared in the years since "Facts and Fantasies" was first published. Reality hasn't lined up with what consumers of GR's research would have expected. Returns have been far less than stocklike, Sharpe ratios have been pathetic, drawdowns have been even more dreadful, and correlations with stocks--while not perfect--have not been particularly low. What gives?

Exhibit 1 Have Commodities Lost Their Magic?

	Total Return %	Standard Deviation %	Sharpe Ratio	Maximum Drawdown	Correlation to Stocks	Correlation to Bonds	Correlation with Monthly Changes in CPI
Dow Jones Commodity Index	1.82	17.17	0.12	-68.06	0.62	-0.05	0.33
Credit Suisse Commodity Benchmark	2.35	20.75	0.16	-73.90	0.62	-0.09	0.37
DB Commodity Index	2.84	17.12	0.18	-70.56	0.60	-0.01	0.25
S&P GSCI	-3.51	23.61	-0.08	-87.22	0.58	-0.13	0.41
Bloomberg Commodity Index	-0.82	16.35	-0.04	-72.02	0.60	-0.03	0.31
Morningstar Global Markets Index	8.30	15.76	0.51	-54.74	1.00	0.06	0.10

Source: Morningstar Direct, FRED. Data from January 2005 through October 2021. CPI correlations calculated from January 2005 through August 2021.

Barrels to Bushels Comparisons

The biggest difference between much of the research on commodity futures and the investable funds underpinned by broad commodity futures benchmarks has to do with portfolio construction. In the case of GR, the commodity futures portfolio they built weights futures contracts equally and rebalances monthly. Equal weighting is a standard academic approach intended to represent the performance of the average commodity--not to represent of the commodity market itself. So, coffee gets the same weight as crude oil, though the market for the latter is much larger.

Weighting commodity futures equally and rebalancing them monthly creates a uniquely potent source of returns for the academics' portfolio--a portfolio diversification return. In a 2006 paper, Claude Erb and Campbell Harvey show that by building a portfolio of volatile commodity futures with low correlations to one another and regularly cutting recent winners and adding to recent losers, the GR portfolio is effectively "turning water into wine." It takes a bundle of assets that individually have long-run expected returns statistically indistinguishable from zero and transforms them into a portfolio with very appealing properties.[5] In fact, Erb and Harvey found that this return may have accounted for most of the GR portfolio's excess returns.

Let's Be Real Here

So, if the portfolios spun in the ivory towers of academia are idyllic and not realistic, where does that leave investors? As far as broad commodity futures indexes and the funds that track them are concerned, there are choices, but it's important to understand them and how different they can be. ...

Why have the historical returns for indexes that are nominally designed to track the same market been so different? These divergences are an artifact of discrepancies in the futures contracts these indexes own, how they weight them, the constraints they put in place, when and how they roll futures contracts, and their approach to rebalancing and reconstituting their portfolios. In all cases, the resulting portfolios are very different from the ones that generated the fantastical returns documented in the research that introduced commodity futures to so many investors over the past two decades. Those investors just getting to know them today should take note.

The Past Is Not Prologue

There are more reasons to take a dim view on a diversified basket of commodities futures. I'll dissect them along the lines of the components of their returns. Exhibit 3 shows the three principal pieces of commodity futures returns, featuring the contribution of each to the total return of the Bloomberg Commodity Index from 1999 through March 2018.

Exhibit 3 Composition of Commodity Futures Returns

	Return %				
	1-Yr	3-Yr	5-Yr	10-Yr	Since 1999
Total Return	8.5	-4.0	-7.2	-7.8	2.6
Spot Return	12.4	3.0	-2.7	-1.3	7.8
Roll Yield	-4.7	-7.4	-5.0	-6.9	-6.6
Collateral Yield	1.3	0.6	0.4	0.3	1.8

Source: Bloomberg, WisdomTree. Data as of March 31, 2018.

Collateral Yield. Investors in futures contracts post cash collateral, which is typically invested in short-term Treasuries. The yield on that cash collateral used to be much higher than it is today. As of this writing, short-term Treasuries' nominal yields were near zero and firmly negative in real terms. This leg of commodity futures returns is going to be lame as long as yields remain low.

