May 2022

As previously shared, on 5/17&18 HCM's clients became fully invested. From today's WSJ:

In the U.S., stocks tumbled shortly after May began and continued falling amid many earnings and economic data that came in worse than expected.

Throughout the month, profit warnings from companies ranging from Snap to Target to Walmart intensified worries about the lingering impact of inflation and spurred investors to dump shares across several industries.

By mid-May, it seemed the S& P 500 was bound to close in a bear market, defined as a drop of 20% or more from a recent high (on 5/20 in dipped into bear territory), before a late-month rally. The S& P 500 ended the month down about 14% from its January high.

The carnage in tech has been severe. From Bespoke on 5/24:

The Nasdaq is down by over 3% today, bringing the index down over 30% relative to its all-time closing high on 11/19/21. If current levels hold, this decline of 30.6% will even exceed the 30.1% decline seen during the COVID crash. Unlike the period during COVID, though, when the Fed aggressively cut rates and Congress stuffed stimulus payments into the pockets of Americans, today, we have nearly the opposite backdrop in place; there are no stimulus checks from DC on the horizon, and the Fed is in the midst of a hiking cycle.

Besides the current plunge, the Nasdaq has only declined 30% or more from a unique all-time high six other times in its history. The last three 30% drawdowns all occurred either right before or early in recessions, and the only two that were not associated with recessions were in 1984 and 1987. In 1998, the Nasdaq got close to falling 30% from a record closing high but came up just short with a decline of 29.5%.

Looking at historical data, the table below summarizes each of the prior 30%+ drawdowns for the Nasdaq in its history. For each period, we show the number of days it took for the Nasdaq to fall 30%, and then how long it took to reach the ultimate low as well as how much further the Nasdaq fell. Regarding the number of days it took for the Nasdaq to reach the 30% threshold, the current period is unique in that the other six drawdowns all occurred either over the span of less than 50 trading days or more than 200. This decline ranks in the middle of those two scenarios at 127 trading days. Once the Nasdaq reached the 30% threshold, forward returns also varied widely. In four of the six periods, the ultimate low occurred in within a week or less, while in the 1973

Nasdaq 30%+ From Record Closing Highs: 1971 - 2022

Date of Closing High	Date of 30% Decline	Trading Days From Closing High to 30%	Date of Ultimate Low	Trading Days From 30% To Lows	Total Peak to Trough Decline (%)	Additional Decline from 30% to Low
1/11/1973	11/26/1973	219	10/3/1974	216	-59.9	-41.7
6/24/1983	7/20/1984	271	7/25/1984	3	-31.5	-1.8
8/26/1987	10/26/1987	42	10/28/1987	2	-35.9	-2.3
10/9/1989	10/9/1990	253	10/16/1990	5	-33.0	-4.0
3/10/2000	4/14/2000	25	10/9/2002	622	-77.9	-66.5
2/19/2020	3/23/2020	23	3/23/2020	0	-30.1	0
11/19/2021	5/24/2022	127	?	?	?	?
	Average	**137**		**141**	**-44.7**	**-19.4**
	Median	**127**		**4**	**-34.4**	**-3.2**

and 2000 periods, it took 216 and 622 more trading days to bottom, respectively. Not surprisingly, the additional decline from the 30% threshold to the ultimate low also varied widely between those periods when the low was reached within a week and the other two periods where the ultimate low wasn't reached until much later.

The table below summarizes the Nasdaq's performance following each other point that it fell 30% from an all-time high. As you can see, the median performance is far stronger than that of all periods for every time range we looked at. However, positivity rates are generally in line with or lower than historical norms for all periods. Broadly speaking, the Nasdaq has tended to post significantly better than average returns following 30% declines from a record high, but the two exceptions proved to be painful. Nothing is ever easy, is it?

If you're looking for a silver lining, it's the forward three-month period. In the three months following the prior six 30% drops for the Nasdaq, the index was higher over the next three months five of six times for an average gain of 17%. The one time the Nasdaq was lower over the next three months was back in late 1973, but that 3-month drop was just 1.1%. This suggests that even if we don't make a low here and we go on to fall much further over the next 12-18 months, the Nasdaq could at least trade sideways or even rally (yes, rally!) this summer.

One other interesting trend to note is that in the four periods where the Nasdaq was higher six months later, it continued to rally for the next six months, whereas the two times it was lower, it continued falling.

Nasdaq 30%+ Drawdowns From Record Closing Highs: 1971 - 2022

Date of	Date of 30%	Nasdaq Forward Performance (%)				
Closing High	Decline	One Week	One Month	Three Months	Six Months	One Year
1/11/1973	11/26/1973	-2.3	-4.2	-1.1	-13.9	-34.7
6/24/1983	7/20/1984	0.0	9.1	8.9	14.7	34.2
8/26/1987	10/26/1987	9.8	5.9	13.5	26.4	30.0
10/9/1989	10/9/1990	-4.0	-0.7	5.4	44.7	53.5
3/10/2000	4/14/2000	4.9	11.9	28.7	-0.1	-40.9
2/19/2020	3/23/2020	13.3	23.8	46.6	57.1	92.6
11/19/2021	5/24/2022	?	?	?	?	?
	Average	**3.6**	**7.7**	**17.0**	**21.5**	**22.4**
	Median	**2.4**	**7.5**	**11.2**	**20.5**	**32.1**
	% Positive	**50**	**67**	**83**	**67**	**67**
	All Periods					
	Average	**0.2**	**1.0**	**3.0**	**6.2**	**12.8**
	Median	**0.4**	**1.4**	**3.5**	**6.7**	**14.4**
	% Positive	**58**	**61**	**65**	**70**	**76**

Follow-ups

Wall Street has been filled with some of our country's very Brightest throughout its history. Perhaps it shouldn't be a surprise that some of them can be very creative in how to separate investors from their savings. What follows is literally a litany of every "investment", using that term very, very loosely in most cases, that we have been repeatedly warning against.

Two from WP:

They spent a fortune on pictures of apes and cats. Do they regret it?

The market for digital collectibles is in flux, leading investors to consider what the artwork is really worth

By Pranshu Verma
May 25, 2022

A non-fungible token called "Celestial Cyber Dimension," created by CryptoKitties, was purchased by Nate Hart for $600,000. (CryptoKitties)

For years, Nate Hart admired a drawing of a cat: It was gray, with unusually large eyes, and pictured on a shattered, smoldering tablet. So last September, when the owner signaled they were willing to sell, Hart swooped in and offered a hefty sum: $600,000.

The price didn't faze him because of a special detail: The cartoon, part of collection of cat images called CryptoKitties, is a non-fungible token, or NFT. NFTs are like Internet land deeds, letting owners lay claim to digital art, music and photographs. By certifying the asset on a digital ledger, called the blockchain, NFTs have transformed online art, turning images into coveted assets that can be owned and that presumably rise in value.

Around the time of his purchase, the market for NFTs was red-hot. Celebrities minted their own, Adidas partnered with prominent collectors, and Hart was part of a throng paying thousands — and in some cases millions — to scoop up their own digital art.

People paid eye-popping numbers: $69 million for a JPEG file by the digital artist Beeple; $10.5 million for a pixelated image that resembled the Joker character in Batman; and $5.4 million for a token of Edward Snowden's face made out of court documents.

But with the crypto market cratering by $500 billion in recent weeks, the hype over NFTs has cooled. And while Hart, who goes by NateAlex on Twitter and is a cryptocurrency investor, is unlikely to sell, he knows that if he puts it on the market today, it would probably sell low. His cat picture isn't from a sought-after collection, he said, like the colorful apes known as the Bored Ape Yacht Club or the pixelated people known as CryptoPunks.

"It's more wait-and-see," he said. "If it becomes a historical artifact, then it's going to be extremely valuable. If that doesn't happen, then maybe it just fades away into where nobody knows or ever cares about it."

Hart isn't alone. A host of collectors have shelled out small fortunes in recent months for digital assets whose worth is now in limbo.

An NFT of Twitter founder Jack Dorsey's first tweet, purchased last year by an Iranian crypto investor for $2.9 million, was put up for auction in April, with bids topping out at $280. A token of a pixelated man with sunglasses and hat that sold for roughly $1 million seven months ago brought just $138,000 on May 8. A digital token of an ape with a red hat, sleeveless T-shirt and multicolored grin — part of the popular Bored Ape Yacht Club — purchased for over $520,000 on April 30, was sold for roughly half that price 10 days later.

Over the past three years, NFTs have generated significant excitement because proponents say they solve tricky problems. Digital images, once viewed as worthless because they could be easily copied, could now be owned and assigned monetary value. Collectible artworks, long seen as exclusive to high society, could now exist on decentralized, community-run networks, making them more appealing to a new generation.

But such high hopes have been punctured by bad actors targeting the industry with scams. In March, North Korean hackers stole more than $600 million from the NFT gaming company Axie Infinity, where tokens are used to gain entry into the game and purchase add-ons. In April, the Bored Ape Yacht Club reported that hackers cracked into their Instagram account, stealing $2.8 million worth of NFTs.

Recently, high-profile hiccups have also deflated investors. In late April, the company behind the Bored Ape Yacht Club, Yuga Labs, auctioned off millions in tokens offering land in a metaverse project they started. Its popularity caused the digital ledger it was being transacted on to nearly shut down. Trading volume also caused transaction fees to rise higher than the actual NFT price in some cases, news reports indicate.

"I think of NFTs as pure froth," said Peter M. Garber, an economist and author of "Famous First Bubbles: The Fundamentals of Early Manias." "It is more of a pump-and-dump, Wolf-of-Wall-Street operation than anything else."

The market for NFTs blossomed in 2021, with investors spending roughly $40 billion on tokens, up from $106 million in 2020, data from crypto intelligence firm Chainalysis found. This year, NFTs have generated roughly $37 billion in sales as of May, data shows.

While that puts sales on pace to surpass last year's, a few notable companies may be driving a large part of the growth, experts noted.

Transactions since last summer have come in "fits and starts," according to a report from Chainalysis, with two spikes probably driving most activity: The late-August release of digital tokens from the Mutant Ape Yacht Club, a different collection of images of apes with colorful disfigurations, and a period between January to early February this year were probably driven by the launch of a new NFT marketplace, LooksRare.

Since then, transactions have declined significantly, the report found, dropping from $3.9 billion the week of Feb. 13 to $964 million the week of March 13, with increases recently coming from the Bored Ape Yacht Club's project to sell land in the metaverse, which garnered $320 million in sales over two weeks ago.

Ethan McMahon, an economist for Chainalysis, said this indicates that the NFT market is starting to consolidate, with few companies holding a growing market share. NFTs generated by lesser-known companies and without celebrity appeal are beginning to lose traction. Those generated by high-end collections — known as blue chips — such as the Bored Ape Yacht Club and CryptoPunks, will probably retain value with their mass appeal, financial backing, partnerships with mainstream brands like Adidas and collaborations with celebrities.

"Things are changing," he said. "[What] we have been seeing is consolidation in the more well-known blue chip collections of NFTs."

In recent days, multiple crypto experts have also noted that the precipitous drop in cryptocurrency has caused the market for high-end NFTs — ones that sell for thousands or even millions — to stall. Fewer bitcoin millionaires, they said, means less spending on luxury purchases like high-priced NFTs.

David Hsiao, the chief executive of the crypto magazine Block Journal, said he sold off his entire NFT collection over two weeks ago for a profit of around $165,000. That included his prized picture of an ape with a lazy stare, glasses, collared shirt and green vest — part of the Bored Ape Yacht Club collection — that he had purchased for roughly $210,000 in October. He said the market for digital assets looks bleak in the days ahead, and he wanted to limit the damage by selling now.

Hsiao added that he expects the NFT market to suffer because of the declining price of cryptocurrency, along with other conditions like inflation, the prospect of rising interest rates, the pandemic and Russia's war in Ukraine. After selling his NFTs, he converted his proceeds to USD Coin, a cryptocurrency pegged to the U.S. dollar.

"If we enter a real recession, NFTs are going to be the first to go," he said. "People aren't going to value art, especially such a new age of digital art, when there's a lot more problems in the world."

Some industries, like video games and the high-end art market, find NFTs useful and likely to retain value.

