October 2021

After September's "Worst Month Since March `20", stocks rebounded in October, with the S&P 500 (+6.9%), Nasdaq (+7.3%), and Dow (+5.8%) closing at record highs on Friday. The Small Cap Russell 2000 (+4.2%) finished the month 2.7% below its March 15th record close.

We have been warning about future inflation since the Trump Administration opened the fiscal spigots, with its tax cuts, and wanton spending, despite our economy being near full employment prior to the pandemic striking. From the front page of Friday's WSJ:

Prices, Wages Increase At Rapid Pace

Strong consumer demand and supply shortages test recovery, spur inflation

BY DAVID HARRISON

Consumer prices rose at the fastest pace in 30 years in September while workers saw their biggest compensation boosts in at least 20 years, according to new government data released Friday.

Consumer spending also rose in September despite the expiration of enhanced unemployment benefits, the data showed.

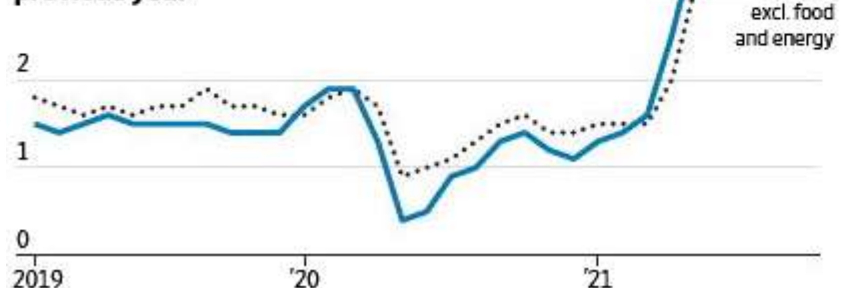
The reports point to a recovery caught between robust consumer demand and severe supply shortages, leading to a rapid uptick in inflation. They also put pressure on Federal Reserve officials as they prepare to meet next week. ...

It could also force the central bank to raise interest rates to keep prices in check. Such a move also risks slowing the economic recovery when the unemployment rate remains higher than it was before the pandemic.

Officials say they expect the recent burst of inflation will be temporary, but they have also raised the possibility they could pull back support for the economy faster than anticipated.

The Fed's preferred inflation gauge, the personal-consumption-expenditures price index, rose 4.4% in September from the previous year, the fastest pace since 1991, the Commerce Department said Friday. ...

Excluding food and energy categories, which tend to be more volatile, the index rose ... 3.6% over the year.



The employment-cost index, a measure of worker compensation that includes both wages and benefits, rose 1.3% in the third quarter from the second, the fastest pace since at least 2001, the Labor Department reported.

Workers in the leisure, hospitality and retail sectors saw particularly high compensation

boosts, as employers struggled to fill open positions.

An index of consumer sentiment also released Friday by the University of Michigan showed Americans remain in a glum mood. The index fell to 71.7 in October from 72.8 in September. It remains well below the level of 101 registered in February 2020, before the pandemic hit.

Consumers in October also anticipated the highest year-ahead inflation rate since 2008 at 4.8%, according to the sentiment survey. Higher consumer inflation expectations are a concern for policy makers because they could prompt firms and workers to raise prices and salary demands in the future, making the expectations self-fulfilling.

Constrained global supply chains have made it difficult for businesses and consumers to find the products they want to buy. Continued fears of the Covid-19 virus and difficulty finding child care have kept workers out of the labor force, despite rapidly rising wages.

About 62% of American adults are either working or looking for work, the lowest rate since the 1970s.

Those factors have combined to push inflation well above the Fed's 2% target. Economists say they expect inflation to remain elevated until the pandemic-related disruptions settle down, perhaps sometime next year. ...

The central bank is expected to announce next week that it will begin paring back its asset purchases in November. Officials have penciled in an interest-rate increase next year once that tapering is complete. ...

Consumer spending rose at a seasonally adjusted annual rate of 0.6% in September, down from 0.8% in August, the Commerce Department said, as higher prices, product shortages and a surge of new Covid-19 cases caused by the Delta variant tempered buying. Personal incomes fell 1% last month, driven by a 72% decline in unemployment insurance benefits that offset a 0.7% increase in wages and benefits, the report said.

Economists say the spending slowdown will be short-lived. The decline in new Covid-19 caseloads and rising wages should keep demand elevated heading into the holiday season.

"If Delta was a net negative for the third quarter and for September, then I think it should be a net positive for the fourth quarter," said Mark Zandi, chief economist at Moody's Analytics. "We should see some revival."

So how is it that stocks continue to climb. One of our DIYers asked us to comment on this October 22nd WSJ Opinion:

The Monetary Bathtub Is Overflowing

By John Greenwood And Steve H. Hanke

The consumer-price index has risen 5.4% over the past 12 months. President Biden says we are facing a temporary bout of price increases caused by supply-chain glitches and bottlenecks that are themselves temporary. But while supply-chain problems affect prices of specific commodities, they have little effect on the overall price level if monetary growth is stable. The problem is that monetary growth in the U.S. has been anything but stable.

“Inflation is always and everywhere a monetary phenomenon,” Milton Friedman said. Inflation isn’t caused by temporary supply-chain disruptions. Take Japan during the 1979-80 oil crisis: Oil prices surged, but consumer prices remained stable. In China today, raw-material prices are soaring, but consumer prices have hardly budged.

To explain what is happening in the U.S. economy, we present the bathtub theory of money and inflation. Money flows into the tub through the faucet. The bathtub has three drains.

One drains into economic growth—a k a growth in real gross domestic product. Another drains into money that the public wishes to hold relative to its income measured by the ratio M/Py, where M is the money supply, P is the price level, and y is real GDP. Nobel Prize-winning economist Lawrence R. Klein called this one of the five great ratios in economics.

In noninflationary times, the inflow from the faucet roughly equals the outflow through these two drains. But if more money is flowing in than out, the level of money rises. It will eventually reach the overflow, which is the inflation drain. It usually takes about two years for any excess money to show up as inflation.

Let’s take a look at the U.S. bathtub. During the early months of the Covid-19 pandemic, the faucet was wide open. Between December 2019 and August 2021, the U.S. money supply, measured by M2, grew by $5.5 trillion, a stunning 35.7% increase in only a year and a half, driven primarily by the Fed’s purchases of Treasurys and mortgage-backed securities. In light of anticipated Federal Reserve tapering, we estimate that by the end of 2024 the money supply will grow another $5.1 trillion.

Out of the total $10.6 trillion in new money, real GDP growth will drain roughly $1.4 trillion. Another $1 trillion will flow down the money demand drain. Since the amount of money flowing into the bathtub far exceeds the two outflows, the excess money in the tub—around $8.2 trillion—will hit the inflation overflow drain.

The huge monetary expansion— $5.5 trillion already in the bathtub— is starting to reach the overflow. Persistent, not transitory, inflation will be with us for the next two to three years.

Mr. Greenwood is chief economist at Invesco in London. Mr. Hanke is a professor of applied economics at Johns Hopkins University.