Roll Yield. Futures contracts expire. To maintain exposure, investors must regularly sell the contracts they own and buy new ones, a process known as rolling. If the next contract is priced above the current one (a state known as contango) the return from this regular rolling (the roll yield) will be negative, as investors are forced to sell low and buy high. When the opposite occurs (a situation referred to as backwardation) the roll yield is positive, as investors are selling high and buying low.

Roll yields are a significant contributor to commodities futures returns. As you can see in Exhibit 3, the negative roll yield for the Bloomberg Commodity Index was nearly as large as the positive contribution from spot price returns from 1999 through March 2018. The headwind from negative roll yields has gotten even stiffer for some commodities in recent years, and it may not abate any time soon. Exhibit 4 shows the percentage of months over rolling 36-month periods when crude oil futures were in contango. What had been a relatively rare phenomenon a few decades ago has become common. Some argue that this has been driven by increased participation among speculators and investors in the futures markets, though there is no smoking gun. Whatever the case might be, should oil and other futures markets see persistent and pronounced contango, the future (no pun intended) returns for investors in these markets will be less than what they've been in the past.

Spot Prices. The final contributor to commodity futures performance is movements in spot prices. Commodity prices are volatile and unpredictable. Over the long term, average spot price appreciation across all commodity contracts has been statistically indistinguishable from zero, which speaks to the fact that commodities don't pay dividends or coupons and most are ultimately either burnt or eaten. But on account of their spot price volatility, diversified commodity futures portfolios will continue to enjoy some amount of the rebalancing returns

mentioned earlier--though not to the same degree as the equal-weighted, monthly rebalanced portfolios like GR's.

All told, I think there's little reason to believe that common commodity indexes and the funds that mimic them will do investors much good over the long haul. And there are plenty of reasons to believe that they have lost any of the magic touch they may or may not have had to begin with.

[1] Ari Levine, A., Ooi, Y.H., Richardson, M., & Sasseville, C. 2018. "Commodities for the Long Run," Financial Analysts Journal, Vol. 74, No. 2, P. 55.

[2] Gorton, G., & Rouwenhorst, G. 2006. "Facts and Fantasies about Commodity Futures." NBER Working Paper 10595. June 2004, Revised March 2006.

[3] Bhardwaj, G., Gorton, G., & Rouwenhorst, G. 2015. "Facts and Fantasies about Commodity Futures Ten Years Later." NBER Working Paper 21243.

[4] Morningstar.com. 2011. "Getting the Most From Commodity Investments." https://www.morningstar.com/articles/395305/getting-the-most-from-commodityinvestments

[5] Erb, C.B., & Harvey, C.R. 2005. "The Tactical and Strategic Value of Commodity Futures." NBER Working Paper 11222

Fidelity Magellan and the Paradox of Skill

How active equity management fell upon hard times.