Noah Davis, who leads NFT work at Christie's, said the auction house will sell the digital assets for a long time. It plans to hold shows biannually in New York, London and Hong Kong where it will sell tokens of artwork, and it is also partnering with OpenSea, an NFT marketplace.

NFTs solve an essential problem, Davis said, in that they "give currency to ephemeral goods in an era where people are tending to favor virtual life," but he agrees there are people who will lose lots of money by making bad investments.

“This is an especially democratic and open marketplace and definitely is affected by hype and FOMO,” he said, using the acronym for “fear of missing out.” “And people make bad decisions in every single market.”

Deepak Thapliyal, the chief executive of the cryptocurrency company Chain, who purchased a rare NFT of a pixelated alien in February for $23.7 million, isn’t afraid. “My decision to purchase a rare Alien Crypto Punk remains the same as it is today,” he said in a statement to The Washington Post. “It is a rare piece of digital art which will have a lifetime of value to the beholder.”

Meanwhile, Frank Chaparro, an NFT collector who works for the crypto news firm The Block, said he has paid more than $20,000 for his collection of NFTs, which includes tokens like Froyo Kittens, which are images of cats in bowls.

Nowadays, they probably have very little value, he said. But Chaparro added that he isn’t worried because what drove him to purchase these NFTs wasn’t a desire to make money, but an attraction to the characteristics of the image and the community they created.

“Does it hurt? Of course,” Chaparro said. “You want what you have to go up, but think about all the things you enjoy having that really don’t have value but they say something about yourself.”

Pranshu Verma is a reporter on The Washington Post's technology team. Before joining The Post in 2022, he covered technology at the Boston Globe. Before that, he was a reporting fellow at the New York Times and the Philadelphia Inquirer

Crypto is a solution in search of a problem

By Adam Lashinsky

May 20, 2022

Adam Lashinsky is the former executive editor of Fortune magazine, where he covered Silicon Valley and Wall Street for two decades.

Inflation keeps rising, stocks keep falling, a war rages in Europe, and the budding market for cryptocurrencies and other digital confections is vaporizing by the day. None of this is cause for joy. But the crypto implosion at least has a cleansing benefit: It offers an opportunity to mop up a speculative and overhyped mess that has gotten badly out of control, snookering gullible investors in the process.

Signs of carnage are everywhere. The price of bitcoin, the pioneering, 13-year-old cryptocurrency, is down 50 percent in six months. The values of other exotically named digital tokens such as solana, ethereum, XRP and dogecoin (begun as a joke and increasingly behaving like one) have fallen by similar percentages.

A “stablecoin” called terraUSD, which was supposed to be pegged to the U.S. dollar to facilitate predictable exchanges, collapsed. Non-fungible tokens, which are tradable renderings of digital objects, have lost their luster. The collector who paid $2.9 million for Twitter co-founder Jack Dorsey’s first tweet reportedly chose not to sell it when the best he could fetch was $14,000.

This all is as painful to enthusiasts as it is confusing for the uninitiated. So, let me explain why the bloodbath, while inevitable, could lead to something better.

Various forms of cryptocurrencies were dreamed up by a medley of venture capitalists, software coders and entrepreneurs in the past decade to constitute an alternative system for finance and other digital transactions. The thinking was that the global financial system is creaky and controlled by sclerotic governments. A new system based on a decentralized accounting technology called blockchain would democratize the worldwide exchange of goods and services.

That's the vision, anyway.

In practice, crypto adherents have struggled to say exactly what their creation is or, more importantly, what it's good for. Cryptocurrencies aren't actual currencies because nearly no one uses them to pay for anything. (Pornography and criminal activity are notable exceptions.) Even Coinbase, a large crypto exchange, charges customers in dollars to trade on its platform. Cryptocurrencies also aren't securities, like stocks and bonds, though regulators are considering declaring them so in the name of protecting investors.

Crypto enthusiasts predicted (okay, maybe hoped) their creations would behave like commodities, particularly gold, as a store of value. But the recent swoon in crypto prices in the face of rising inflation has punctured these dreams. Instead, speculative bets on unproven cryptocurrencies have gone bad alongside other failing wagers.

Warren Buffett got it right recently when he called bitcoin and its ilk unproductive assets. They go up when people pay more for them and down when people pay less. But they have no value unto themselves.

All this search for meaning would be good and fine if not for all those who have lost real money investing in the imaginary kind. You can draw a straight line from the dot-com bubble of the late 1990s to the subprime mortgage debacle a decade later to today's crypto fad. Each involved the kernel of a good idea that was then puffed up by hucksters, charlatans and other confidence men and women, convincing average consumers they were investing rather than speculating. The high-water mark of this era might prove to be the announcement last month by the staid Fidelity Investments that it would give employers the option to allow employees to allocate a portion of their retirement plans to bitcoin.

Given the carnage, I would not be surprised to see Fidelity slow-walk its plans as few companies take the bait.

Crypto cheerleaders predictably call this a blip — and one they have seen before. The Silicon Valley investment firm Andreessen Horowitz, for instance, issued a report last week that unironically referred to the downturn as one in a series of "price-innovation" cycles.

But there are real losers here, egged on by celebrities and public figures, such as New York Mayor Eric Adams (D), who, in the name of promoting his city as a "fintech" capital, vowed to convert his first three paychecks into bitcoin and ethereum. Matt Damon, Gwyneth Paltrow and LeBron James are just a few of the A-listers who have shilled for various crypto offerings. A friend of mine decided last year to invest $1,000 in a basket of crypto so he could see what all the fuss was about. It's worth $280 today.

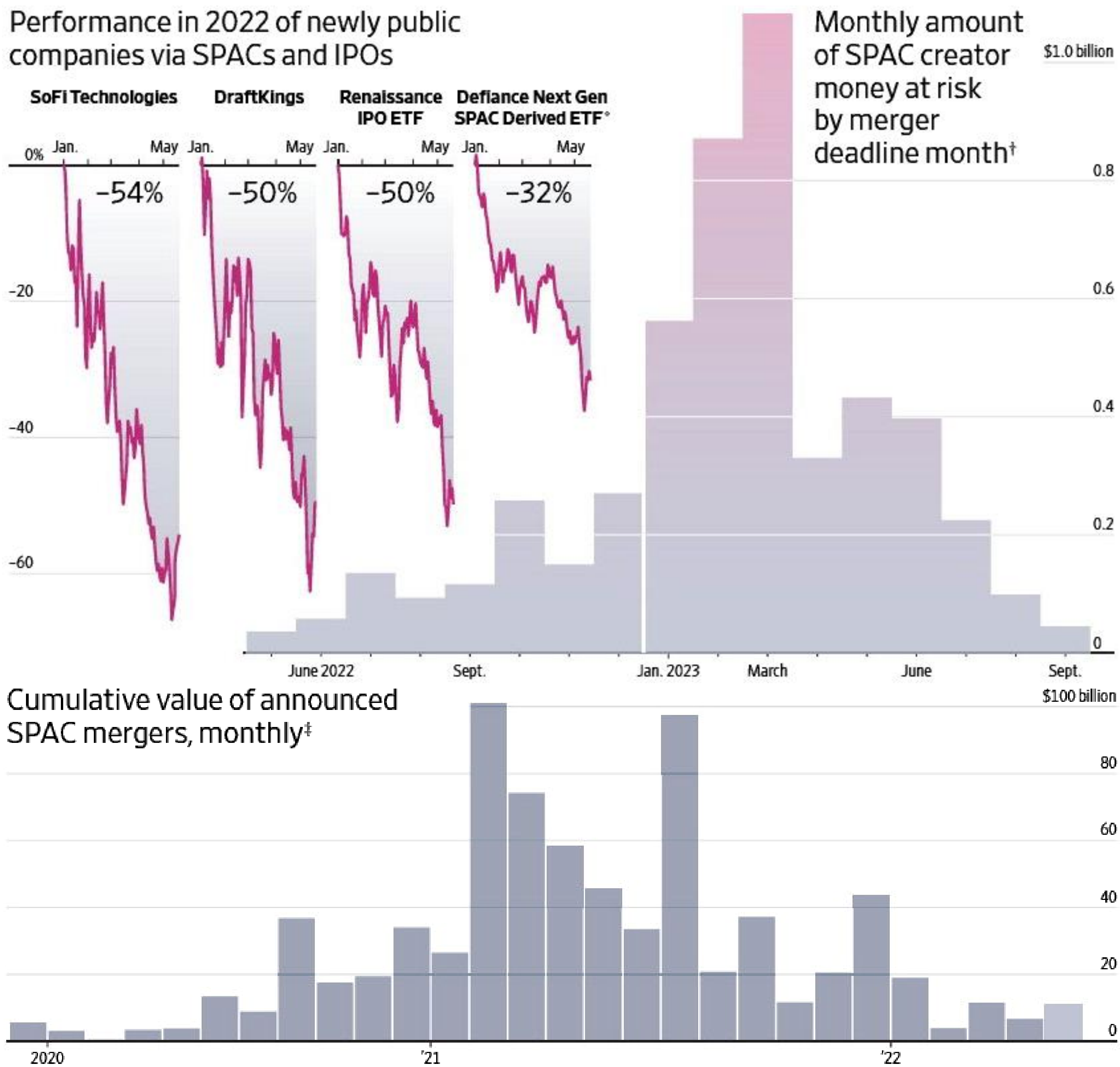
As with the aftermaths of other financial bust-ups, something good likely will emerge from the great crypto meltdown. Legitimately beneficial products, firmly regulated by governments, undoubtedly will emerge that will make someone a fortune and improve people's everyday lives.

Until then, crypto remains a solution in search of a problem.

From May 19th's WSJ:

Stock Selloff Hits SPAC Creators

BY AMRITH RAMKUMAR



*Includes some pre-merger SPACs †Figures are estimates from early May; SPAC creators can pay to extend deadlines ‡Latest figure through Tuesday
Sources: FactSet (performance); Methuselah Advisors analysis of SPAC Research data (SPAC creator money); Dealogic (announced SPAC mergers)

An investor stampede out of risky trades is squeezing SPACs that are running out of time to find companies to take public, potentially leaving their architects without deals and saddled with sizable losses.

Companies that have gone public through mergers with special-purpose acquisition companies have tumbled lately alongside the technology sector and cryptocurrencies. Supply-chain disruptions and technological setbacks have hurt many startups, combining with worries about high inflation and rising interest rates.

An exchange-traded fund tracking companies that have merged with SPACs is down about 30% for the year, a much sharper drop than the broader market. Some previously popular stocks such as sports-betting firm **DraftKings** and personal-finance startup **SoFi Technologies** have slid 50% or more. ...

Those declines have slowed the creation of new SPACs and the pace of deals to a fraction of last year's record levels. They have also prompted some companies that had previously agreed to go public through SPACs ... to call off the deals and attempt to raise money privately instead. The slowdown mirrors weakness in the broader market for initial public offerings, which is off to its weakest start in years after 2021's bonanza.

A unique element of the SPAC market is that shell companies' creators typically have two years to find a company to take public, otherwise they must return money to investors and forfeit the $5 million to $10 million on average that they pay to set up the blank-check firms through lawyers and auditors and evaluate mergers.

Because so many SPACs raised money during the frenzy early last year, roughly 280 face deadlines in the first quarter of 2023, figures from data provider SPAC Research show. If the current pace of SPAC deal making continues, analysts estimate that a large percentage of those blank-check firms won't find mergers. The merger window for many SPACs is closing because it often takes months to find a deal and many companies that previously might have considered such mergers are now electing to stay private, bankers say.

Creators of those SPACs and other insiders together are now expected by early next year to lose $1 billion or more—money known as "at-risk capital" that they have already spent setting up the SPACs and can never get back. If the creators do strike deals, they stand to make several times their money on paper because of how those deals are structured. ...

Some investors expect many SPACs to pursue low-quality companies to take public at improper valuations to stave off possible losses. They say that possibility shows the incentive problems inherent in such deals. Even with that expected push, analysts say many SPACs won't find mergers because there simply aren't enough companies that will want to complete SPAC deals in time.

Analysts say the expected losses are a distinctive aspect of the current stock-market selloff because there is no way to recover the money for SPAC creators who can't find deals. Never before have more than 600 shell firms raised money with such a limited time to put it to work.

The recent market collapse is already triggering some SPAC liquidations and throwing a wrench in deal negotiations, bankers say. It also comes as federal regulators are tightening rules on how blank-check companies make disclosures and business projections when taking companies public.