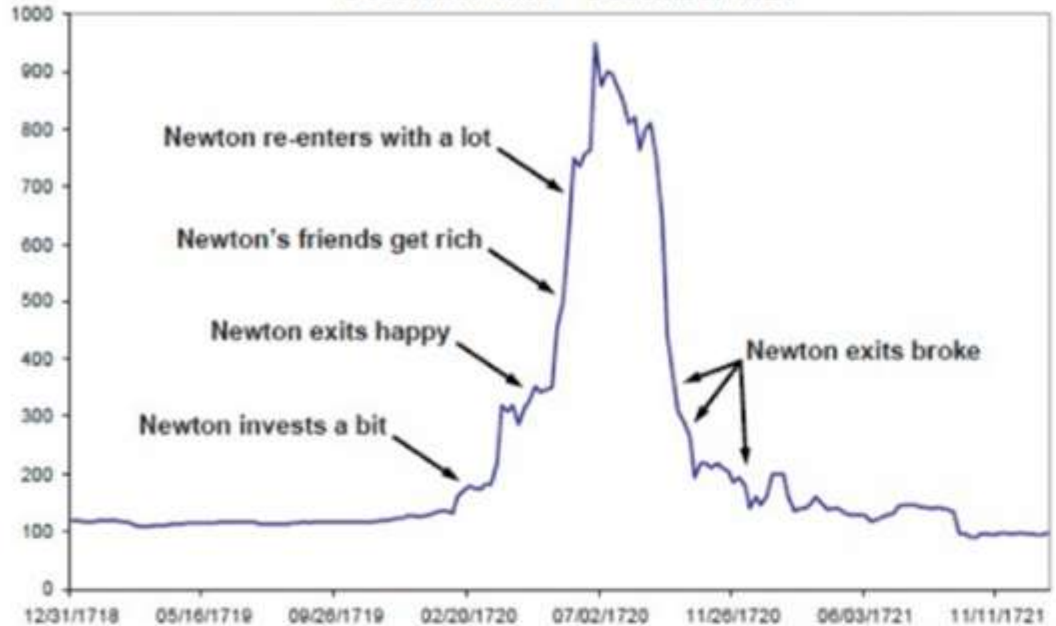
We concur with the premise. The unasked question above is what does this mean for investors. Historically, the overflow has resulted in asset bubbles, a subject I cover in my OU course, Advanced Topics in Investments. Two examples from the seven I detail:

A classic tale highlighting the perils of trying to time a bubble comes from Isaac Newton and the South Sea Bubble of the early 1700s. Newton thought he could time the bubble and earn a fortune by buying during the stock’s upward trajectory, and selling right before it crashed. And he was correct, the first time he traded. However, as the stock continued to skyrocket without him, he couldn’t resist reentering the speculative frenzy. His second trade cost him everything.

As Warren Buffett describes:

"Long ago, Sir Isaac Newton gave us three laws of motion, which were the work of genius. But Sir Isaac's talents didn't extend to investing: He lost a bundle in the South Sea Bubble, explaining later, 'I can calculate the movement of the stars, but not the madness of men.' If he had not been traumatized by his loss, Sir Isaac might well have gone on to discover the Fourth Law of Motion: *For investors as a whole, returns decrease as motion increases*."

Exhibit 4 Isaac Newton's Nightmare
South Sea Stock December 1718 – December 1721



Marc Faber, Editor and Publisher of "The Gloom, Boom & Doom Report."

My second example is of more recent vintage. In a December 5, 1996 speech then Federal Reserve Chairman Alan Greenspan famously warned investors about "irrational exuberance": "But how do we know when irrational exuberance has unduly escalated asset values, which then become subject to unexpected and prolonged contractions as they have in Japan over the past decade?" A quick look at the chart below reveals just

how prescient his dire warning was for investors. As previously shared, one of our favorite quotes: **"I don't know anyone who's got it right. In fact, I don't know anyone who knows anyone who's ever got it right."** - Jack Bogle, founder of the Vanguard Group, on the ability of investors to successfully time the market. From October 4th's WSJ:

How Bull Markets Usually End

BY MARK HULBERT

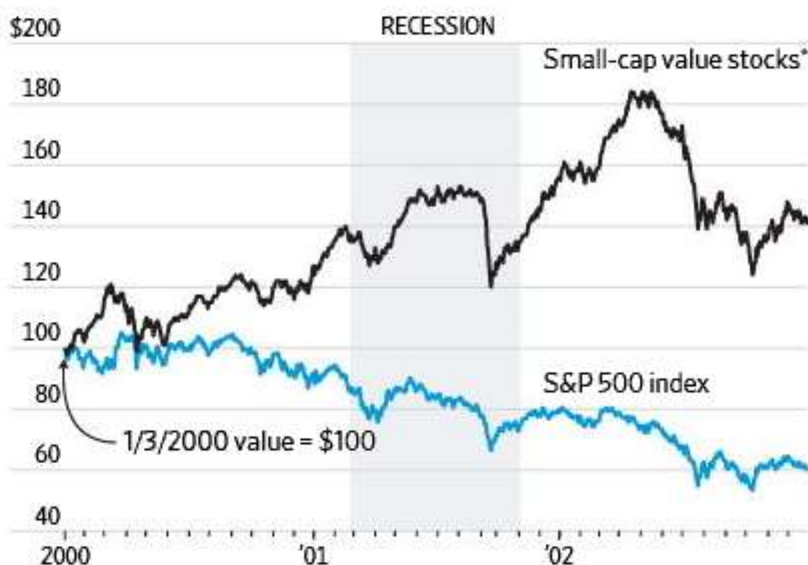
Unlike bear-market bottoms, which tend to be short and violent, bull-market tops in the stock market tend to occur gradually over time, as first one sector or investment style hits its peak and turns down, and then another.

... Of course, there is no way of knowing whether the current stock market—which pulled back brutally from record highs in late September, before Friday's rally to start October—has entered such an extended topping process. But the bull market will someday come to an end, if it hasn't already, and it's important to review the characteristics of past tops so that you don't manage your portfolio on the assumption that you will be able to catch the top in real time.

A recent illustration that not all sectors and styles hit their bull-market highs at the same time came at the top of the internet-stock bubble in early 2000. Though the S&P 500 and Nasdaq Composite indexes hit their bull-market highs in March 2000, value stocks—and small-cap value stocks, in particular—kept on rising. The S&P 500 at its October 2002 bear-market low was 49% lower than its March 2000 high, and the Nasdaq Composite was 78% lower, but the average small-cap value stock was 2% higher than it was in March 2000, according to data from Dartmouth professor Kenneth French.

A look at 30 bull markets

While this is just one example, it isn't unique. Consider what I found upon analyzing the 30 bull-market tops since the mid-1920s that appear in the calendar maintained by Ned Davis Research. In each case, I determined the dates on which various market sectors hit their particular bull-market highs: the large-, mid- and small-cap sectors, as well as the value, growth and blend styles, as measured by stocks' price-to-book ratios. Averaging across all 30 bull-market tops, there was a 225-day spread between the earliest date on which any of these sectors hit their tops and the latest. That's more than seven months.



There are exceptions, especially when an external event causes the market to crash and virtually all sectors drop in unison. The 1987 stock-market crash, as well as the declines in

the wake of the 9/11 terrorist attacks and the March 2020 pandemic lockdowns, are good examples. But in most cases it's more accurate to view a bull-market top as a process rather than a single event.

Sentiment factor

Another reason to view market tops as a process is that it's unlikely that, on the day on which broad market indexes such as the S&P 500 hit their bull-market highs, you will have any idea that a bear market is imminent. Instead, you will most likely be caught up in the exuberance of the moment. Only in retrospect will it become clear that a bear market was in the process of starting. ...

Viewing market tops as a process can counterbalance this exuberance, since it leads investors to focus on their individual positions rather than the market as a monolithic whole.

Many resist this advice because their memories play tricks on them, leading them to believe it is possible to spot a bull-market top as it is happening. It most definitely isn't, according to my firm's day-by-day tracking of the advice of stock-market timers—advisers who tell clients how much of their investment portfolios should be in equities and how much in cash. On those days over the last four decades in which the S&P 500 hit a bull-market high, these timers' average recommended equity exposure level was 65.7%. That's a higher exposure level than on 95% of all other days over the past 40 years.

On those days when the S&P 500 hit its bear-market lows, in contrast, stock-market timers' average recommended exposure level was just 5%.

2007 memories

Think back to October 2007. Even though the S&P 500 was about to embark on a 16-month decline of 57%, virtually none of the approximately 100 stock-market timers that my firm monitors were envisioning anything of the sort.

This failure was true even for those market timers with the best long-term records coming into that month. One of the top long-term performers at the time was telling clients that a bear market was such a remote possibility that it wasn't even on his radar screen. Another moved from being fully invested to going 25% on margin—borrowing to invest even more in stocks—the day before the exact day of the S&P 500's bull-market high.

If these market professionals with good long-term records weren't able to anticipate the beginning of one of the most serious bear markets in U.S. history, you're kidding yourself if you think you can consistently do any better. ...

So if timing the top is beyond mere mortals, is there anything we can do. The answer is an emphatic yes! We can remain disciplined in our approach, selling stocks that become fully valued (see ARES & CIO under Positions below), and trimming those that become too large a percentage of our portfolios (all but one client with individual stocks should have noted such sales in October), while watching for opportunities (see HIBB under Positions below).