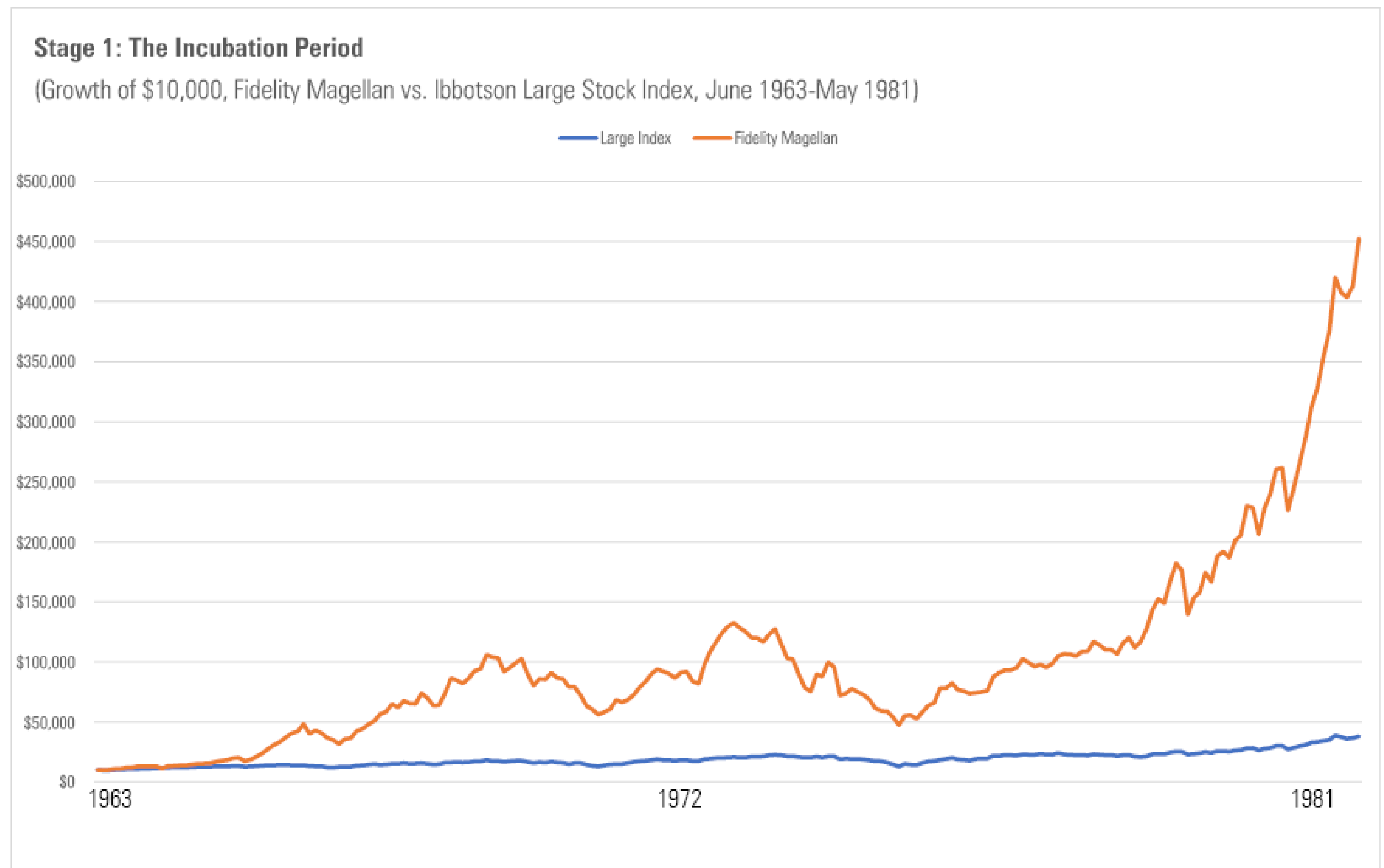
John Rekenthaler
Jan 13, 2022

A Case Study

Within institutional investing, the paradox of skill is a familiar concept. When the level of competition rises, the best contestants perform worse. It's one thing to beat up on second-rate rivals; it's quite another to excel against a strong field. Famously, the evolutionary biologist Stephen Jay Gould applied this postulate to baseball, arguing that that Major League Baseball hasn't had a .400 hitter since 1941 not because batters are worse, but because pitchers have become better.

The retail mutual fund Fidelity Magellan (FMAGX) exemplifies this institutional idea. These days, Magellan attracts little attention. It is an unremarkable 3-star large-growth fund, slightly lagging its Morningstar Category average over the trailing 10 years. Ho hum. But things were once very different. During the first half of its existence, the fund showed what trained portfolio managers could accomplish--when the competition consisted mostly of enthusiastic amateurs.

The Wonder Years



Source: Morningstar Direct

Magellan was founded in 1963, as an "incubator fund" available only to Fidelity insiders. The fund would not open to outsiders until 1981, a full 18 years later. Thus, its initial results require a large asterisk. As incubated funds tend to be tiny, they often invest speculatively, by trading rapidly and/or holding very tiny companies. Such strategies cannot necessarily be continued after they open their doors. Incubated funds also benefit from their shareholders' predictability. They need not struggle to meet unexpected redemptions nor to invest sudden inflows.