About 90% of the companies that completed SPAC mergers during the boom that started in 2020 now trade below the SPAC's initial listing price, according to SPAC Research. A SPAC is a shell company that raises money from outside investors and trades on a stock exchange with the sole intent of merging with a private company to take public. It typically has two years to do a deal or it must return the money to investors and forfeit the money its creators put in to set it up.

Hundreds of SPAC creators from former business executives to celebrity athletes dove into the market at its peak, hoping to benefit from the lucrative incentives that come with consummating a deal.

Creators can pay to extend their deadlines, particularly when they are in talks with a company to take public or have announced but not closed a merger. But observers say it will be challenging for so many SPACs to bring companies public given current market conditions. ...

Three from the NYT:

Tech's Reckoning Is Upon Us

May 12, 2022

By Kara Swisher

Inflation? Rising interest rates? The lingering pandemic? The Russia-Ukraine conflict?

All of the above explain the tech stock dive. After the very good times in 2021, the reckoning for tech valuations, as well as start-up funding by venture capitalists and cryptocurrency, is officially here, with all plunging into the Mariana Trench of finance. The only question is whether it is 2001 (the Web 1.0 crash) or 2008 (the Web 2.0 crash) or some new web3 crash.

The canary in the coal mine is how those typically sunny venture capitalists' Twitter accounts have flipped to earnest talk of "market corrections" and "company right-sizing."

Most of the big company stocks have been in the tank, with even solid businesses suffering over the past month — Apple is down about 15 percent; Alphabet over 12 percent; Airbnb close to 28 percent. Weaker ones have seen a more precipitous decline; Netflix stock has lost half its value since mid-April.

Oddly, the one staying relatively stable now is Twitter, which spent years being lapped by other Silicon Valley firms. No doubt it's being propped up by the $44 billion takeover bid by Elon Musk — and yet even that acquisition is in doubt now since the collateral for the purchase rests with his fortune at Tesla. Like its peers, Tesla's bottoming out, its stock having dropped nearly 30 percent in the past month.

That might make the $1 billion walkaway fee much more attractive to Musk, who could come back when Twitter inevitably craters post-breakup. In the starkest of terms, he should not pay $54.20 a share for the troubled company (it was trading around $45 a share on Thursday), no matter how much he likes to troll.

Oh, but that is not all in the techopalypse.

As The New York Times noted: "The number of people and groups trying to unload their start-up shares doubled in the first three months of the year from late last year," citing Phil Haslett of EquityZen, which helps private companies and their employees sell their stock. Share prices of some unicorn start-ups have fallen as much as 44 percent in recent months, The Times wrote. "It's the first sustained pullback in the market that people have seen in legitimately 10 years," said Haslett.

That has also been accompanied by a significant drop in venture funding due to a fast fading I.P.O. market.

And what about cryptocurrencies, which were booming after a slide last summer? Bitcoin, the most stable, rose to around $68,000 last November, but has fallen off a cliff to just above $28,600 today. The crypto trading platform Coinbase is another big loser, down over 60 percent in the past month. Meme stock catchphrase HODL ("hold on for dear life") might actually cost you your life, your financial one at least.

As tech's gloomiest venture capitalist, Bill Gurley, who is frequently right and never in doubt, wrote in April on Twitter: "An entire generation of entrepreneurs and tech investors built their entire perspectives on valuation during the second half of a 13-year amazing bull market run. The 'unlearning' process could be painful, surprising and unsettling to many. I anticipate denial."

And he also noted: "Revenue & earnings quality matter."

He's wrong on that last point — at this moment, nothing matters, so it might be a good idea to sit very quietly and think hard about the growth-at-any-cost mantra that has illuminated tech for the past 13 years. No less than the chief executive of the size-obsessed Uber, which Gurley financed, was out this week preaching restraint. "We have to make sure our unit economics work before we go big," said Dara Khosrowshahi in a note to his employees. "We will be even more hard-core about costs across the board."

As it turns out, there is always a cost.

Bitcoin Is Increasingly Acting Like Just Another Tech Stock

The cryptocurrency's plunging value has mirrored losses in the Nasdaq, a benchmark that's weighted toward tech stocks.

By David Yaffe-Bellany

May 11, 2022

SAN FRANCISCO — Bitcoin was conceived more than a decade ago as "digital gold," a long-term store of value that would resist broader economic trends and provide a hedge against inflation.

But Bitcoin's crashing price over the last month shows that vision is a long way from reality. Instead, traders are increasingly treating the cryptocurrency like just another speculative tech investment.

Since the start of this year, Bitcoin's price movement has closely mirrored that of the Nasdaq, a benchmark that's heavily weighted toward technology stocks, according to an analysis by the data firm Arcane Research. That means that as Bitcoin's price dropped more than 25 percent over the last month, to under $28,000 on Thursday — less than half its November peak — the plunge came in near lock step with a broader collapse of tech stocks as investors grappled with higher interest rates and the war in Ukraine.

The growing correlation helps explain why those who bought the cryptocurrency last year, hoping it would grow more valuable, have seen their investment crater. And while Bitcoin has always been volatile, its increasing resemblance to risky tech stocks starkly shows that its promise as a transformative asset remains unfulfilled.

"It delegitimizes the argument that Bitcoin is like gold," said Vetle Lunde, an analyst for Arcane. "Evidence points in favor of Bitcoin just being a risk asset."

Arcane Research assigned a numeric score between 1 and -1 to capture the pricing correlation between Bitcoin and the Nasdaq. A score of 1 indicated an exact correlation, meaning the prices moved in tandem, and a score of -1 represented an exact divergence.

Since Jan. 1, the 30-day average of the Bitcoin-Nasdaq score has approached 1, reaching 0.82 this week, the closest it had ever been to an exact, one-to-one correlation. At the same time, Bitcoin's price movement has diverged from fluctuations in the price of gold, the asset to which it has been most often compared.

The convergence with the Nasdaq has grown over the course of the coronavirus pandemic, driven partly by institutional investors like hedge funds, endowments and family offices that have poured money into the cryptocurrency market.

Unlike the idealists who drove the initial enthusiasm for Bitcoin in the 2010s, these professional traders are treating the cryptocurrency as part of a larger portfolio of high-risk, high-reward tech investments. Some of them are under pressure to secure short-term returns for clients and are less ideologically committed to Bitcoin's long-term potential. And when they lose faith in the tech industry more broadly, that affects their Bitcoin trades.

"Five years ago, people who were in crypto were crypto people," said Mike Boroughs, a founder of the blockchain investment fund Fortis Digital. "Now you've got guys who are across the whole span of risk assets. So when they're getting hit over there, it's impacting their psychology."

Worries in the stock market — affected by challenging economic trends, including Russia's invasion of Ukraine and the historic levels of inflation — have particularly manifested themselves in falling tech stocks this year. Meta, the company formerly known as Facebook, is down more than 40 percent this year. Netflix has lost 70 percent of its value.

On Wednesday, shares of Coinbase, the cryptocurrency exchange, plummeted 26 percent after it reported declining revenue and a loss of $430 million in the first quarter. The company's stock has fallen more than 75 percent overall this year.

The Nasdaq is already in bear-market territory, having ended Wednesday down 29 percent from its mid-November record. November was also when Bitcoin's price hit a peak of nearly $70,000. The crash has been a reality check for Bitcoin evangelists.

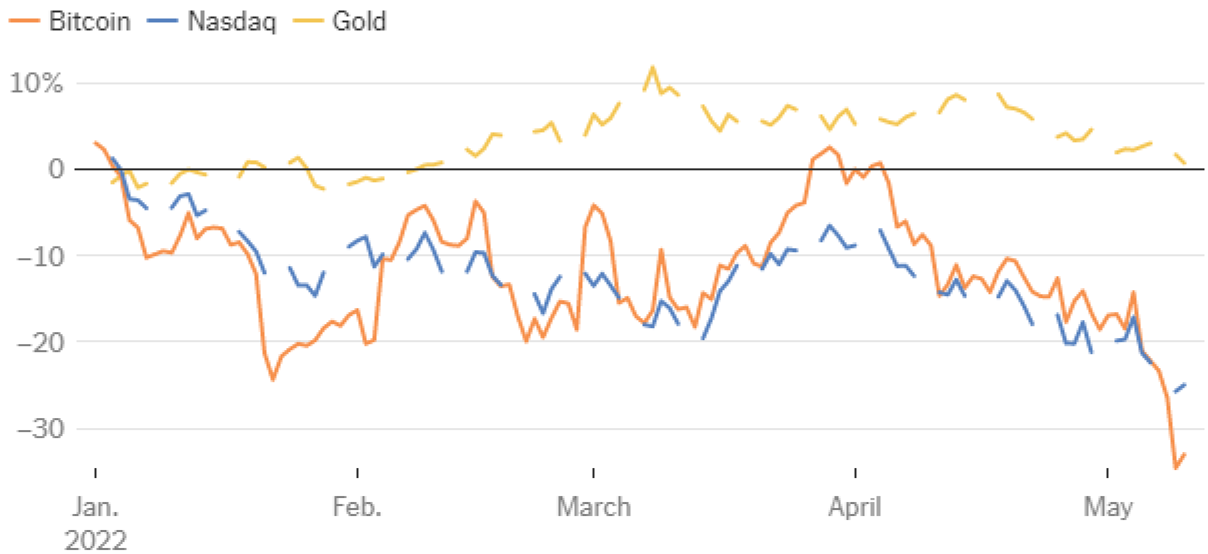
"There was this undeniable retail belief that Bitcoin at the end of last year was an inflation hedge — it was a safe haven, it was going to replace the dollar," said Ed Moya, a cryptocurrency analyst at the trading company OANDA. "And what happened was inflation started to become very ugly, and Bitcoin lost half of its value."

The prices of other cryptocurrencies have also been crushed. The price of Ether, the second-most-valuable cryptocurrency, has dropped about 25 percent just since early April, to under $2,300. Others, like Solana and Cardano, have also experienced precipitous drops this year.

Bitcoin has rebounded from major losses before, and its long-term growth remains impressive. Before the pandemic boom in crypto prices, its value hovered well below $10,000. True believers, who call themselves Bitcoin maximalists, remain adamant that the cryptocurrency will eventually break from its correlation with risk assets.

Bitcoin acts more like a tech stock and less like gold.

Year-to-date change in the dollar price of gold and Bitcoin and in the Nasdaq composite index



Values for Bitcoin, which trades every day, are based on the latest value of the day in Coordinated Universal Time. Nasdaq and gold markets generally are open Monday through Friday. • Source: CoinMarketCap and FactSet • By The New York Times

Michael Saylor, the chief executive of the business-intelligence company MicroStrategy, has spent billions of his firm's money on Bitcoin, building up a stockpile of more than 125,000 coins. As the price of Bitcoin has cratered, the company's stock has dropped roughly 75 percent since November.

In an email, Mr. Saylor blamed the crash on "traders and technocrats" who don't appreciate Bitcoin's long-term potential to transform the global financial system.

"In the near term, the market will be dominated by those with less appreciation of the virtues of Bitcoin," he said. "Over the long term, the maximalists will be proven correct, because billions of people need this solution, and awareness is spreading to millions more each month."

What Is Happening to the People Falling for Crypto and NFTs

May 5, 2022

By Farhad Manjoo

To understand the latest incarnation of the colossal crypto grifts that continue to engulf the internet, I suppose we should start with all those bored apes, because how could we not?

I don't mean real apes — little of what's in this column is about stuff you could call in any tangible sense "real." Instead I'm talking about the collection of digital art known as the Bored Apes Yacht Club. Created about a year ago by a quartet of mysterious, pseudonymous cryptocurrency enthusiasts, Bored Apes is a collection of thousands of "programmatically generated" hypercolor drawings of coolly disheveled primates, the kind you don't bring home to mama.

For reasons that don't seem much deeper than weird things happen online, bored apes have become a hot commodity in the market for nonfungible tokens, or NFTs. As of Thursday morning, the cheapest available Bored Ape NFT — a kind of digital certificate that grants its holder nebulous ownership of the ape illustration — was selling for the equivalent of about $340,000; last year, an NFT of a very rare Bored Ape, one of a small number with gold fur, sold at Sotheby's for $3.4 million.