We can remember John Maynard Keynes' admonition **"The market can remain irrational longer than you can remain solvent."** Our Worth Sharing on May 23rd was titled "What's your view on Cryptocurrncy?", and included an analysis from

Bitcoin Trade Update

After being up as much as 50%, our short Bitcoin trade got stopped out for a loss. We remain bearish on Bitcoin and have decided to reinstate the trade.

Global Investment Strategies. What we didn't share was their recommendation to short Bitcoin. However, we have shared their trade update (shown above) from Oct. 22nd. Their loss was 25.5%. We don't short, for ourselves, or our clients.

Most importantly, we can avoid investments where speculation is running rampant. The two "investments" we have been most recently warning against are Cryptocurrencies, and SPACs. From the front page of October 23rd's WSJ:

Trump SPAC Swept Up in GameStop-Like Frenzy

BY AMRITH RAMKUMAR AND CAITLIN OSTROFF

Shares of a blank-check company tied to Donald Trump’s new online network surged again Friday, implying a valuation of several billion dollars for the new firm following a buying frenzy fueled by individual investors on social media.

Digital World Acquisition Corp. shares more than doubled to $94.20 on Friday after trading as high as $175. Trading in the stock was heavy, prompting a number of brief trading halts.

The shares rose from less than $10 to $45.50 Thursday after the firm announced a deal to combine with a newly formed media company backed by Mr. Trump that plans to launch a Twitter-like platform called Truth Social.

... The stock’s ticker, DWAC, has been trending on several internet platforms over the past few days. Day traders on platforms like Reddit have posted photos of their quick fortunes, inspiring others to jump on board, some analysts said. Some posts also indicated that individuals wanted to buy the stock to support Mr. Trump’s political movement.

“This is the new hot meme stock,” said Matthew Tuttle, whose firm Tuttle Capital Management runs a few exchange-traded funds tied to special-purpose acquisition companies and the companies they take public. Meme stocks are those that become wildly popular among online traders for reasons other than their business prospects, as GameStop and others have this year.

Also called a blank-check firm, a SPAC such as Digital World is a shell company that raises money and lists publicly with the goal of merging with a private company such as Mr. Trump’s. The private company then replaces the SPAC in the stock market. SPAC mergers have become popular alternatives to traditional initial public offerings and have allowed startups with scant records to list publicly.

The gains for Digital World are unprecedented even for SPACs, which are known for wild price swings and exploded in popularity early this year alongside meme stocks. Among the roughly 115 SPACs that have announced mergers but not yet completed them, Digital World’s stock price is by far the highest, according to data provider SPAC Research. ...

The current Digital World stock price implies a valuation for Mr. Trump’s startup media company in the billions of dollars, several times the announced valuation of $875 million, a figure that isn’t strictly comparable because it includes debt.

“It’s a level of speculation that I once thought unfathomable,” said Julian Klymochko, who manages a SPAC-focused fund at Accelerate Financial Technologies.

Some other SPACs that rocketed up have later fallen, hurting individuals who piled in while company insiders are protected through special incentives. The sharp declines for companies popular among individual investors have prompted scrutiny among regulators and lawmakers about the SPAC structure and whether it disproportionately benefits insiders and professional investors.

Hedge funds that are large buyers of SPACs when they initially go public often notch outsize gains from moves like the one in the Digital World SPAC. They buy shares at the listing price of $10 or below that level after the shares begin trading publicly. If the stock like Digital World rises after a deal announcement, they are typically quick to sell to lock in a profit.

Even if the stock falls or trades flat, they are protected by the right to withdraw $10 a share plus a tiny bit of interest before SPAC deals are completed.

The Digital World SPAC is led by Patrick Orlando, a former derivatives trader at Deutsche Bank AG. One of the blank-check company team's past SPAC deals, a roughly $7 billion deal with energy transportation solutions firm Giga Energy, was terminated in mid-September amid a share-price slump for many SPACs. The combination was announced in May.

So far, the Digital World SPAC hasn't released many concrete financial details about Mr. Trump's new business. The Digital World SPAC has about $290 million that the social-media venture could use to fund its growth, though investors have the right to pull money out at $10 a share before the deal gets completed.

In the coming months, the SPAC will have to publicly release an S-4 regulatory filing with the Securities and Exchange Commission detailing the merger. The filing will include the financial information and ownership structure of Mr. Trump's new venture, Trump Media & Technology Group.

Regulators will then review the documents, before an official shareholder vote on the deal. If the merger is approved, Trump Media & Technology Group would replace Digital World in the stock market and begin trading under that name.

In that same WSJ issue was the following Jason Zweig column:

What to Do When Your Adviser Catches a Case of Crypto-Fever

The advent of bitcoin-related ETFs makes it easier for financial professionals to help you add crypto to your portfolio. It also lets them earn fees on it.

Some days it seems just about everybody is urging you to buy bitcoin. Now, your financial adviser might, too. (If that is the case, our advice is to find a new Advisor.)

This week, the first cryptocurrency-focused exchange-traded fund in the U.S., ProShares Bitcoin Strategy ETF, raised $1.1 billion in its first two days of trading. Advisers who want to buy bitcoin directly for clients have to clear some onerous regulatory hurdles first; in comparison, buying a bitcoin related ETF is as easy as breathing.

That could give some financial professionals the entree into crypto they have long craved. If you've been suffering from FOMO lately, imagine *their* fear of missing out.

Millions of individual investors already own bitcoin or other digital currencies. Many have racked up gains of 400% or more over the past year. Alongside that, the stocks and ETFs that advisers typically recommend can feel like fossils.

In a recent survey by Bitwise Asset Management, an investment firm in San Francisco, 81% of financial professionals (including HCM, as previously shared) said clients had asked in the previous 12 months about investing in crypto. Nearly three-quarters said clients already own, or might own, digital assets.

Only 9% said they already have put some of their clients' assets in cryptocurrency. But 17% of the financial professionals who haven't yet bought any crypto for clients said they would in 2021—more than double last year's number. ...

The advent of bitcoin-related ETFs in the U.S.—the ProShares fund is likely the first of many—makes offering crypto easier for advisers. It also lets them earn fees on it.

So will a new service from Interactive Brokers Group, an online brokerage based in Greenwich, Conn. The firm announced this week that it will permit financial professionals to trade bitcoin and several other digital currencies through its platform.

Interactive Brokers acts as a custodian— safekeeping assets, handling trades and maintaining records— for more than 5,700 advisers with a total of $60 billion in clients' assets.

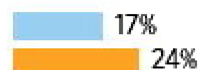
Crypto-Curious

Percentage of advisers...

...whose clients have asked about crypto in past 12 months

...who allocate to crypto for clients

...who own crypto in their personal portfolios



...already allocating to crypto for clients, who plan to add more in next 12 months

...not yet allocating to crypto for clients, who plan to do so in next 12 months

Source: Bitwise/ETF Trends 2021 survey of financial advisers

Its new service will enable advisers to buy crypto for their clients and report it on the same account statement as conventional assets like stocks, bonds and ETFs.

Interactive Brokers' chairman, Thomas Peterffy, tells me that "we did get hundreds of calls from [advisers] and are following up, while new calls keep coming in."

Until now, financial professionals generally haven't been able to manage clients' digital assets alongside other holdings. That's made it hard to know how much risk their clients are taking, how to minimize their taxes and how to help them plan for retirement. Services like Interactive Brokers' new offering should change that. ...

Maybe you've never owned any cryptocurrency and don't want to. Maybe you haven't yet but you might. Maybe you already do. What should you be on the lookout for if your financial adviser brings it up? (Once again, a new Advisor!)

First, beware of anyone flogging a new bitcoin-related ETF. The new ProShares fund and those sure to follow don't hold digital currency; instead, they own futures contracts, whose returns can deviate widely from it. ETFs owning bitcoin itself haven't arrived yet in the U.S. ...

Adding crypto to your portfolio, whether you do it or your adviser does, requires both of you to start from scratch.