That said, the incubated performance of Fidelity Magellan was breathtaking. From inception until going public, Magellan outgained the Ibbotson Large Stock Index by an annual 15.9 percentage points. For comparison's sake, the largest victory over the past 18 years that a diversified, nonleveraged fund has recorded against that index has been an annualized 7.4 percentage points, by Baron Partners (BPTRX). (That strikes me as a sector fund, and thus an unfair comparison, but who am I to quarrel with Morningstar's categorization?)

For amusement's sake, I present a "growth of $10,000" chart for Fidelity Magellan versus the index over that 1963-81 period.

(Properly speaking, Growth of $10,000 charts should use a logarithmic scale, which eliminate the hockey-stick effect by equalizing all percentage changes, so that an increase from $10,000 to $20,000 occupies as much space on the graph as does a move from $100,000 to $200,000. But doing that would be no fun.)

Admittedly, the Ibbotson Large Stock Index is a flawed benchmark. During its incubation years, Magellan preferred small companies. The Ibbotson Small Stock Index therefore makes for a better measure. It also provides a sterner test, as small stocks thrashed large companies during that period. (That showing prompted academic researchers to suggest that, over time, small stocks will outgain blue chips. As Tuesday's column related, that did not come to pass.) Against the Ibbotson Small Stock Index, Magellan's annual lead shrinks to 7.4 percentage points.

Well, OK. When suitably benchmarked, the incubation version of Magellan continued to look excellent. But its relative performance was no better than that recorded by its modern equivalent of Baron Partners. Why all the fuss, then?