Are you with me so far? People online are going ape for what are essentially primate Pokemons. You may be wondering what the apes do and why people are paying so much for legally uncertain claims to them, and how you ever got so old and out of touch. All good questions — but we're well past those now.

In the past year Yuga Labs, the well-funded start-up that makes Bored Apes, has embarked on a parade of new and even farther-out digital spinoffs of its simians. Its latest ventures have highlighted the head-scratching, money-burning, broken-casino vibe of what's being called the internet's next big thing. Cryptocurrencies, blockchains, NFTs and the constellation of hyped-up technologies known as "web3" have been celebrated as a way to liberate the internet from the tech giants who control it now. Instead what's happening with Bored Apes suggests they're doing the opposite: polluting the digital world in a thick haze of errors, swindles and expensive, largely unregulated financial speculation that ruins whatever scrap of trust still remains online.

The latest ape sale took place last weekend, and it was a disaster from top to bottom. Huge demand overloaded Ethereum, the open-source blockchain that hosts the Ether cryptocurrency and had been developed to be a more capable crypto system than Bitcoin. The technology's shortcomings led to thousands of people paying about $180 million collectively in transaction fees. Some appeared to pay more in fees than what they paid for the NFT. They were the lucky ones; some paid steep transaction fees only to see their ape purchases fail for unknown reasons. (Yuga said it has refunded money spent on failed transactions.) Still others suffered various hacking and phishing scams. Meanwhile Yuga, whose backers include some of Silicon Valley's biggest venture capital firms, generated at least $320 million in sales. Sales of what? Oh, plots of "land" in Otherside, a virtual world that might come out soon.

Of course, buyers participated in the sale willingly. You might find it hard to muster much sympathy for folks who paid huge sums to speculate on digital goods in an unbuilt corner of the metaverse. Play stupid games, win stupid prizes.

But Molly White, a software developer who runs Web 3 Is Going Just Great, a website and Twitter feed that documents the spectacular crashes happening seemingly every day in crypto, told me that a lot of people are getting suckered into being guinea pigs for a set of new technologies that are much less solid than boosters acknowledge.

"On the one hand we're seeing problem after problem after problem on a scale that has not been seen in most technologies," she told me. On the other hand, well-funded companies are running Super Bowl ads pushing crypto to the public, and big financial firms are gearing up to let people invest in digital currencies as part of their retirement funds. And much of this stuff is unregulated.

"There will only be a lot more damage as it continues," White said.

Web3's nominal aims are quite noble. The original internet boom of the late 1990s, what you might think of as web 1.0, was a time of great stock-market valuations that created a few enduring companies and a lot of dead dot-coms. The post-bust, web 2.0 era of mid- to late 2000s was marked by an explosion of new technologies and new companies — mobile devices, social networks, streaming services and a much more dynamic, interactive web. In the past decade, though, four companies — Google, Facebook, Amazon and Apple — emerged as the central gatekeepers of the internet and, in a larger sense, the tech industry.

Proponents of crypto and associated web3 innovations say these technologies can reverse the internet's monopolistic turn. They argue that by building the next generation of internet apps on blockchains — essentially public ledgers that can record monetary transactions and store data in a way that is decentralized, meaning not under the thumb of any tech giant — we can pull the rug out from under today's internet giants. Web3's boosters also point to a variety of other so-far-unrealized virtues. They say crypto will free us from large financial powers like Wall Street and the Federal Reserve, that it will allow people to send and receive money cheaply, or will bring millions of the world's "unbanked" into the modern financial system.

Honestly, I have long tried to keep an open mind to these claims, because I have been incredibly dismayed by the way a handful of firms have taken over an internet that I once thought of as a font of innovation. If there really is a new web that's going to solve all the problems of the old web, sign me up.

But the continual blowups should crater those expectations. At the same time that the Ethereum blockchain was getting crushed by last weekend's Bored Apes sale, another supposedly smart crypto network, Solana, was taken offline by bots — one of several full or partial outages it has experienced this year. Two other crypto ventures, Rari Capital and Saddle, were hit with attacks that led to a loss of a combined $90 million in Ether. Early last week, Deus Finance lost $13.4 million in the second attack in two months. I could go on — and on, and on.

There's also little of the decentralization that we're being promised. Many web3 companies are funded by the same people who built the web we're now trying to reform.

The main problem isn't that these technologies will become the basis for the future of the web. They are clearly not ready for that: As White put it, "If web3 can't handle 55,000 Bored Ape NFTs, how can it handle web-scale technology?"

But how many people have to lose their shirts before we realize that web3 isn't a solution to any of our problems?

Four from Morningstar:

How Low Can ARK Innovation Go?

Taking a broader perspective.

John Rekenthaler
May 23, 2022

Anchoring and Adjusting

Ask people when Charlemagne became emperor, while wondering aloud if the event occurred before A.D. 1200, and the reactions will be as follows. Those without a clue will respond with dates near 1200, while those who realize that Charlemagne was coronated before that time, but who do not remember when, will shave their estimates. Roughly, their median reply will be 1000.

Conduct the same exercise while mentioning A.D. 400 as the possible moment, and the responses will change. The uninformed will once more defer to the cue, thereby cutting their estimates by eight centuries. Meanwhile, those who vaguely know the answer will again alter the original suggestion, but this time by raising their estimates. Their median reply will be the year of the Lord 600, give or take.

Charlemagne's actual coronation took place in A.D. 800 (Not that I need remind *you* of that.) The educated parties overshoot the mark in the first exercise and undershoot it in the second. They err because they reason through anchoring and adjusting. That is, they begin with a benchmark, then make an adjustment. But such modifications are usually insufficient. The anchor proves too heavy.

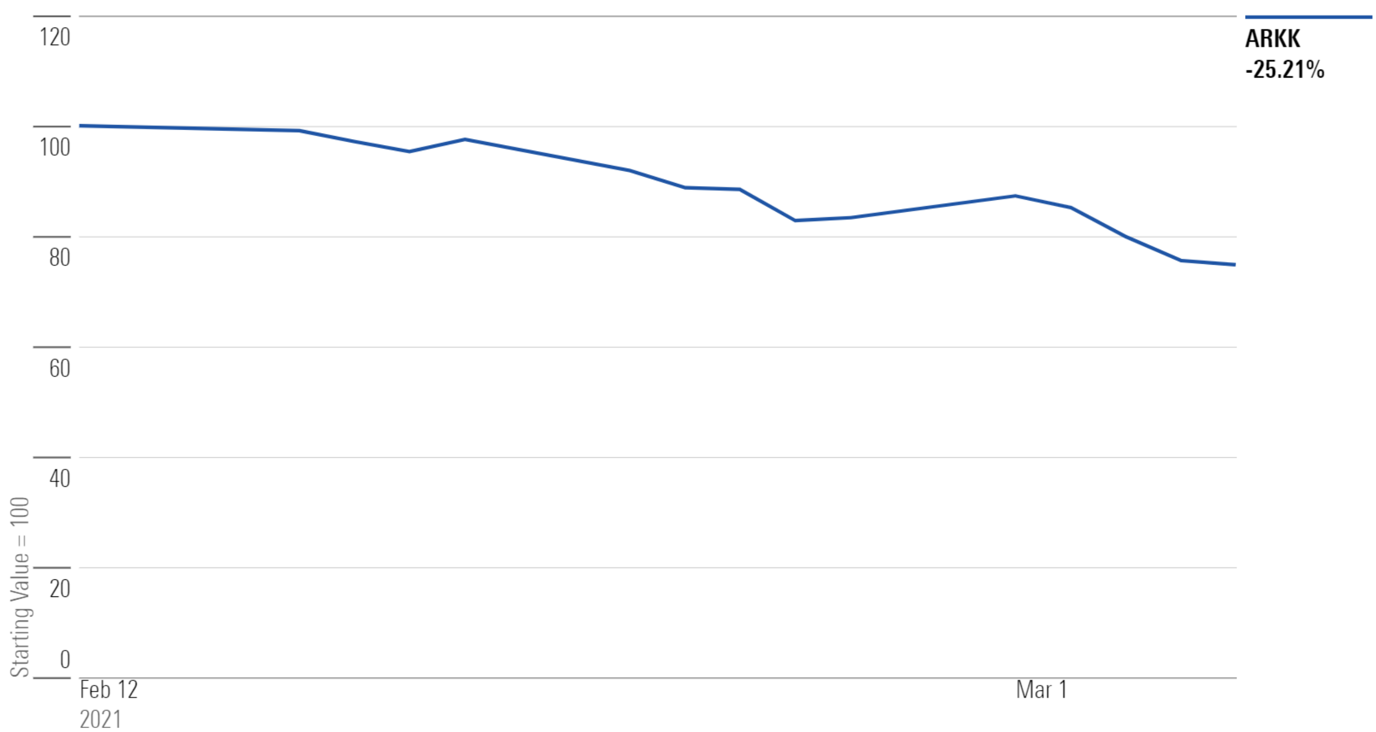
For Example

The reaction by both investors and observers to ARK Innovation's (ARKK) performance has provided a textbook case of anchoring and adjusting. Most have used the fund's high-water mark as their reference point. That is typically how people view investments—how far has it declined from its peak value? From that perspective, a large loss implies an upcoming rally. But such thinking comes from anchoring and adjusting, and may therefore be flawed.

On Feb. 12, 2021, ARK Innovation reached its high-water mark. The previous year had been breathtaking, with the fund notching a 156% total return. It looked to be on its way to repeating the feat in 2021, appreciating by another 26% during the year's first six weeks. However, ARK Innovation suddenly headed south, dropping 25%

The First 25% Loss

Ark Innovation ETF (Feb.12, 2021—March 5, 2021)



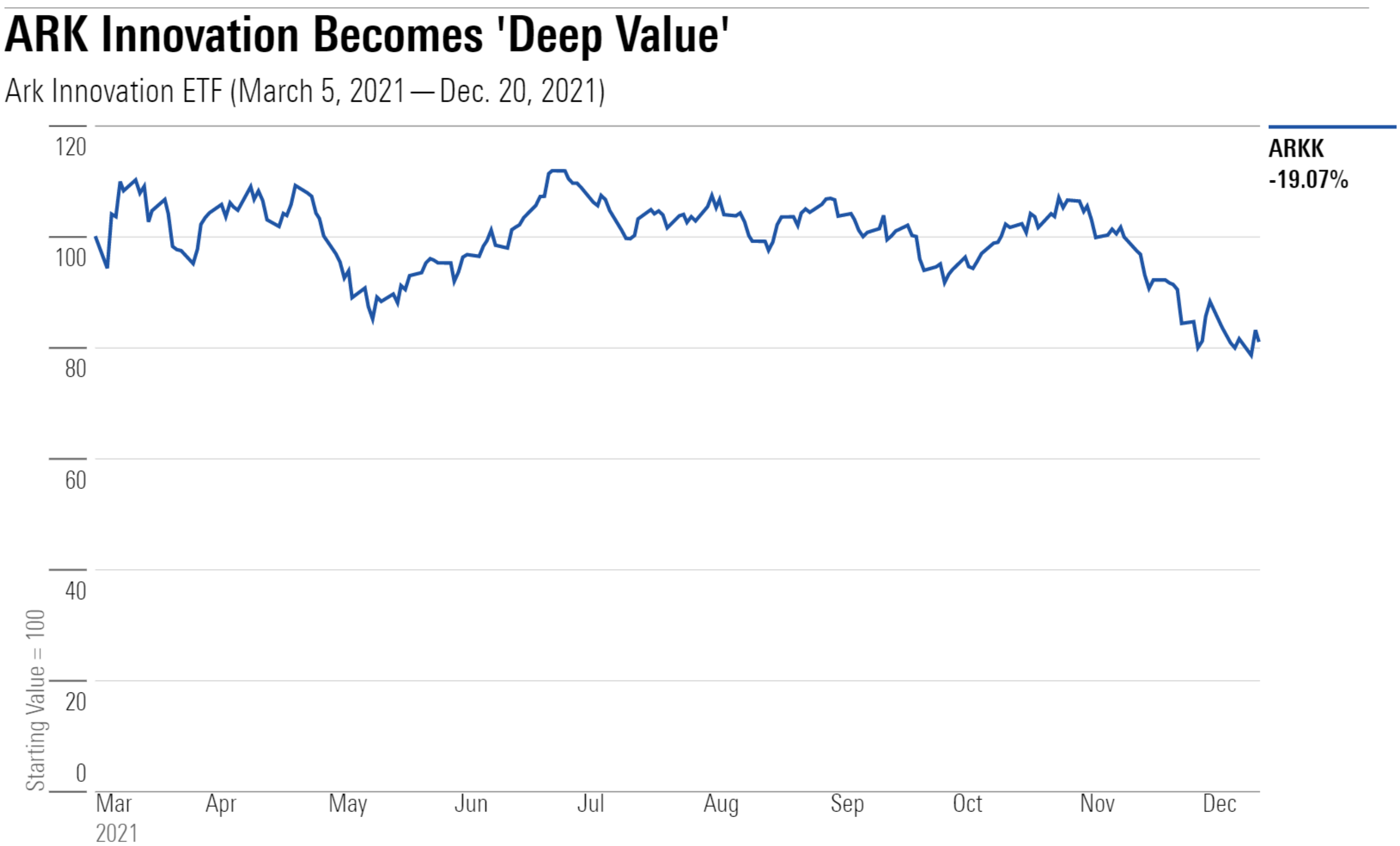
Source: Morningstar Direct. Data as of March 5, 2021.

in three weeks.