Even a small allocation to digital currency can transform your entire portfolio's risk and return. Has your tolerance for risk changed? How much, and why? Your investment policy statement, which explains your portfolio's goals and how your assets are positioned to achieve them, needs to be revised. ...

If buying crypto is your idea, your financial advisers are just doing their job if they ask you to review these documents with them first.

If buying crypto is their idea, then it's your job to say "no" if it makes you uncomfortable.

If you and your advisers together decide to buy some crypto, insist that they review your risk tolerance. They should also revise your investment policy statement to mandate monthly reviews of your crypto holdings and redraft your financial plan to account for the new strategy. Make sure they discuss how it would fit in your overall portfolio and square with your financial objectives—rather than just how it might jack up returns. ...

Two from Morningstar:

With High Income, Don't Believe Your Eyes

There's always a catch.

John Rekenthaler
Oct 28, 2021

Say What?

An exemplary reader referred me to a recent *Forbes* article, called "3 Funds That Let You Retire on Dividends Alone." (Every reader is good, but a reader who submits a column idea rates as exemplary.) Wrote the reader, "John, these funds have the possibility of declining in value, but they are always presented as being fairly risk-free. Please do an article that exposes the risks."

Your wish, my command.

The author's recommended funds are closed-end funds. (Once popular enough to challenge their cousins, mutual funds, closed-end funds have become an industry backwater. It is a backwater that can provide profitable hunting in down markets, as even good CEFs can fall to enticing discounts to NAV. HQH, which we covered in September's Newsletter, is an excellent example.) According to the author, Liberty-All Star Growth (ASG), Gabelli Equity Trust (GAB), and Clough Global Opportunities (GLO) each pay annual dividends exceeding 7%. Given that those funds invest solely in equities, that figure arouses suspicion. How on Earth, in today's marketplace, can stock funds yield more than 7%?

The Reality

The answer is simple: They do not. The table below provides: 1) the total income received by each fund from its investments during its most recent fiscal year; 2) the fund's expenses; and 3) the fund's net income, derived by subtracting the second item from the first. The table then shows 4) each fund's size, as of its fiscal year-end, which can be used with its net income to calculate 5) the fund's true yield. Against that figure is juxtaposed 6) the fund's purported yield, per the "3 Funds" article.

(Officially, funds publish a statistic called an income ratio that is similar to my true yield calculation. However, as the income ratio requires data that I cannot obtain from public reports, I have substituted my homemade version. Close enough.)

Exhibit 1 True versus Purported Yields (Dollar Figures in $ Millions)

Fund	Total Income	Expenses	Net Income	Size	True Yield (%)	Purported Yield (%)
Liberty All-Star Growth	1	3	(2)	338	-0.53	7.50
Gabelli Equity Trust	30	19	11	1534	0.72	8.80
Clough Global Opportunities	9	11	(2)	337	-0.59	10.80

Source: Public filings, author's calculations.

Quite a difference! Here is the reason for the discrepancy. Although these funds pay little income, they routinely make capital gains distributions, created from their net realized profits when trading their portfolios. In addition, the Gabelli and Clough funds (although not, at least in recent years, Liberty's fund) enhance their capital gains distributions by periodically returning investment capital.

When reporting their distributions, closed-end funds frequently conflate all three varieties into a single figure that they call "dividends." Those are not dividends in the conventional sense, that being portfolio income. Rather, they are dividends in a very loose sense, meaning "payments that the funds make to shareholders, regardless of the source of those monies." In other words, a closed-end fund that stashed its assets under a mattress, then disbursed $5 out of every $100 that it possessed each year, could (and no doubt would) claim that it pays a 5% dividend.

Nothing Special

The author's funds don't offer remarkable yields, as the term is normally defined. The funds make large distributions not because they receive extensive income, but instead because of accounting tricks. An S&P 500 fund could operate similarly, were it extremely tax-inefficient. As could you. Buy several stocks, trade them often, then remove the cash from your profitable trades. Voila! You, too, can enjoy an impressive portfolio "yield."

My quarrel is not with the funds themselves. Each has outgained its Morningstar Category average over the trailing 10 years, with Liberty's fund also managing the additional and impressive feat of beating the S&P 500. My dispute is instead with the suggestion that these funds are special. They are not. They are ordinary funds that invest in ordinary fashion, and which achieve ordinary (albeit strong) performances.

The author's choices will not suit his audience of income-seeking retirees. Because they are fully invested equity funds, they plummet when the stock market crashes. In 2008, the *best*-performing of the three funds was

Liberty All-Star Growth, which dropped 40.6%. The author states that holding a portfolio that consists of these three funds will make “a retiree comfortable.” Surely not.

Exploring Another Path

The question arises: If retirees can’t receive high and safe income from equity funds, can they do instead with balanced or bond funds?

No, they cannot. Unfortunately, generous income is inevitably linked to stock-market performances. Besides high-dividend equities, which naturally suffer when stocks tumble, high-income funds either hold bonds that directly respond to economic downturns, such as junk bonds, or those that are indirectly sensitive, for example, emerging-markets debt. Either way, such funds are far too volatile to be relied upon by retirees, except as slivers of their overall portfolios.

For example, of the 157 closed-end funds that currently yield more than 4%, the average 2008 total return was negative 31%. (The results are similar for conventional mutual funds.) During March 2020, when COVID-19 roiled the global markets, the average return for those 157 funds was negative 14%. There was little escape. In 2008, all but five of those 157 funds suffered double-digit losses, while in March 2020 not a single fund turned a profit.

In that sense, the author’s instincts were correct. He recommended only three funds in his article, which seems at first glance to be rash. Surely retirees will wish to place their eggs into more than three baskets. However, with funds that truly pay high yields--that is, as opposed to the low-yielding funds that the author advocated--diversification brings little benefit. Owning many high-paying funds merely means more ways to lose money when the stock market crumbles.

A Dangerous Illusion

The “3 Funds” article makes a bold claim: a portfolio that succeeds on “*dividends alone*--without having to touch our principal.” (The italics belong to the author.) Many investors find such promises alluring. They would like to generate high income, through a portfolio that maintains a relatively steady value, without ever dipping into their capital. Spending only income, while leaving principal intact, feels responsible.

Their wish is an illusion. It can’t happen. Rather than pursue yield that isn’t truly yield at all, as with the author’s recommended funds, or stretch for income by owning bonds that crash along with the stock market, it’s best to rein in one’s income expectations. Settle for a lower yield, then supplement those receipts as necessary by withdrawing portfolio assets. After all, that is exactly how the asset managers that were cited by the author have invested.

John Rekenthaler 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.

Investment Horror Stories--and the Lessons They Teach

March 2020. The oil-pocalypse. The emerging-markets party that never came. Gather round and hear these tales of horror, and learn from these mistakes.

Ruth Saldanha
Oct 27, 2021

It is a dark and stormy night--or a brightly lit desk in an open-floor-plan office--when you spot an opportunity. Shadowy, distant, and…perfect. This is the one that will make you rich beyond your wildest dreams. Or is it? The rising panic as stocks fall, the desperate rush to sell, no value to be found anywhere. These are the stories that Bay Street and Wall Street whisper in the dead of night. Stories so grim, so full of fear, that many try to banish them from their minds.

This Halloween, we asked some foremost financiers and voices of reason to dig deep into the depths of despair, to find their worst investment horror stories, and relive them here, sharing the lessons they learned, to help retail investors like you evade these pitfalls and bypass the descent into the madness of financial disaster. March 2020. The oil-pocalypse. The emerging-markets party that never came. Hear these tales of terror so that you may tread carefully.

The Selling

Horror stories are designed to artificially trigger our "fight, flight, or freeze" responses that send a wave of adrenalin through our bodies and prompt us to take action to escape the perceived threat. ... Investors will be all too familiar with this experience. Like a hapless character in a movie who runs from one threat right into the hands of the villain, a sudden fall in asset prices can prompt us to take swift action only to discover later that we made a terrible decision. In my previous career managing portfolios directly for individuals, I witnessed several examples of clients who insisted on selling their entire portfolio when assets were falling. While they often saved money when measured at the bottom of the market cycle, they typically failed to reinvest, believing they had escaped the threat of falling prices. Only later did they realize that they had run into the arms of the great threat of not investing, and they drifted further away from their goals. When watching horror movies or market movements, it is typically better to look away when you are feeling uncomfortable.