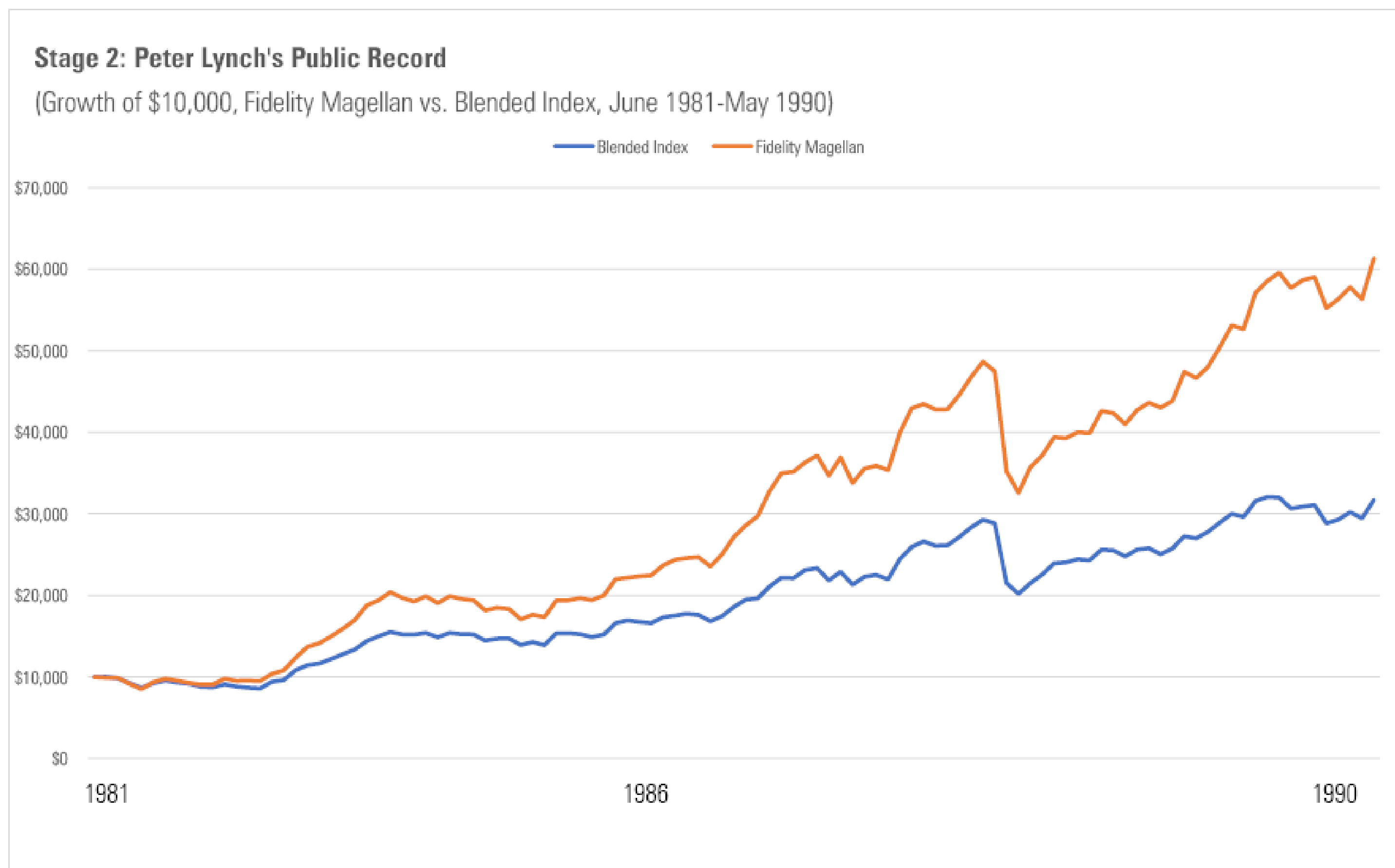
Rise and Fall

The next nine years answer that question. Within 18 months of Magellan's public appearance, the fund had ballooned to 30 times its previous size. In doing so, it lost much of its investment freedom. At $2 billion (in real money; had the fund been a publicly traded stock, it would have been among the nation's 200 largest), Magellan was forced to supplement its small-cap stocks with blue chips. And its shareholder base was no longer stable.

Yet the fund remained excellent. For the next nine years, until manager Peter Lynch (whom we have previously written about, and whose quotes we often share) retired, Magellan compounded assets near its previous rate, gaining 22.3% per year. During that period, the fund no longer correlated so highly with small-company indexes. A more appropriate comparison, given Lynch's catholic tastes (the pun is accidental), is a blended benchmark that consists of 50% Ibbotson Large Stock Index and 50% Ibbotson Small Stock Index.

That blended benchmark appreciated by an annual 13.7%, thereby giving Magellan a 9.6-percentage-point edge. In other words, after going public, Magellan *increased* its margin over the most relevant stock index, even while carrying the investment and public-relations burden of being the world's largest mutual fund. There are, of

course, no similar cases today. The only current funds that boast anything like Magellan's 1981-90 results are both specialized and much smaller than the industry leaders.



Source: Morningstar Direct

The three decades after Lynch's retirement brought Magellan back to earth. The fund continued to thrive for the next three years, hit a bump during 1994 when then-manager Jeff Vinik raised cash while stocks were rising, and then became thoroughly ordinary. Its 30-plus year record is pretty much as Jack Bogle depicted the fate of actively managed stock funds: able to stay within sight of the indexes but not good enough to exceed them once their expenses are paid.

An Unfriendly Trend

At first glance, this tale seems to be more about Peter Lynch's superiority than the paradox of skill. However, Magellan excelled for more than three decades, from mid-1963 through early 1994. Lynch was in charge for only 13 of those years. The fund was in other hands during most of the incubation period, as well as during its three excellent post-Lynch ~~decades~~ years. Without question, Lynch was the most talented of Magellan's chiefs. But he was not its only successful portfolio manager.

Ultimately, changing conditions grounded Magellan, not Lynch's departure. Through the first half of its existence, the fund was fortunate enough to operate when retail stockbrokers and their clients dominated equity trading. In such a climate, a truly exceptional investment professional could post truly exceptional returns. Now, however, institutional investors determine equity prices (meme stocks excepted). No longer can a mutual fund perform as Magellan once did.

Source: Morningstar Direct

Misreading the Tea Leaves

The attached note jogged my memory. When Peter Lynch retired, many observers interpreted his decision as an implicit criticism of the stock market. Lynch was getting out on top, leaving those who remained in equities holding the bag. For four months, this argument appeared prescient, as stocks promptly fell during summer 1990. Then followed the longest bull market in U.S. history. Mind reading is a difficult task.