So far, so expected. Such things happen with risky securities; and manager Cathie Wood never maintained that ARK Innovation was anything but volatile. Nor did the fund's prospectus. Its discussion of "Principal Risks" occupies seven pages. One would blanch if a 2025 target-date fund were to abruptly shed one fourth of its assets. Not so for ARK Innovation.

A Value Fund?

After treading water, albeit vigorously, for the next eight months, the fund nosedived again. By Dec. 20, 2021, it had fallen an additional 19%. The decline prompted Wood to proclaim that the fund's stocks had become so cheap that they were in "deep-value territory." After all, ARK Innovation was down almost 40% from its February peak. Its holdings had thus become bargains.



Source: Morningstar Direct. Data as of Dec. 20, 2021.

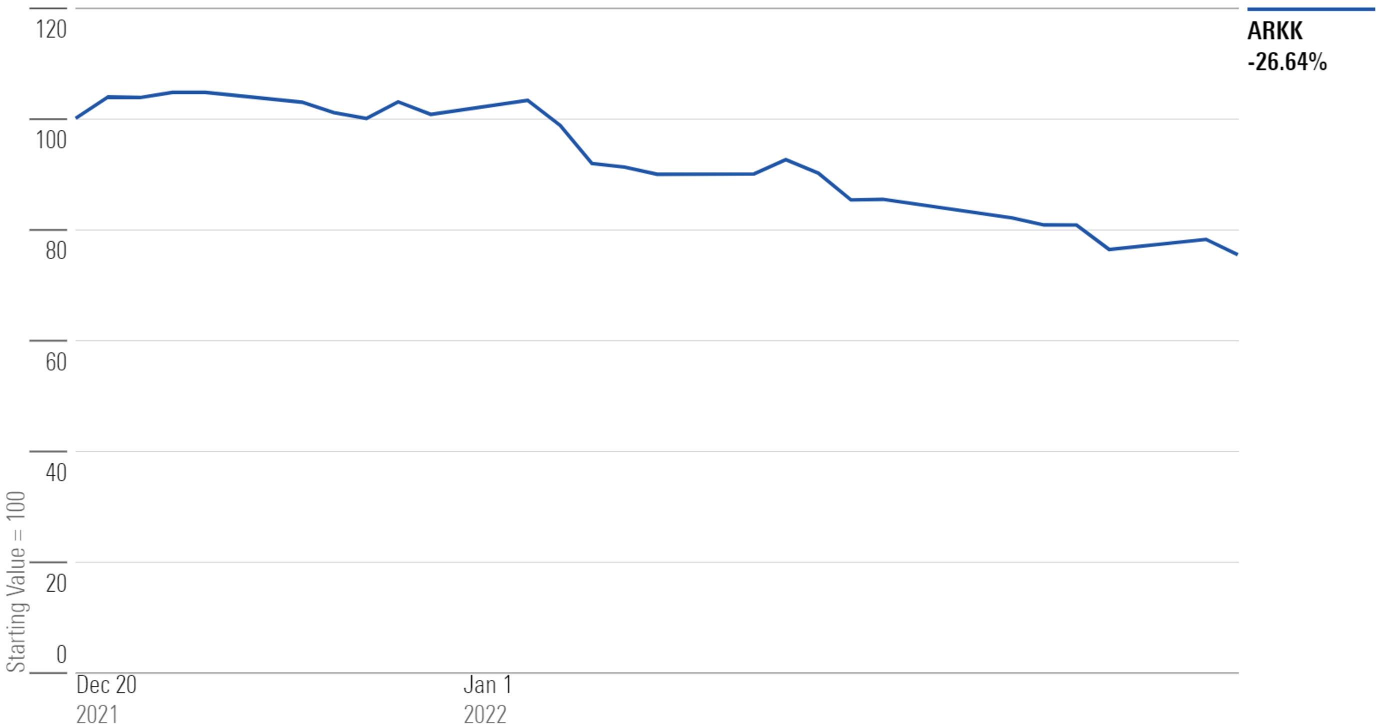
That would indeed have been the result if the stock market had anchored and adjusted. But equity prices do not necessarily act that way. They may for blue-chip firms. A company that earns steady profits is unlikely to lose more than half its stock market value, even when threatened by severe recession and/or steep inflation. However, businesses that sell mainly on promises, as with those in ARK Innovation's portfolio, trade differently. It is difficult to see their floors.

Rinse, Repeat

Following Wood's pronouncement, ARK Innovation promptly dropped again, by another 25%.

Another 25% Loss

Ark Innovation ETF (Dec. 20, 2021—Jan. 25, 2022)

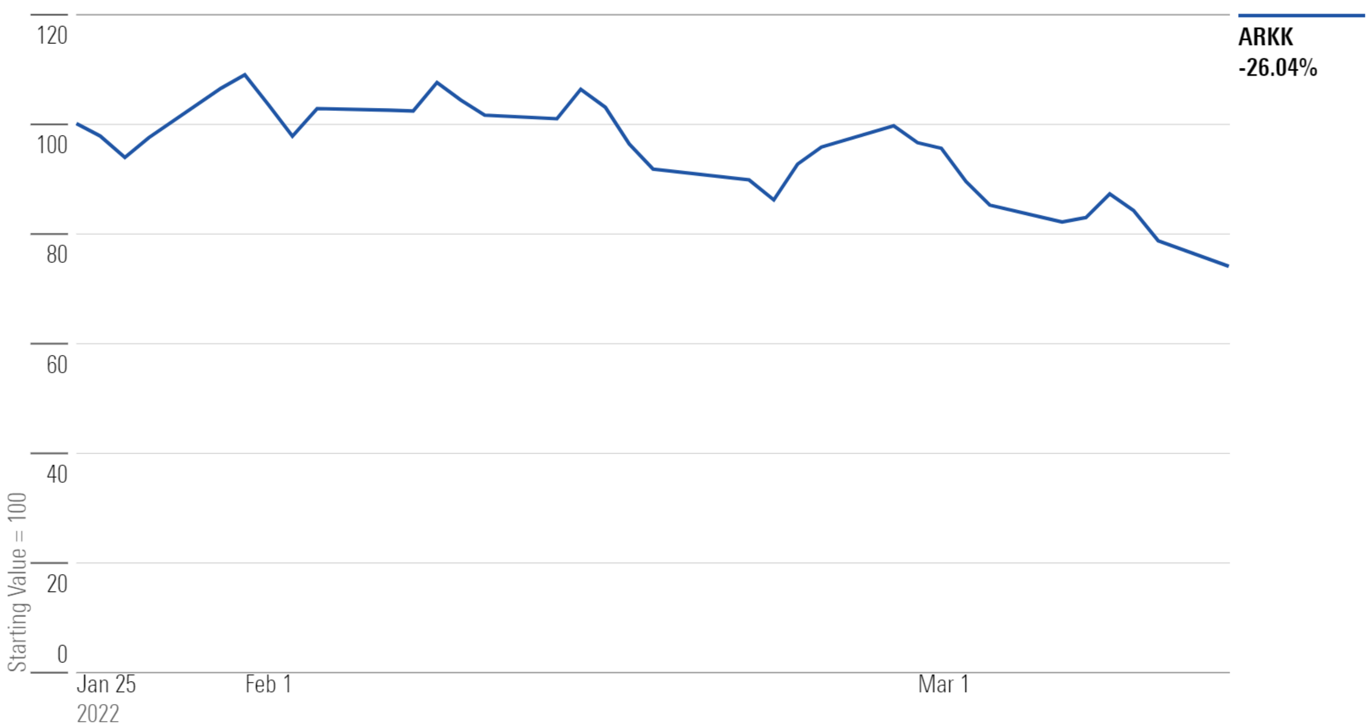


Source: Morningstar Direct. Data as of Jan. 25, 2022.

If ARK Innovation had previously been oversold, then surely that slide signaled a fire sale. On Jan. 26, 2022, the day after the above chart ends, *The Motley Fool* reported that Wood had been "bargain-hunting" by

And Another

Ark Innovation ETF (Jan. 25, 2022—March 14, 2022)



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

"doubling down in her conviction." A few days earlier, an article from InvestorPlace contended that ARK Innovation would rebound. It argued by anchoring and adjusting: Stocks "don't go down forever—and Cathie Wood's stocks have fallen too far, too fast."

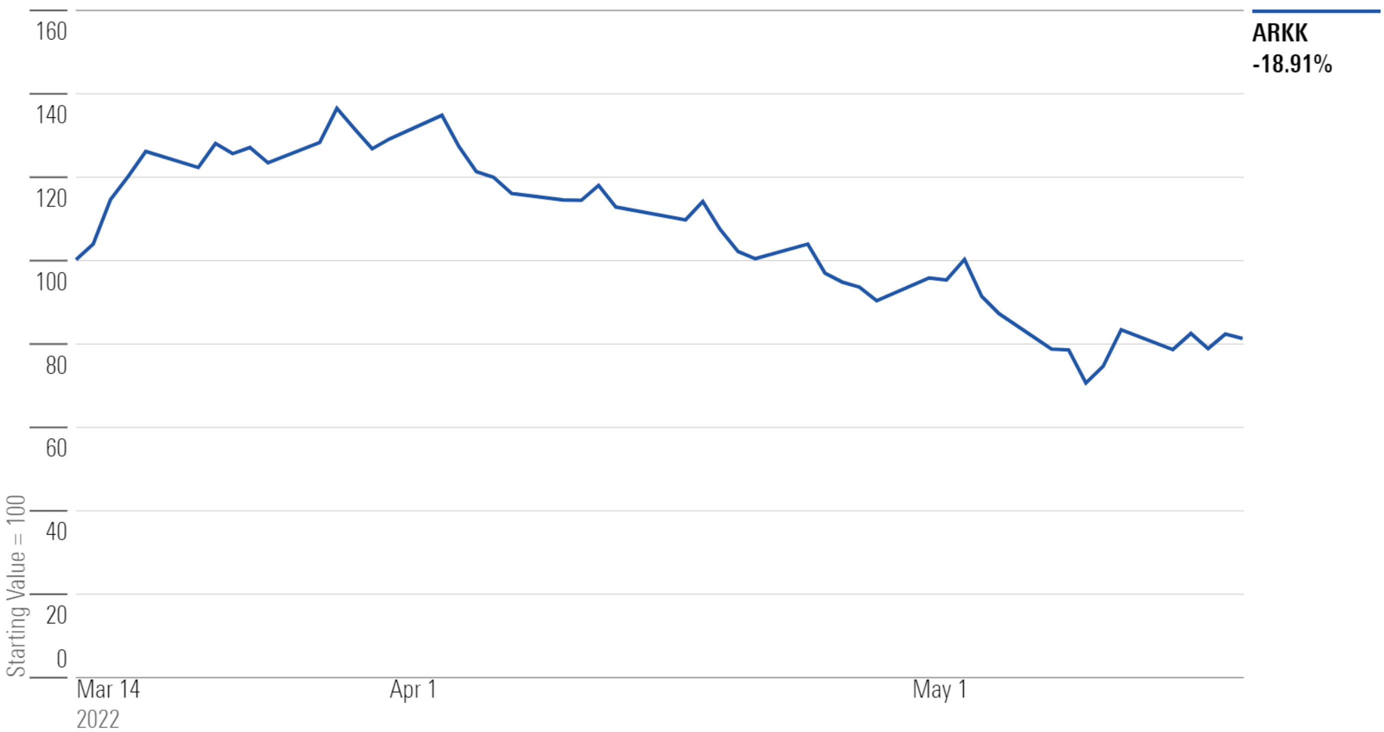
That may be, but by mid-March, ARK Innovation had shed an additional 25%. (In case you have lost track, that makes for three 25% declines, plus a 19% decrease.)