-Dan Kemp, global chief investment officer, Morningstar Investment Management Europe

It Emerges, Chapter 1

I cut my teeth in the industry as a closed-end fund analyst at Morningstar in the early 1990s. I felt fortunate when Templeton Emerging Markets was on my coverage list; back then, manager Mark Mobius was the king of emerging-markets investing. I'd track down Mobius wherever he was around the globe to get an update on the fund's holdings. More often than not, I'd be interviewing him in my jammies from my kitchen at home, as it was usually 2 a.m. and he was in some far-flung corner of the world.

Mobius was exceptionally articulate: He *sold* the emerging-markets story, hard. Who could resist the idea of participating in the economic promise of developing markets? And I bought it: Specifically, I bought Mobius' similarly run open-end cousin, Templeton Developing Markets, as the first investment outside of my 401(k) plan. I was excited to have *the* Mark Mobius managing *my* money, and I couldn't wait for him to generate a 70% return for me, just as he had for his shareholders the 12 months prior to my purchase.

You can guess where this story is headed: Over the next couple of years, emerging markets hit a pothole, and so did Templeton Developing Markets. I sold the fund for a loss. While it might be a stretch to call this an investing horror story, it was nevertheless a meaningful investment lesson: Don't chase performance, don't

expect a quick return on a story that may need years to play out, and don't let great manager interviews speak louder than sound investment planning.

-Susan Dziubinski, director of content, Morningstar.com

It Emerges, Chapter 2

The year was 1993, and I happened to see Mark Mobius, then-manager of several emerging-markets funds for Templeton, speak about the incredible promise he saw in those markets. I was sold--hook, line, and sinker--and convinced my husband that we should invest at least some of our wedding gift money into one of his funds. Never mind that we were trying to save for a house, so we had no business investing in any stocks, let alone an incredibly volatile emerging-markets stock fund. The fund was also expensive and carried a sales charge, even for people like us, who weren't working with an advisor. It was a classic case of an ill-conceived, story-driven purchase made without regard for our risk capacity or our spending horizon. We were lucky we didn't have more money at stake!

-Christine Benz, director of personal finance, Morningstar

Ghost Train to BioNTech

I have a stash of mad money that I deploy to invest in relatively speculative companies and funds. In late 2020, I tapped those funds to buy some shares of BioNTech. I had become interested in the company before I understood it was playing such a big role in addressing the pandemic. I read Morningstar's research about how the mRNA technology it was developing might someday be used to cure certain cancers. When I made the "buy" decision, though, I consciously told myself, "This is a long-term investment. BioNTech is not going to cure cancer overnight." I did not, however, establish a price--vis a vis a company valuation--at which I would sell the shares.

Thanks in large part to the U.S. FDA's emergency authorization in late 2020, the company's shares took off soon after I bought them. While I was on holiday on Aug. 9, the company's valuation briefly exceeded $100 billion, at a share price of $447. It had achieved what I would consider a long-term valuation level, but it had done so in a very short time. I thought, "Wait, hold on. Don't sell. You're in this for the long run." I also must admit that I committed one of the cardinal sins of selling: I wanted to get into long-term capital-gains territory. And for that, I'd need to wait until Sept. 21. Dumb. The stock market doesn't care about my taxes, and BioNTech shares have since fallen to about $260 from $447. I have held on to all of my shares in the meantime.

Lessons Learned

1. When buying a stock, establish a price at which you'd be comfortable selling it. (As noted above, we will sell a stock when it becomes fully valued, but not at some arbitrary price determined when we buy it.)

2. Even when you're buying for the long term, sometimes a company hits its long-term valuation target quickly.

3. If the stock has already far exceeded your target, don't let tax minimization concerns cloud your sell discipline. (For taxable accounts, we have and will continue to potentially delay a sale in order for it to be a long-term capital gain.)

-Sylvester Flood, senior editorial director, Morningstar

A Nightmare on Oil Street

This horror story happened before my most recent social media-fueled trading spree, but it started everything. I had connected with someone on social media who described himself as an experienced investor in his 70s. He hated the risk profile of stocks and having to hand over his money to portfolio managers. He loved options and had a passion he liked to share. I was skeptical, but we had great discussions and I learned a lot from him. Over many weeks that followed, he took to teaching me the ins and outs of options. He was a big fan of covered calls. Specifically, oil-related plays: "You can count on OPEC to control the price. I've seen this happen for a long time. Just write a call that's *years* out. The price of oil will come back into equilibrium and you'll keep the premium [on the option] as profit."

His underlying exchange-traded fund of choice was ProShares' UltraPro 3x Crude Oil ETF (For you DIYers, when you see "3x" or any other number followed by a "x" in the fund's name, it should be a warning sign.), which is now defunct of course. He had been making about 30% annually for a couple years thanks to the volatility with 300% leverage and suggested I try. I remember asking him about potential demand catastrophes and he said over time the underlying ETF would recover. I dipped my toes in and began writing covered calls. I started, and I began to make a small but steady return over a few months…until the oil-pocalypse.

Nearly my entire investment evaporated. I remember feeling numb as futures dove before heading to bed. But I had been stung in one good way at least, only for options to become a hobby I now enjoy. (We don't invest in options, for ourselves or clients.) That man disappeared from the forum around that time. I wonder how he did and what he thinks of OPEC now.

Lessons Learned

1. When using leverage (Don't!), keep in mind that your investment could be vaporized between trading sessions.

2. Cartels can and do occasionally lose control.

3. Incorporate the structure of any individual funds into your investment strategy. Commodity products (Should be avoided as detailed on our website.) involve futures, roll yield, …and loss. ETNs differ from ETFs. These factors can affect the overall risk/reward profile of your strategy and help you size your bets accordingly.

-Andrew Willis, content editor, Morningstar Canada

Oil Be Back

My worst investment experience is related to an oil-services company I spotted in the course of 2013 before the oil market started to crash. I made several mistakes. I was stubborn because I thought I was right on my valuation (assets that I thought would keep their value), and therefore I added to my position (this is dollar-cost averaging, which we don't recommend as noted below) at the wrong time. My other mistake is that I completely missed the bigger picture: 1) the oil crash came after a huge capital expenditures cycle by the oil and gas industry, and there was clear overcapacity in the industry; 2) oil prices are heavily influenced by external factors (geopolitics, macro) that I didn't factor in appropriately and were out of control by the company I selected. It was an expensive but useful lesson I will always keep in mind. It has helped me improve my checklist before

investing. I also try to be careful of the bigger picture, the capital expenditures cycle of the industry I'm interested in, and any major disruption that might upset it.

-Jocelyn Jovène, senior financial analyst, Morningstar France

Tick, Tock, Time's Running Out!

While the markets recovered from the March 2020 sell-off, I feared a "dead cat bounce"--meaning a further decline. Therefore, I waited patiently on the sideline while the stock markets climbed higher and higher. After realizing that the bull had indeed defeated the bear (at least at that time), I eventually bought stocks at much higher valuations.

Lessons Learned

1. Timing the market is extremely difficult.

2. Dollar-cost averaging (which we don't recommend for individual stocks) can serve you well because it can reduce the impact of regret aversion: the tendency to refrain from making decisions to prevent any potential mistakes, for example "I should have bought" or "I shouldn't have bought."

I think Peter Lynch sums it up well: "Far more money has been lost by investors preparing for corrections, or trying to anticipate corrections, than has been lost in corrections themselves." (One of our favorite quotes.)

-Christopher Greiner, data journalist, Morningstar

The Descent

As a young kid out of college just entering the world of finance, and having saved up some money from my first few paychecks, I was excited to start investing in stocks. I had been watching "Wall Street Week" with Louis Rukeyser and listened as a portfolio manager reviewed their top picks. One of them sounded especially intriguing, and I wrote down the ticker. The next Monday morning as the market opened, I eagerly phoned in my order and bought my first stock, only to watch it sink precipitously over the next few weeks. Without having done any of my own work to understand the company's future outlook or valuation metrics, I didn't know whether to hold the stock or sell out of it. Finally, I couldn't take the pain any longer and sold the stock for a couple hundred dollar loss (a good deal of money back then for a 22 year old) … but what I learned was much more valuable.