It has been quite some time since the height of the hype over Cannabis stocks resulted in several quires from clients. Our warnings to avoid were clear. From a Jan. 13th Morningstar Specialists interview titled **Will Cannabis Stocks Revive in 2022?**

Dziubinski: After doing pretty well in 2020, cannabis stocks really struggled in 2021, with the names we cover ending the year anywhere between 20% to 70% in the red. What happened?

Inton: First, I'd make a distinction between what happened for American cannabis stocks, which are Curaleaf and Green Thumb and the Canadian cannabis stocks that we cover, Canopy Growth, Aurora Cannabis, Tilray, and Cronos. Every cannabis stock fell as optimism for federal legalization reached a fever pitch after Democratic wins in the Senate and the White House early last year. But the drop was much bigger for the Canadians in general as the cannabis market there has been incredibly hard compared to the robust American market. Oversupply, price competition, and lack of dispensaries are all challenges the Canadian producers faced

that Americans didn't. Furthermore, U.S. federal prohibition has kept the Canadians out of the more attractive American market.

Why SPACs Are a Racket

If you like paying load fees, you'll love special-purpose acquisition companies.

John Rekenthaler
Jan 6, 2022

For Openers

This column is based on a paper from Michael Klausner, Michael Ohlrogge, and Emily Raun, entitled "A Sober Look at SPACs." Their research has circulated for a while, appearing in various articles, but as the paper was updated over the holiday break, it's worth a fresh look, particularly as the industry is once again occupying the front of the business pages, with the SPAC Digital World Acquisition Company (DWAC) preparing to merge with a firm owned by Donald Trump.

Special-purpose acquisition companies, or SPACs, are publicly traded stocks. They raise capital from seed investors, promising to invest those proceeds into a privately held company Such transactions are called "mergers." The SPAC transfers its cash to the target in exchange for equity ownership. The private company has therefore gone public. Those who held SPAC shares through the merger now own shares in the previously private company.

Allegedly, this structure leads to a win/win/win. SPAC shareholders win by investing in the formerly privately held organizations at wholesale prices, rather than buying at an inflated value after the bigger players have flipped the merchandise. The private firms win because they acquire liquidity by going public, with underwriting costs that are claimed to be lower than with traditional IPOs. And, of course, the promoters of SPACs win, because such is Wall Street.

The promoters have indeed thrived. The companies have posted mixed results. But shareholders … sigh. Not so much.

Five Actors

Understanding the results requires appreciating each party's role. SPACs have five performers: the sponsor, the underwriter, IPO investors, private investors, and secondary investors. The first three, broadly speaking, are the insiders who make the product. The fourth are privileged outsiders, while the fifth are nonprivileged outsiders.

1. *Sponsor*. SPACs are typically created by Wall Streeters or by industry executives. Examples include Barry Sternlicht, who heads the $60 billion investment firm Starwood Capital, and Tilman Fertitta, CEO of the privately held hospitality firm Landry's and owner of the NBA's Houston Rockets.

   For their efforts, sponsors receive an immense amount of free (or almost-free) SPAC shares, typically 20% of the eventual float.

2. *Underwriter*. As with conventional IPOs, the underwriter for a SPAC is hired by the organization to distribute the initial shares. These are, in fact, the same organizations that distribute IPOs; Citigroup (C), Goldman Sachs (GS), and Credit Suisse (CS) lead the 2021 SPAC charts.

   The standard underwriting fee is 5.5% of the SPAC's initial proceeds.

3. *IPO Investors*. This is where a SPAC differs from other stocks. Whereas traditional IPOs unofficially dole out special favors to Wall Street insiders by giving them early access to shares, SPACs make that relationship official. When SPACs issue their initial shares, they exclude the public, providing the opportunity instead to hedge funds.

   Accompanying those initial shares are warrants that give the hedge funds the right to buy additional SPAC shares--usually at a large discount. In practice, the hedge funds cash out the original shares they purchase, either by reselling them to secondary investors or by redeeming them. (Before a merger closes, SPAC shareholders generally have one or two months during which they may redeem their shares at par if they wish.) Either way, the hedge funds recoup their outlays while retaining the possibility to profit through their warrants, which they have in effect been given for free, in exchange for supporting the SPAC until the time of the merger.