Another loss, another opportunity. On March 14—the very day that the above chart concludes—Reuters reported that, when questioned by an angry client who had "millions invested with her fund," she responded that the fund had become more attractive because of its lower valuation. When the conversation ended, the customer not only remained in the fund, but he committed additional monies.

Perhaps his faith will be rewarded. Since the date of that client's purchase, though, ARK Innovation has dropped another 19%.

Most Recently

Ark Innovation ETF (March 14, 2022—May 20, 2022)



Source: Morningstar Direct. Data as of May 20, 2022.

The Worst Case

Clearly, anchoring and adjusting has not adequately explained ARK Innovation's performance. To better understand the fund, investors must cease looking at the trees and instead view the forest. Forget what ARK Innovation was once worth, then adjusting one's assessment accordingly. That information is immaterial. What matters is how far such a fund might fall, if worse truly comes to worst.

That, of course, cannot be stated with certainty, both because history does not repeat precisely, and because ARK Innovation is so unusual. Few funds are as hazardous. However, during the new millennium, one fund was even more daring: Jacob Internet (JAMFX). It, too, invested in unproven fare—but those businesses were smaller than those held by ARK Innovation, even less profitable, and confined to a single industry. Wherever ARK Innovation's floor resides, it likely rests above that of Jacob Internet.

That is the good news for ARK Innovation's shareholders. The bad news is how Jacob Internet behaved after it was similarly pummeled. From March through November 2000, Jacob Internet lost 72.6%—the amount of ARK Innovation’s current cumulative decline. According to the precept of anchoring and adjusting, Jacob Internet had become a bargain. If you liked the fund at $1.00, surely you will love it at $0.27.

If anybody did, their adoration was misplaced. This is how Jacob Internet performed over the ensuing 10 months, following its initial 72.6% delcine:

Where Jacob Internet Then Went

Jacob Internet Fund (Nov. 16, 2000—Sept. 27, 2001)

Source: Morningstar Direct. Data as of Sept. 27, 2001.

In Conclusion

As stated, I do not believe that ARK Innovation is as risky as Jacob Internet was. Thus, I would be surprised if it were to suffer an additional 80%-plus loss, as Jacob Internet did after it was already deeply depressed. But I certainly would not be astonished by a further 40% decline.

This, mind you, is not a prediction: For all I know, ARK Innovation's recovery starts today. It is instead an attempt at setting a realistic possibility for the limits of the fund's performance. Because so far, the efforts have not been successful.

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.

Cryptocurrency Is Failing Its Investment Test

Why own an umbrella that does not block the rain?

John Rekenthaler
May 12, 2022

Bad Timing

Julius Caesar once suffered through a similar week, during mid-March, 44 B.C.

It has been just about that disastrous for cryptocurrency. Over the past several days, the "stablecoin" UST, designed to be worth one U.S. dollar, plunged to $0.26. (Some "currency" that!) The stock of cryptocurrency exchange Coinbase (COIN)--the National Basketball Association's exclusive crypto platform, should you care--shed more than half its value. And the price of the oldest cryptocurrency, bitcoin, dropped 30%.

The industry's struggles illustrate the logic behind the SEC's go-slow approach to cryptocurrency approvals. Although cryptocurrency vendors claim to have sorted through the details—UST was not called an "unstable coin," after all—they overstate what they know and can deliver. As with their customers, the industry's vendors are learning as they go. The field remains new, untested, and fickle.

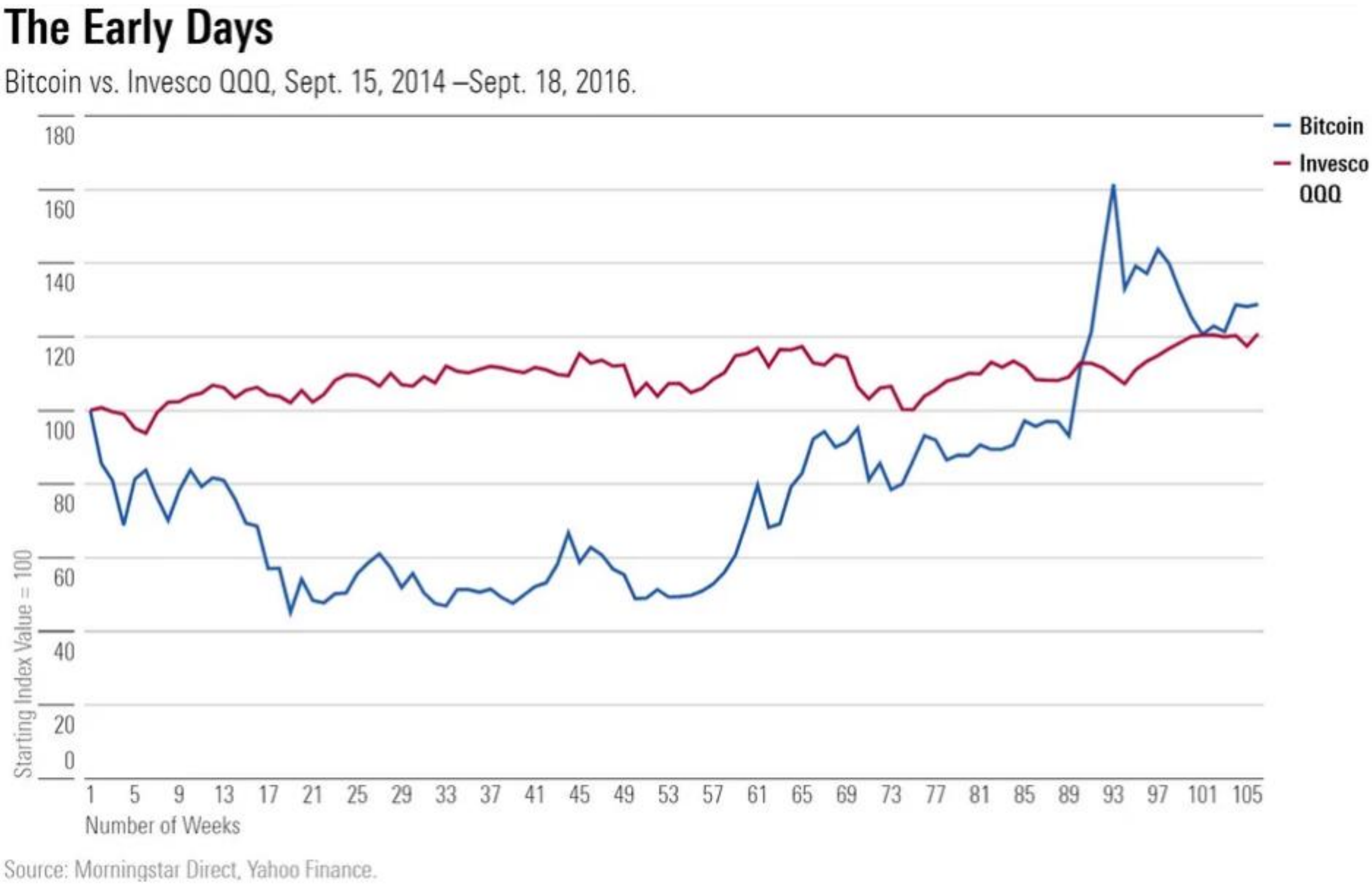
All that is acceptable, as are the investment losses. If I were to dismiss every asset that has on occasion been misunderstood, while disappointing its owners, pretty much all equities and real estate would be banished, along with most bonds. The drawback of cryptocurrency as a potential investment is not that it sometimes flops. It is instead the timing of its current problems.

The Glory Days

Because cryptocurrency's invention is a mystery wrapped in a shroud, we do not know to what extent cryptocurrency was intended to be an investment. (Probably not much; the white paper that accompanied bitcoin's creation emphasizes the prosaic details of the payment system, rather than cryptocurrency's revolutionary powers.) Be that as it may, people quickly realized that they might profit more from trading cryptocurrencies than from using them to buy goods and services.

And profit they did, in the best possible way. Not only did cryptocurrency rapidly appreciate—for this column, I will show only the performance of bitcoin, but my comments apply to the industry overall, since the major cryptocurrencies behave similarly—but it did so on its own terms. Cryptocurrency performances were not closely correlated with other assets, meaning that in addition to providing gains, the investment helped to diversify portfolios.

Consider, for example, a relatively staid early period, from September 2014 to September 2016. Over those two years, bitcoin almost exactly matched the total return for Invesco QQQ Trust (QQQ), an exchange-traded fund that tracks the Nasdaq 100 Index. However, as the following chart demonstrates, the two investments very much went their separate ways.



As indicated by the 0.07 correlation between the two sets of weekly returns, there was almost no relationship between bitcoin and Nasdaq stocks. Consequently, investors would have done well to own both. The combination exemplified the founding principle of Modern Portfolio Theory: Better to spread one's assets among different risky assets, than to hold more of the same.

The Stars Align

Over time, however, the link between cryptocurrency and the U.S. stock market (meaning also global equity markets) began to strengthen. This pattern was obscured because cryptocurrency was so capricious. It was difficult to perceive bitcoin's connection with *anything* when it gained 1,325% in 2017, or when it lost 72% the following year. More recently, though, the connection has become all too clear.

The next graph depicts the same investments of bitcoin and QQQ, but on this occasion over the trailing 12 months, through last Friday. The two assets began by moving in opposite directions, with bitcoin slumping while QQQ advanced. Soon though, they began to move largely in tandem. Their correlation for the full year was 0.44. Crypto still offset growth stocks, but its usefulness was declining.

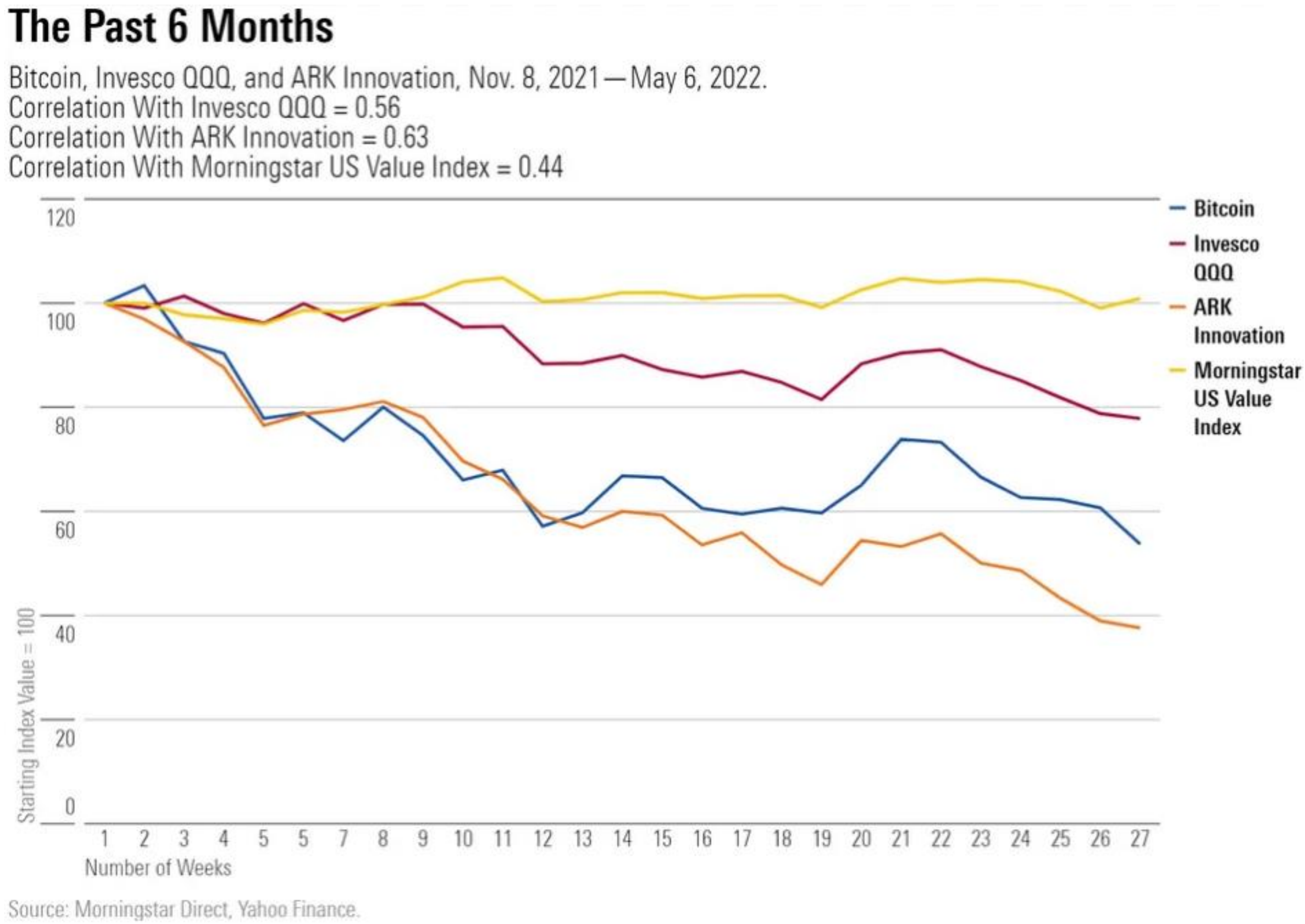
Unfortunately, the relationship between two investments was strongest when diversification mattered. Having one investment zig during a bull market while the other zags may show that portfolio obeys the principles of Modern Portfolio Theory, but it solves no problems. What counts is how the assets perform during downturns. And during the second half of the period, QQQ had begun to fall. That was the time for crypto to prosper, or at least hold its own.