Lessons Learned

Before putting money to work, to do your own due diligence, synthesize an investment thesis, decide at what valuation to buy a stock, and learn when to either cut a loss or build a larger position (this is dollar-cost averaging, which we don't recommend as noted above) when the market moves against you.

-Dave Sekera, CFA, chief U.S. markets strategist, Morningstar

For a batch of investment horror stories I've personally encountered, you can read my old (but still pertinent) article here: https://medium.com/@DevinLHughes/when-is-it-time-to-shop-for-a-new-investment-advisor-f39776dbd729

Follow-ups

Oct 28, 2021

Trump's SPAC Is Screwing His Own Supporters While Enriching Wall Street Elites

Dan Alexander Forbes Staff

Donald Trump set off fireworks on Wall Street the night of October 20, when he announced that a new business, the Trump Media and Technology Group, planned to go public via a special purpose acquisition company (or SPAC). Shares soared 550% in a week.

At one point on Friday, when they hit their peak at $175, a little-known investor who organized the SPAC controlled a stake of more than $1 billion. Hedge funds who got in early were sitting on hundreds of millions in gains, assuming they hadn't already cashed out. And everyday Trump supporters, betting on the SPAC from their brokerage accounts, were doubling and tripling their money in a matter of hours.

"Holy s-—, I am rich with $DWAC," a Twitter user named Huy Tran said on Thursday, using the ticker symbol for the SPAC. He wasn't the only one gloating about his gains. "I knew it was big this morning," said another person. "Enough to throw $310K at it. Would've done more if I had more capital freed up, but damn, that was shocking. Incredible move and probably pushes $100 tomorrow. Best day of my trading career."

Not everyone is going to make money. In any frenzy, there are suckers and there are sharks. The suckers want to play the game but don't necessarily understand the rules. In this case, that's likely the Trump fans and day traders buying up the stock. Some of them will get lucky. But many—especially the true Trump believers, who want to stick with the former president for the long haul—seem destined to lose big.

The sharks, on the other hand, already won the game before anyone else even came to the table. Take the SPAC's organizer, for example. Or the group that did the underwriting. Or the Wall Street firms that bought in early. The biggest shark, however, seems to be the former president, who will probably make a fortune on the frenzy, even as those who trust in him get crushed.

In order to understand all of this, you need to be familiar with how SPACs actually work. We'll start at the beginning, with Patrick Orlando. It is Orlando—not Trump—whose firm serves as the so-called sponsor of the SPAC. On Trump's final day in office, January 20, Orlando's firm paid $25,000 for what would become 8.6 million shares of a SPAC named Digital World Acquisition Corp., or about three tenths of a penny per share.

At the time, Digital World Acquisition had no assets and no operations. But soon enough, Orlando gathered a small team, including a chief financial officer named Luis Orleans-Braganza, who is a member of Brazil's National Congress. Orlando's firm handed Orleans-Braganza 10,000 shares around the time he signed on as CFO.

In addition, Orlando enlisted an outfit named Benchmark Investments to help him do what SPAC organizers do—raise a big pile of cash from investors by taking a shell company public, with the hope of merging that company with a private firm, allowing the combined business to trade publicly. For the division of Benchmark handling the deal, it seemed to be a big transaction. The division's website lists dozens of past deals, including a handful of involving SPACs, but almost all of them are smaller than the roughly $290 million fundraise for

Digital World Acquisition. Benchmark and two smaller underwriters ended up handling the assignment in exchange for $10 million and 144,000 shares.

Next, Orlando started looking for big institutional investors that would help lend some credibility to his effort. He made them a hard-to-refuse offer—one that didn't ask them to put much faith in his ability to operate a business. If they paid $10 apiece for 2.1 million Digital World Acquisition units, which each consisted of one share and one partial warrant, the investors could redeem the shares down the line for about $10.20—basically guaranteeing a $415,000 profit. On top of that, they could keep the warrants, which could become huge moneymakers if the stock performed well. *And*, as an additional sweetener, Orlando promised to sell them 150,000 shares at the same rate he had paid, three tenths of a cent apiece. For the investment firms, it was pretty much a can't-lose deal, with enormous upside. Unsurprisingly, 11 signed on, including the well-known firm D. E. Shaw.

All these backroom agreements happened before any retail investors even had a chance of getting involved. But on September 8, Digital World Acquisition, which had neither operations nor revenue, launched an initial public offering. The investors still weren't really betting on an actual business. Instead, Orlando was selling the same product he had offered to the institutional firms—a combination of shares and warrants, just without the extra shares for three tenths of a penny. But it remained essentially a can't-lose trade. The units sold out, and Digital World Acquisition came away with about a $290 million pile of cash.

The next month, on October 20, they announced a target company to infuse with that money and take public in the process. The Trump Media and Technology Group, which no one had really heard of before last week, appeared to consist of little more than a hackable Twitter prototype and ambitions to do a lot of other business. A deck for the company listed competitors as Twitter, Facebook, Netflix, the Walt Disney Co., CNN, iHeartMedia, Amazon, Google and Stripe. The presentation included zero financial information.

Even compared to other SPACs, which are notorious for offering flimsy financials, the Trump deal stands out. In an earlier era, before SPACs went mainstream, it's hard to imagine the Trump group going public at all. "You couldn't do a traditional IPO," says Michael Ohlrogge, a professor at the New York University School of Law who studies SPACs. "I don't think you'd be able to find any investment bank who would have done this."

Enter the suckers. Last Thursday, the day after the announcement, a crowd of ordinary investors piled into the stock, excited about the prospect of taking ownership in Trump's bold ambitions. Shares of Trump Media and Technology Group were not for sale—that company remains private. Instead, traders seeking to get in on the action had to invest in the SPAC, Digital World Acquisition, on the belief that it would successfully merge with Trump's group, ultimately giving them a stake in the combined venture.

Doing so got expensive, fast. On October 20, shares of Digital World Acquisition closed at $9.96, right about where they had traded since the day they went public. That price made sense. Remember, investors holding shares of Digital World Acquisition could choose to redeem them for about $10—making any purchase below that look like a no-lose proposition.

But on Thursday morning, after the late-night announcement, the stock opened at $12.73. New investors in Digital World Acquisition could no longer bank on the ability to redeem their shares for $10 without incurring a loss. Now, a new class of investors was getting involved: speculators and people who wanted to invest in the idea of a Trump's media and entertainment company.

But the numbers didn't provide much reason to be optimistic. With no operating business, Digital World Acquisition is now little more than a pile of cash—and a diluted one, at that. In the best-case scenario for investors, no one will redeem their shares, allowing the SPAC to retain its cash in the merger. That would leave it with an estimated $280 million and 37.2 million shares outstanding after it combines with Trump's company and pays the underwriters. Put it another way, the amount of cash per share would be just $7.62. That's because, although some of the initial investors put $10 into the pot, many of them—Orlando, his team members, the underwriters and the insiders who got special deals—put in less. The salesmen behind all of this should be fine, even if those who fall for their sales pitch get screwed.

The higher the share price climbs, the more difficult it is to rationalize. At one point on Friday, shares of Digital World Acquisition were trading for $175 apiece. That means investors were paying $175 to buy a $7.62 chunk of a cash pile. Shares closed yesterday, October 27, at a $64.89 apiece. It would be like if a jar with $100 in coins went up for sale, and people were bidding $850 for it because doing so might allow them to invest the coins in a Trump-branded venture.

If this seems absurd, that's because it is. The investment firms that got in early aren't complaining, though. Six of them disclosed holding investments last month that probably cost them less than $25 million apiece. By the end of the day Friday, those blocks were worth more like $250 million. While Trump acolytes, including Rep. Marjorie Taylor Greene, jumped into the stock, lots of Wall Street money was cashing out. D. E. Shaw ditched its unrestricted shares. Same with Lighthouse Investment Partners. A firm called ATW Spac Management amended an SEC filing to show it no longer held stock. Another investor, Boaz Weinstein, whose wife lost the primary to become the Democratic nominee for Manhattan District Attorney earlier this year, told reporters he got rid of the unrestricted shares that his Saba Capital controlled—spinning it as a righteous divestment. "Many investors are grappling with hard questions about how to incorporate their values into their work," he said in a statement. "For us, this was not a close call."