4. *Private Investors*. Before a SPAC merges with a target, it usually attempts to acquire additional capital, by seeking so-called PIPE monies from private investors. (PIPE stands for "private investment in public equities.") Once again, these are institutional investors, rather than retail buyers.

   Details from one PIPE to another vary considerably, but sometimes SPAC sponsors sweeten the deal, either by offering private investors discounted shares or by presenting them with warrants. (If this sounds fuzzy, so too is SPACs' disclosure of such agreements.)

5. *Secondary Investors*. Finally come the secondary investors. They bought their shares on the secondary market--shares originally held by the hedge funds that were the IPO investors--and have decided to retain those shares through the merger. Secondary investors consist either of retail buyers or of institutions that didn't place higher on the SPAC ladder.

   Unlike the previous parties, secondary investors do not receive special grants in the form of discounted shares, warrants, or fee payments.

Exhibit 1 SPAC Participants

Role	Background	Source of Profit
Sponsor	Investment/Executive Star	Free Shares
Underwriter	Wall Street Firm	Upfront Fee
IPO Investor	Hedge Fund	Free Warrants
Private Investor	Institutional Investor	Discounted Shares
Secondary Investor	Retail Shareholders?	Regular Shares

Source: "A Sober Look at SPACs."

High Costs

Secondary investors seem to have paid a very large bill. The paper's authors calculate for the 47 SPACs that were issued between January 2019 and June 2020: 1) the dilution that arises from the sponsors' shares; 2) the various fees paid by the SPACs, underwriting and otherwise; 3) and the dilution caused by the IPO investors' warrants. The median amounts appear below.

Exhibit 2 Median SPAC Costs (SPACs That Merged From January 2019 through June 2020)

Source	Percentage
Promoters' Shares	24%
Fees	10%
Warrants	7%
Total	43%

Source: "A Sober Look at SPACs."

Talk about a load fee! For several decades, mutual fund buyers paid a maximum front-end commission of 8.5%, which the industry eventually cut to 5.5%. Even then, investors were displeased: Few fund sales today involve any front-end charge at all. Thus, while mutual fund investors balk at single-digit admission charges, secondary SPAC shareholders accept 43%.

Such is the allure of popular investments, which tempt potential buyers into overlooking the fine print. Also contributing to secondary shareholders' willingness to foot the bill, of course, is that the charges are either implicit, or (as with the underwriting fees) paid before they purchase their shares. It doesn't *feel* like a 43% hit.