Instead, it dropped even further than the Nasdaq index, while following a similar pattern. It is not that Nasdaq stocks declined for one reason, while cryptocurrency fell for another. The returns of the two investments were clearly and openly related. Whatever factors dragged down one also dragged down the other.

Also affected, of course, was ARK Innovation (ARKK), the riskiest of technology funds. In fact, bitcoin was even more correlated with ARK's fund than it was with QQQ. Exactly what one would *not* wish to hear during a growth-stock bear market!

The strongest testament to cryptocurrency's inability to improve a growth-stock portfolio is that U.S. value stocks behaved less like QQQ than did bitcoin. The top line of the above chart, in yellow, depicts the total returns over the past six months for the Morningstar US Value Index. As evidenced by the eye test, as well as the official correlation statistic, holding value stocks better diversified a portfolio of growth stocks than did owning cryptocurrency.

Such performance must be considered deeply disappointing. Cryptocurrency has been promoted as a virtual alternative to gold—an asset that hedges against a loss of confidence in the global financial system. In particular, it has been touted, both by outsiders and by industry executives, as an inflation hedge. Hmmm. Global inflation is currently raging, thereby clobbering stock prices. The apparently perfect climate for cryptocurrency has instead been perfectly awful.



There Is Only One Reason to Have Diamond Hands

The best strategy for maintaining conviction is a diversified stock portfolio. The others are merely lottery tickets.

John Rekenthaler
May 5, 2022

A Bridge Too Far

If you are old enough to have voted for or against Bill Clinton, you may be unaware of the term *diamond hands*. (If you can say the same for Jimmy Carter, almost certainly not.) The phrase was coined only recently, in a Reddit discussion board. Per dictionary.com, "Diamond hands is a slang term for an investor who refrains from selling an investment despite downturns or losses."

That seems sensible. Novice investors are counseled not to be rattled by stock market slumps, but instead to stay the course. The 401(k) system is similarly structured, with participants expected to retain their funds for decades. And the most respected of all investors, Warren Buffett, famously stated that "our favorite holding period is forever."

The precept of investing with conviction, however, has been stretched well past its breaking point. In practice, the term *diamond hands* is rarely used to describe investors who hold either diversified equity funds or the type of blue-chip businesses that Buffett buys. Instead, the phrase typically describes those who hold, and keep holding, highly uncertain assets, such the stock of an emerging company, cryptocurrencies, and nonfungible tokens.

Investment Faith

There is nothing regal about such assets. They might eventually become virtual diamonds, being worth far more than their owners paid, but their outcomes cannot determine their statuses. After all, a winning lottery ticket can also be wonderfully lucrative, but steadfastly playing the lottery is neither virtuous nor wise. Nobody ever called holders of lottery tickets diamond hands.

Unlike with the U.S. stock market, speculations do not provide a reasonable expectation of success. For two centuries, corporate America has consistently, if sometimes erratically, grown its earnings. Of course, as David Hume argued, that the sun rose yesterday does not mean that it will rise tomorrow. The pattern may change. Nevertheless, that is overwhelmingly the way that one would bet.

Not so with the shares of an emerging company. Most will languish, some will post moderate gains, and a happy few will flourish. But investors will rarely be able to distinguish between those three groups in advance. Such securities are another form of lottery ticket. Venture capitalists, who know the field better than anybody, realize how the emerging growth stocks should be treated. They buy stakes in dozens of companies, not just one.

Even less certain are the prospects of collectibles that will never generate cash, such as cryptocurrencies and NFTs. As collectibles cannot be valued by formal calculations, their success depends on market psychology. They are worth what somebody else will pay. Holding them is thus a matter of investment faith.

That conviction is misplaced. Not, mind you, that I am predicting collectibles' downfall. Quite the contrary; last October, I suggested that as speculations go, bitcoin was sounder than most. (So far, I have been laughably wrong.) Rather, I deny that collectibles can be diamond-hand investments. Any alleged "analysis" is guesswork, masquerading as insight.

Mental Accounting

There is a smorgasbord of reasons why so many diamond-hand investors believe they're winning the game. Among the many psychological tendencies documented by behavioral researchers that might lead to such assurance are:

Overconfidence: Sometimes called "the illusion of validity." People know less than they think that they do, and their predictions are less accurate than they suppose them to be. (Well, of course, we respond—that perfectly describes our spouses.)

Optimism Bias: People overestimate the probability of a successful outcome. They remember their successes and forget their failures.

Endowment Effect: People often place a higher value on items that they possess than on similar items that they do not. Consequently, even in nontaxable accounts, they tend to retain existing investments that they would not buy today.

Sunk Cost Fallacy: This quirk should be familiar. Once people have invested time and energy into something, they are reluctant to change direction.

Ostrich Effect: A corollary of the sunk cost fallacy is that people disregard news that might force them to re-evaluate their decisions. The ostrich effect is also related to Confirmation Bias, which describes how people cling to their beliefs.

Dunning-Kruger Effect: This error could also be called “the sucker at the table.” The Dunning-Kruger effect asserts that when people are in far over their heads, they sometimes react by thinking that the rest of the world is mistaken, not them.

The Real Thing

In short, although most portfolios that are said to require diamond hands are nothing of the sort, various mental biases nudge their owners into regarding them as relatively sure things. That diamond-hand investors are typically males under the age of 40 is no coincidence. Men suffer more from overconfidence than do women, and the young assume greater risks. Combining the two attributes leads to the group that dominates not only diamond-hand-style investing, but also online gaming and sports gambling.

Don’t take it solely from me. In a well-timed note, Bloomberg’s Matt Levine cites an academic paper bearing the indelicate title of, “Individual differences in susceptibility to financial bullshit.” (I need to start writing better headlines.) The authors conclude: “Consumers particularly vulnerable to financial bullshit are likely to be young, male, have a higher income, and to be overconfident with regards to their own financial knowledge.” In other words, those with diamond hands may have been sold coal, without realizing the difference.

The one portfolio worthy of diamond hands? That I have already disclosed. It is a diversified equity portfolio. It may come variously—through directly held securities, or actively managed funds, or indexes. The method is immaterial if the costs are low. What matters is shifting the odds. A diversified equity portfolio does that, by placing history on investors’ side. It supplies the reason for the investment faith.

Have Growth Stocks Bottomed?

They are off to their worst start since the Great Depression.

John Rekenthaler
May 2, 2022

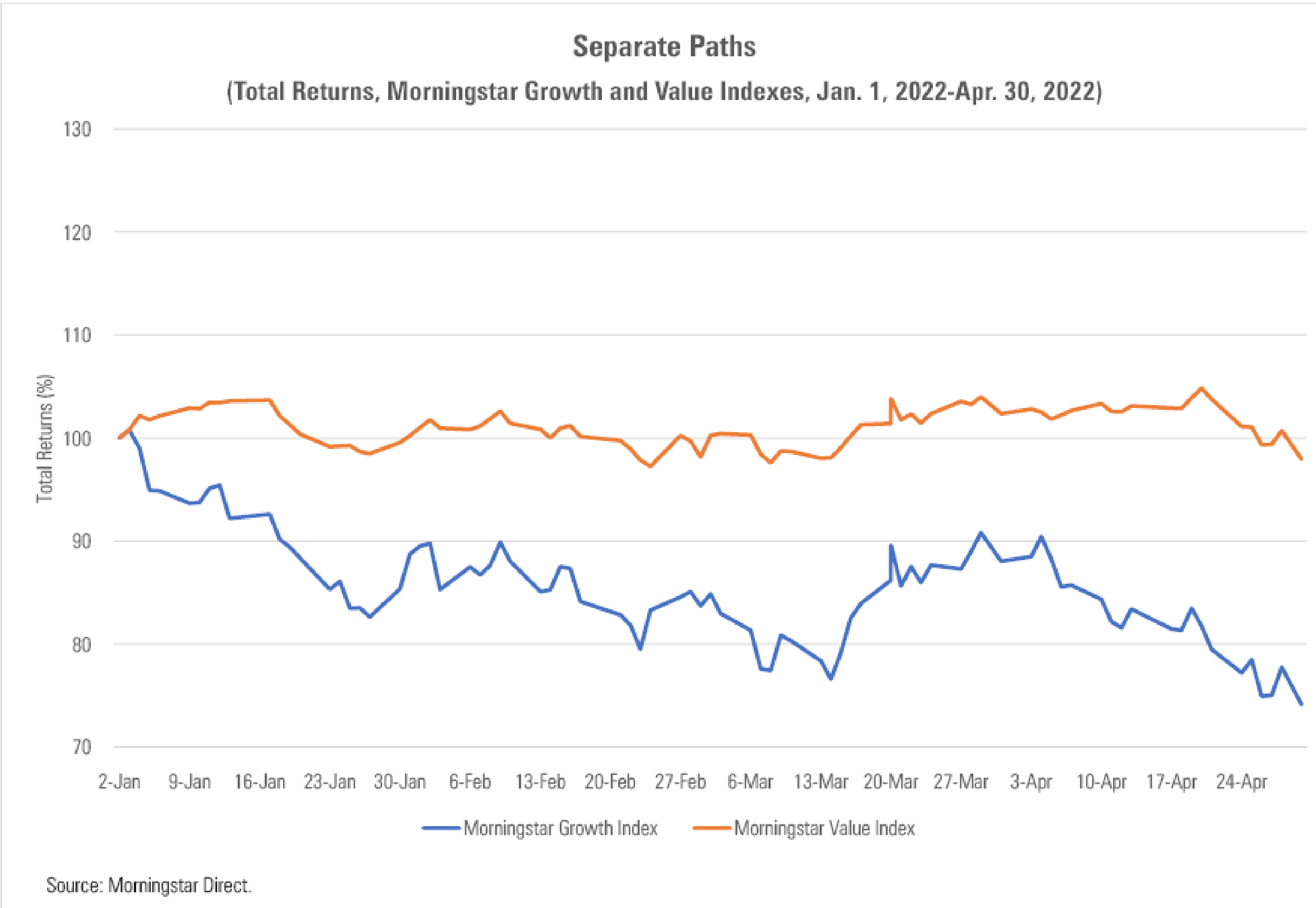
Making History

It’s been a terrible year for growth stocks.