Orlando, meanwhile, is probably up even more money than any of the fund managers. It's hard to pinpoint his personal stake, but his firm disclosed holding 6.6 million shares last month, for which it paid a total of $11 million. Its holdings are now worth an estimated $450 million. Representatives for Orlando did not respond to requests for comment.

As for Trump, it's unclear exactly what percentage of the Trump Media and Technology Group he owns, though there are indications that it's a significant share. A press release calls him "chairman" of the business, and an agreement calls him the "company principal." A separate document mentions a "majority stockholder," without saying who it is.

Assuming he has a big stake, the former president is sitting pretty right now. The deal announced last week, before the stock soared, valued Trump's enterprise at $875 million initially. But by bidding up the price of the SPAC, investors are signaling that they think Trump's business is worth far more. If shares remain at their $64.89, the current owners of Trump's group will receive an estimated $5.6 billion worth of stock in the transaction.

And that's just the start. Once the deal closes, if the share price consistently hits $30 during a period of roughly six weeks, the owners of the Trump Media and Technology Group will receive an additional 40 million shares in the merged business, diluting the investors buying into the SPAC today but enriching the owners of Trump's group. At the current share price, the incentive bonus would be worth an estimated $2.6 billion more. In other words, if shares remain at their current level, the owners of Trump's group should receive about $8.1 billion of

stock. Add in the shares and warrants that the current SPAC investors hold, and you get to an estimated $11 billion for the whole enterprise.

To underscore how little sense that makes, consider this: Trump's entire real estate empire—which he has spent his life accumulating—is worth just $2.5 billion. Investors are currently treating his barely formed media business as if it's worth more than four times as much as everything else the former president owns. "Welcome to SPAC world," says Michael Klausner, a business and law professor at Stanford. "Combine Trump with SPAC, and that's what you get. It's like more hot air than either started with in the first place."

It's impossible to predict the future, and perhaps Trump's media empire will in fact turn into a giant. According to a March poll from The Hill and HarrisX, 54% of Republican voters said they would use a Trump-backed social media platform. In a more recent survey, from Politico and Morning Consult, 61% of Republicans said they would engage with Trump's new platform "some" or "a lot." Even if the business never takes off, it's possible that the former president's supporters will continue to believe it will, propping up the stock for the long run.

It seems more likely, however, that investors will eventually begin to question the math underlying all of this. Shares of the SPAC dropped 30% in the first three days of this week. Trump seems to be intent on pumping things back up. On Tuesday, he issued a 900-word statement hyping the company. If his statements aren't enough to keep the price at its current level, he should still be okay. Even in a disaster scenario, in which the stock fell more than 90% to $5 per share, wiping out over $1 billion for SPAC investors, the owners of the Trump Media and Technology Group would still be left with shares worth an estimated $430 million. And that stock would be more valuable than anything else Donald Trump currently owns.

Our oft- repeated advice is to avoid Bitcoin, and the rest of its ilk, but if you are determined to speculate, don't do it with an ETF. From Morningstar:

Bitcoin ETFs: Should You Jump on the Bandwagon?

Bitcoin believers have better options.

Ben Johnson, CFA
Oct 25, 2021

Even as the first bitcoin-tracking exchange-traded fund pulled in buckets of money, ProShares Bitcoin Strategy ETF (BITO) was showing why funds of its kind are a bad deal for investors.

The issue isn't with the fact that the ProShares ETF, along with another new entrant, Valkyrie Bitcoin Strategy ETF (BTF) are bitcoin-tracking strategies. It's how they do it.

Rather than investing in bitcoin itself, these funds invest in bitcoin futures contracts. This may sound like a technicality, but it's not.

This strategy--based on what we've seen over the past week in the futures market--could end up reducing investor returns by a double-digit percentage per year compared with the actual returns on bitcoin. And a key futures-market trading deadline at the end of this week could highlight this gap.

Not only that, the bigger these funds get, the more they could lag returns on bitcoin. As we said last week, "these aren't the bitcoin ETFs you are looking for."

A Big Debut

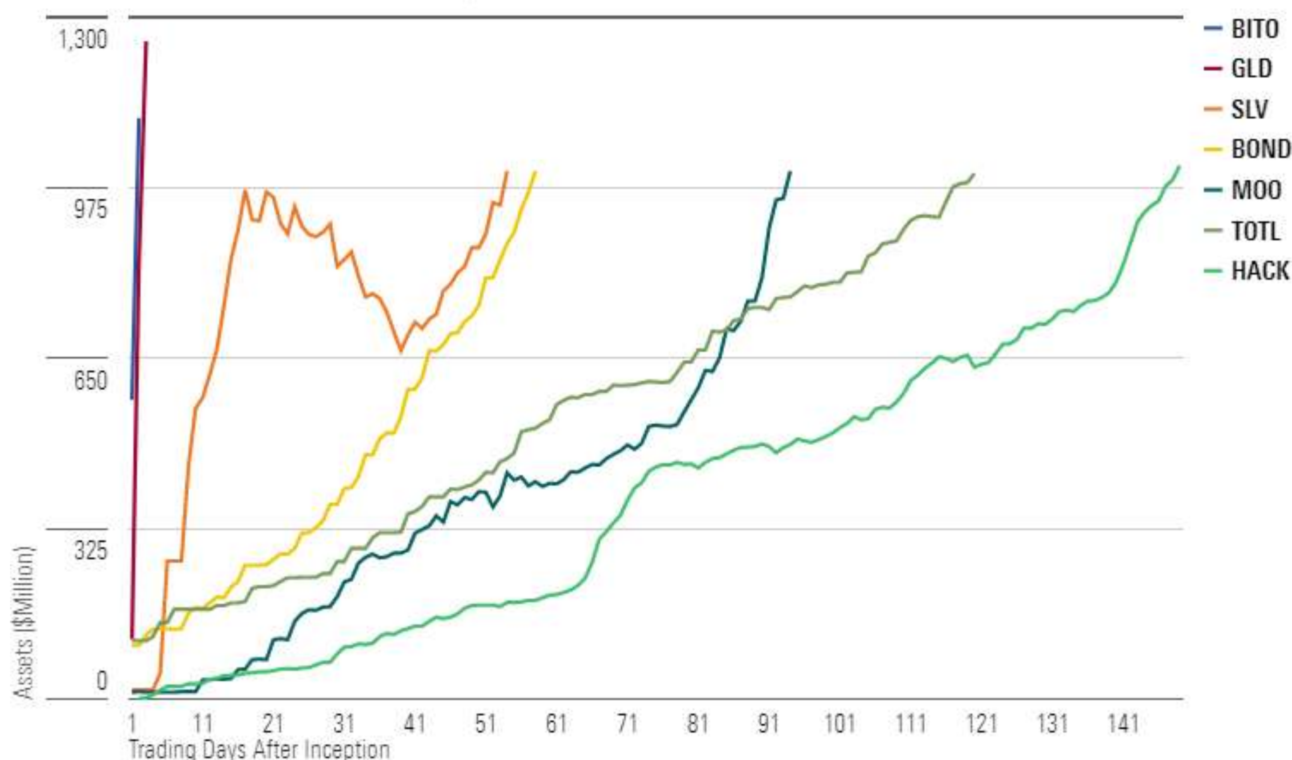
BITO's launch broke records. It saw more trading volume on its first day than any ETF in history, and it topped $1 billion in new assets faster than any ETF that came before it.[1] BTF was a fast follower, but apparently not fast enough--its first day trading volumes were a fraction of BITO's, and it netted about $30 million in new assets in its debut.

Exhibit 1 BITO Traded More in Its Debut Than Any ETF Before It

ETF	Ticker	Inception Date	First Day Trading Volume ($Mil)
ProShares Bitcoin Strategy ETF	BITO	10/18/2021	994
VanEck Social Sentiment ETF	BUZZ	3/2/2021	428
iShares Silver Trust	SLV	4/28/2006	324
ARK Space Expl & Innov ETF	ARKX	3/30/2021	299
Vanguard Total Stock Market ETF	VTI	5/24/2001	289
SPDR® Gold Shares	GLD	11/18/2004	265
Invesco QQQ Trust	QQQ	3/10/1999	265
United States Oil	USO	4/10/2006	263

Source: Morningstar Direct, Bloomberg.