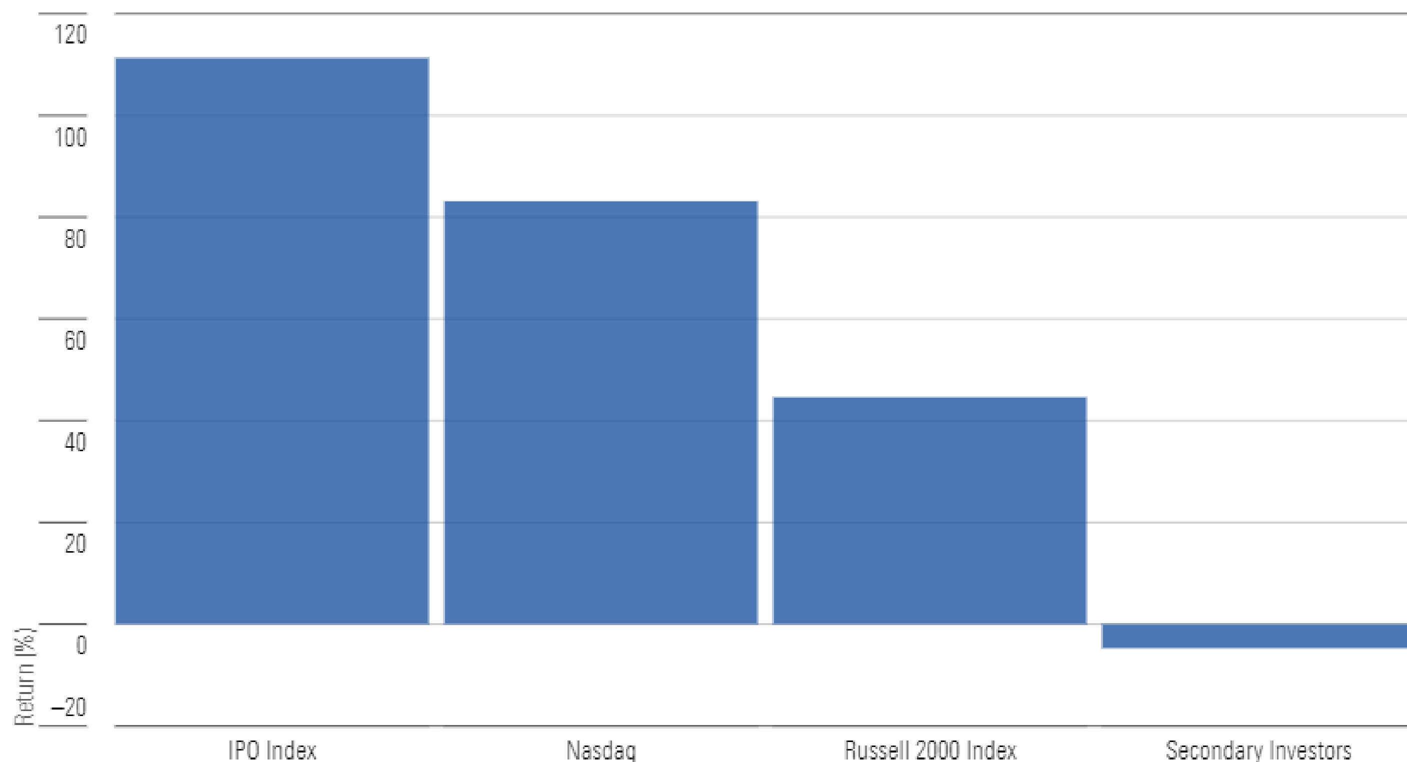
Low Returns

After the insiders collected their dues, secondary investors retained only $0.57 on the dollar. The good news for them was that, thanks to strong equity markets, their postmerger returns almost overcame that handicap. Through Nov. 30, 2021, the median return for the secondary SPAC investors in the authors' database was negative 4.7%. Not an enviable result, to be sure, but impressive given how much ground that secondary shareholders initially conceded.

The bad news was the opportunity cost. While secondary SPAC investors didn't lose much, as measured by the median result, they left a huge amount of money on the table, because other stocks were flying. Particularly successful were the stocks of companies that were most like the businesses into which the SPACs merged: small, emerging firms. The following picture may induce 1,000 tears (Exhibit 3).

The Companies' Perspective

This all leads to the final question, of how the companies that were acquired through SPAC mergers fared. Clearly, those who promoted the SPACs profited. Sponsors received free shares; underwriters collected their fees and then departed; and IPO investors quickly recouped their outlays while retaining warrants that could pay them in the future. Equally clearly, shareholders who arrived late to the game got stuck with the bill. But what about the firms that were acquired by the SPACs? How should we consider their fates?



My initial thought was that the companies also suffered. After all, it was their stocks that lagged. But that evaluation is incomplete, because it ignores the starting point: the price at which the merger occurred. My suspicion (which the authors share) is that SPACs overpay for their acquisitions. Thus, when the postmerger stocks trail the market, that isn't a true problem for the companies, because their initial prices were unsustainably high. The underperformance returned their stocks to their proper positions.

Unfortunately, secondary SPAC investors can take no such solace.

Positions

BG - We consider a company fully valued when its valuation metric (PEG, or, if not available, EV/EBITDA or EBIT) increases to the 5th decile or higher. We recalculate deciles for all 3 metrics annually. As a result, we sold BG for 6 clients on 1/10 @ 97.16:

BG 96.11
yahoo!finance
96.11
95.00
90.00
85.00
80.00
75.00
70.00
65.00
Feb
Mar
Apr
May
Jun
Jul
Aug
Sep
Oct
Nov
Dec
2022