In late January, I published “The Stock Market’s Dominoes Are Falling,” which showed how equities were following the stereotypical bear-market pattern, by imploding from the outside. First to falter had been the most-speculative issues: meme stocks, special-purpose acquisition companies, and ARK Innovation ETF (ARKK). Then came the rest of the small-growth universe. Finally, in January, the industry leaders cracked. At the time of that article, all growth stocks were in free-fall.

After staying afloat for several weeks, they resumed their slide in April, which featured Nasdaq's largest monthly drop since 2008. The overall news was worse yet. Through April, U.S. growth stocks had posted their weakest performance since 1932. Not since the Great Depression had they fallen so far during a year's first four months—not in the 2008 global financial crisis, nor the 2000-02 technology selloff, nor the 1973-74 bear market.

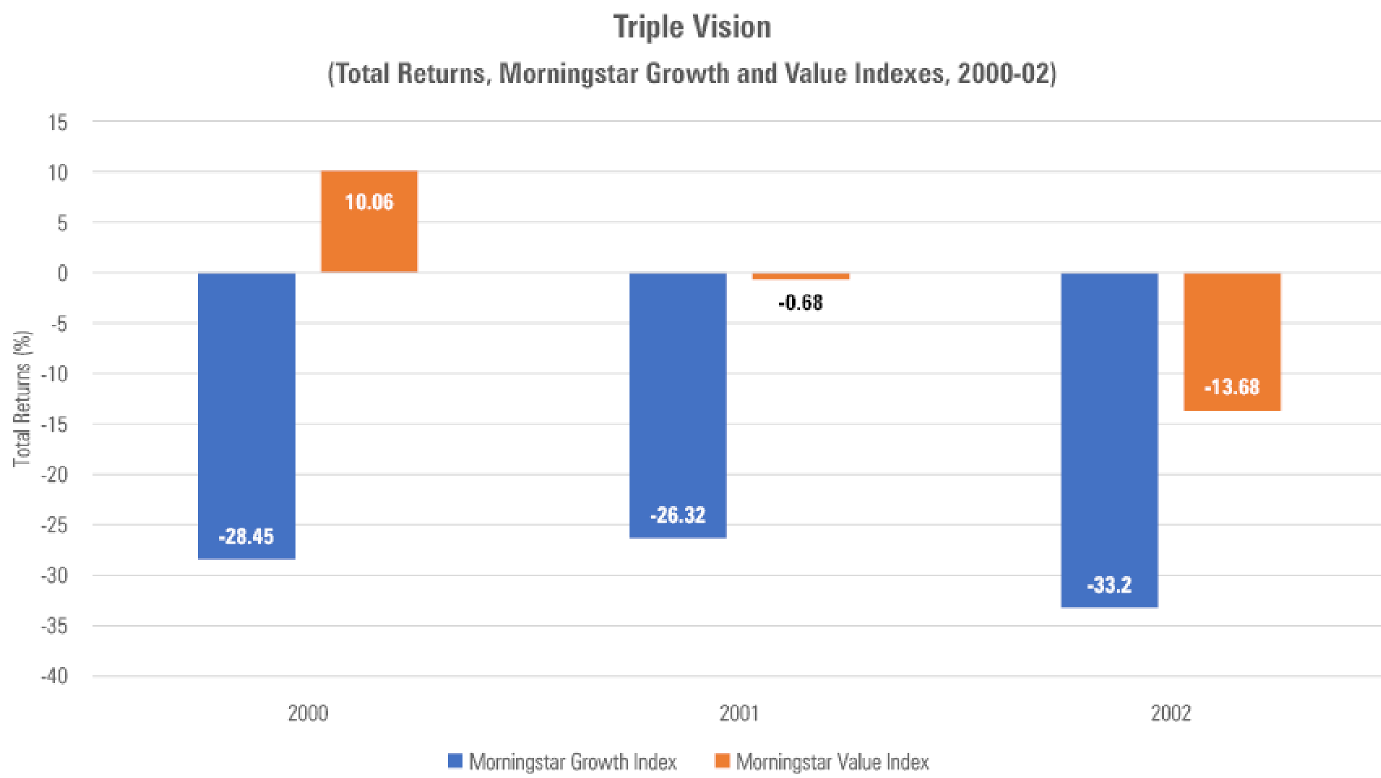
The grim details appear below. As the chart indicates, value stocks are unfazed. the Morningstar US Value Index is down only slightly for the year to date. Life has been perfectly acceptable for most U.S. equities. Not, however, for growth companies, as the Morningstar US Growth Index has slumped by 25.9%.



It Could Be Worse

Which leads to the headline's query: Has the growth-stock slump run its course? Naturally, growth-stock investors believe so. Earlier this year, ARK Innovation portfolio manager Cathie Wood averred that after absorbing its pounding, her fund should be considered a "deep value" investment. Since that comment, ARKK has dropped another 45%. Make that a *very* deep value investment.

Unfortunately for growth-stock devotees, the math doesn't necessarily work that way. Consider, for example, how the Morningstar US Growth Index fared entering the millennium. In 2000, that index lost 28%, while value stocks gained 10%. The performance discrepancy was even greater than today (although occurring over 12 months rather than four). However, that outcome did not presage a growth-stock rebound. Far from it.



Source: Morningstar Direct.

As Wood can attest, what has descended can always descend further. If growth stocks are to recover, they require one of two circumstances: Either the economy must change, or they must become too cheap for investors to ignore.

Economic Matters

It's not that the economic reports are entirely bad. Inflation is rampant because of soaring commodity prices and supply chain disruptions. (Also to blame may be fiscal and monetary policies, although the jury must remain out on those effects, as they take longer to assess.) Consequently, the Federal Reserve is raising interest rates, always a challenge for equity prices. On the other hand, employment is booming and researchers expect aggregate corporate profits to grow by 5%-10% during the first quarter, despite higher input costs.

However, current conditions are inhospitable for growth stocks. As their stellar 2020 returns demonstrated, growth stocks perform best when a recession lurks and interest rates are low, for two reasons. First, as their businesses tend to be healthier than those of value stocks, growth companies are better positioned to weather economic downturns. Second, because growth stocks are primarily prized for their future output, they suffer more when interest rates rise. Higher interest rates reduce the value of prospective earnings.

(The above paragraph smacks of hindsight analysis. It is true, as Morningstar's Don Phillips has long remarked, that stock markets are devilishly difficult to predict on New Year's Day yet simple to explain on New Year's Eve. That said, 2022's early returns were easier than most to forecast, because the salient features were established entering the year. In Jan. 4's "The Stock Market Faces Strong Headwinds in 2022," Morningstar's Dave Sekera correctly identified the looming troubles, while citing value stocks—in particular, energy firms—as a refuge.)

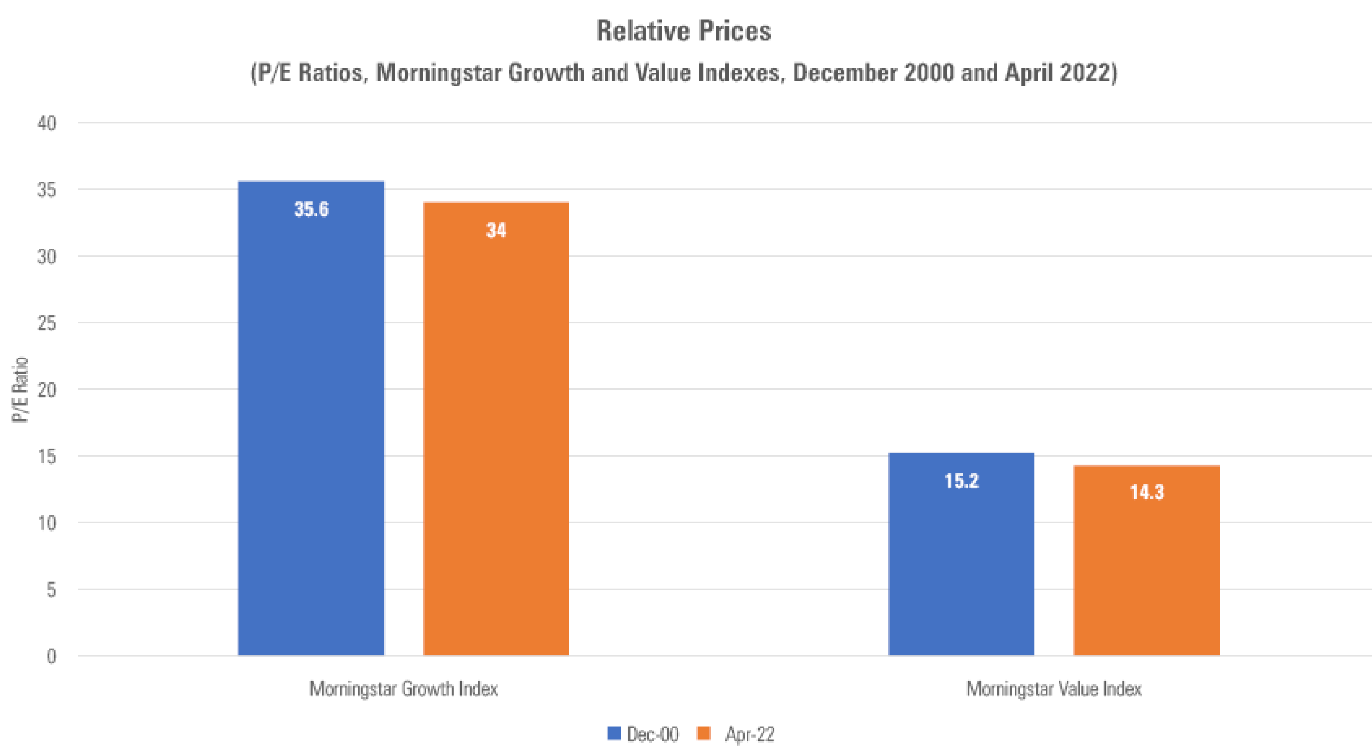
Although some observers expect that the Fed's interest-rate hikes will halt the economy, most are sanguine. In a recent poll of economists by *The Wall Street Journal*, 72% believed that the United States would remain recession-free during the next 12 months. Should they become more pessimistic, the relative fortunes of growth stocks will likely improve. For them, weak economic news often means strong investment results.

Is the Price Right?

Alternatively, growth stocks may have become so cheap that they no longer require a friendly economy to revive. But judging that event is even trickier than foretelling the economy. Determining the "correct" price for growth stocks requires superhuman (and super artificial intelligence) abilities. One needs to know not only the amount of future corporate earnings, over many years, but also their volatility, as well as the level of interest rates. Good luck with all that.

However, if no calculations can assist, we can at least test the proposition via the back of a metaphoric envelope. In December 2000, growth stocks were in a rut, much as they now are. Yet they continued to struggle for another two years. Was that because their prices were well above current levels? If so, one might reasonably see a light at the end of the growth-stock tunnel. If not, however, it would be difficult to argue that cost alone will spark a growth-stock rebound.

This test is both easy to administer and easy to interpret. Each month, Morningstar computes the price/earnings ratios for the growth and value indexes. The following chart compares the December 2000 P/E ratios for each index with those from April 2022. (Technically, I updated the most-recent available figures, which were from March, but close enough.)



Source: Morningstar Direct.

Oh dear. When comparing the P/E of growth and value stocks, today's totals almost exactly match those from December 2000, a time that represented not the bottom for growth stocks, but instead the midpoint. (When I examined the indexes' price/book ratios, the outcome was the same.)

Wrapping Up

None of this is to state that growth stocks won't rally. If this article marked the week that growth stocks recovered, I would be amused, but not surprised. That said, nothing suggests to me why their turnaround will occur anytime soon. The end of interest-rate increases is nowhere near in sight; recession does not appear to be imminent; and nothing about growth stocks' prices suggests that they are a bargain. I conclude this article less optimistic about growth stocks' prospects than when I began it.

Positions

TUP - For taxable accounts we sell any stock with >20% loss at the end of the year, unless it still meets our buy criteria. On 12/30/21 we sold for 4 clients @ 15.5117. On 5/4 TUP reported a Negative Earnings Surprise, dropping 32.2% on 8.5x average volume. Three out of 4 analysts lowered their earnings estimates for the next 2 quarters. Two analysts lowered their recommendations to Hold, and all 4 analysts lowered their Target Price. On 5/25 we sold for the remaining client @6.0114.