Exhibit 2 BITO Was the Fastest ETF to Break the $1 Billion Mark



Source: Morningstar Direct, State Street Global Advisors, ProShares..

These Aren't the Bitcoin ETFs You're Looking For

BITO, BTF, and other Bitcoin(ish) ETFs that may soon follow do not invest directly in Bitcoin. Again, they *do not* invest directly in Bitcoin. Instead they invest in Bitcoin futures contracts. It is critical to understand the difference.

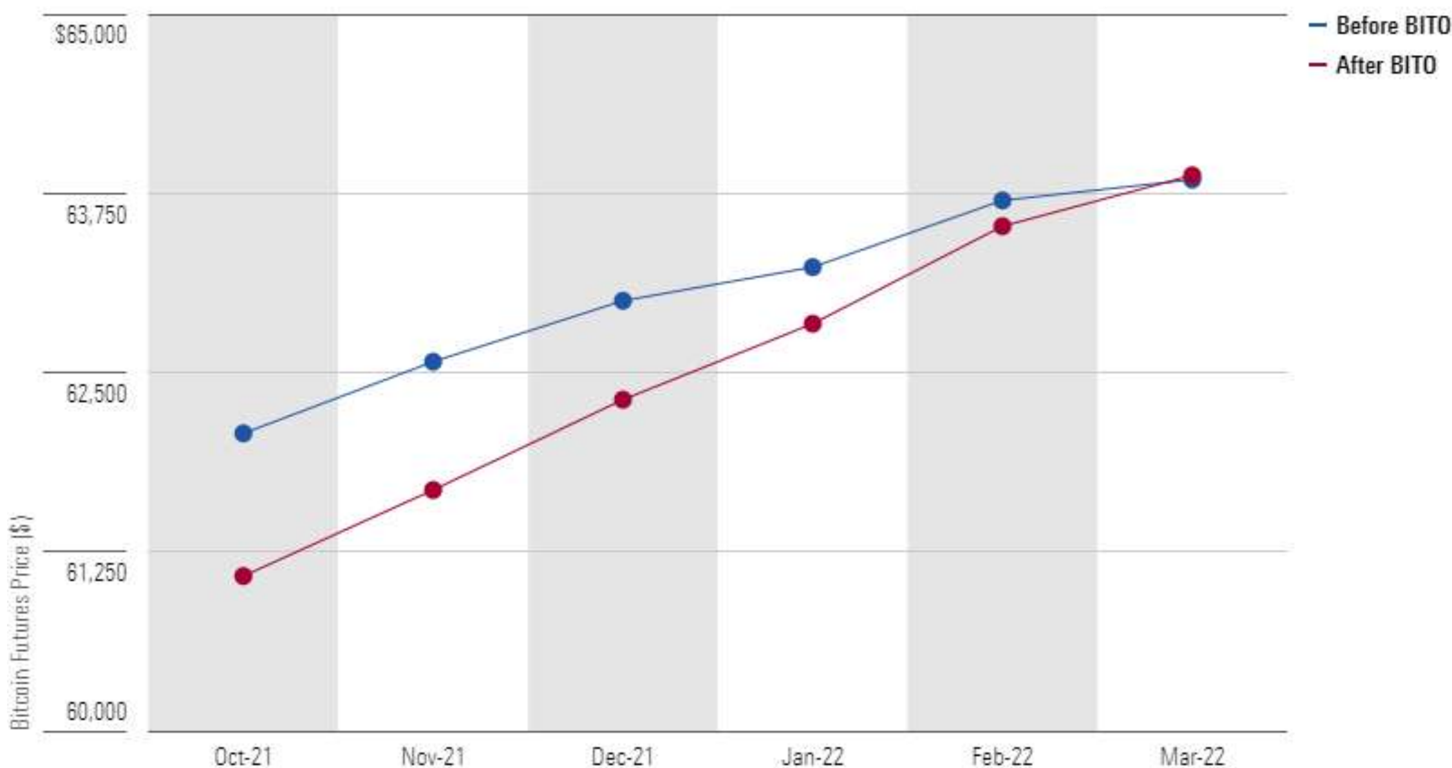
Futures contracts are an agreement between two parties to buy or sell a specific asset on a specific date in the future at a specific price. In the case of Bitcoin futures ETFs, that asset is Bitcoin (Bitcoin futures are actually cash-settled, but Bitcoin is the reference asset), that date is usually the last Friday of each month, and the price will vary, but it is based on the Bitcoin Reference Rate, or BRR, which averages Bitcoin spot prices from five major Bitcoin exchanges: Bitstamp, Coinbase, Gemini, itBit, and Kraken. Investing in Bitcoin futures is much different from investing directly in Bitcoin.

Bitcoin futures contracts, like all futures contracts, expire. Bitcoin futures ETFs will regularly sell the contracts they own and buy new ones. This process is commonly referred to as “rolling.” The costs (or benefits) of rolling futures contracts depend on the differences between their prices. When subsequent months’ contracts are trading at prices higher than the current month’s contract, the futures curve is upward-sloping. This is a state known as contango.

As an investor, contango is not the kind of dance you want to be doing. When the futures curve is in contango, futures-based strategies are forced to sell relatively low-priced contracts and purchase higher-priced ones. At risk of stating the obvious, selling low and buying high is not a successful investment strategy.

Conversely, when subsequent months’ futures contracts trade below the current month’s contract, the curve slopes downward, a state referred to as backwardation. Backwardated futures markets can give futures strategies a bit of a boost, as they will be selling high and buying low.

As of the close of trading on Friday, Oct. 22, the Bitcoin futures curve (see Exhibit 3) was in contango. The



October contract closed at a price of $61,080, while the November contract closed at $61,680. Based on these prices, the implied annualized cost of rolling from one month to the next (also known as the roll yield) would be around 11.8%.

The costs of regularly rolling into higher-priced contracts will compound over the long term. As a result, if the futures market is typically in contango, investors who own futures contracts will experience much lower returns than those who own the asset directly. To date, this has been the case with Bitcoin. Since Bitcoin futures were launched in December 2017, the futures curve has been in contango more often than not. As a result, the Horizons Bitcoin Front Month Rolling Futures Index ER (an index that owns the front-month futures contract and regularly rolls into the next) cumulatively underperformed the spot price of Bitcoin (Source: CoinDesk) by 93 percentage points from Dec. 15, 2017, through Oct. 21, 2021. Investors relying on futures contracts for long-term exposure to bitcoin are likely going to leave a lot of coin on the table.

Clearly, roll costs have been a headwind for investors in Bitcoin futures. Now that Bitcoin futures ETFs have arrived, this headwind may become stronger and more persistent. Since BITO launched on Oct. 18, the futures curve has gotten steeper (see Exhibit 3). The implied annual roll cost at the end of Friday, Oct. 15 (the last trading day before BITO launched) was 9.7% versus 11.8% as of the end of trading on Oct. 22.

Bitcoin futures ETFs' arrival has created a large and growing source of demand for both the front-month futures contracts as well as those further out on the curve. This has clearly had an impact on futures prices, and it could have meaningful, negative long-term impacts on investors in these funds. This impact will be felt in the coming days, as the October Bitcoin futures contract expires on Friday, Oct. 29.

Capacity Concerns

BITO's success in gathering assets may be cause for concern. This is because there are limits on how many futures contracts these funds can own. On Sept. 30, 2021, CME Group announced that the limit on the number of front-month futures contract any one entity could own would increase to 4,000 from 2,000, beginning with the November 2021 contract. As of Oct. 22, BITO owned a total of 3,812 Bitcoin futures contracts, split between the soon-to-expire October contract and the soon-to-be-front-month November contract. The fund's rapid growth has it quickly pushing toward its limits.

If BITO and its peers continue to take in new money, these limits will loom larger, and the steps that they take to stay in bounds may work against them. The funds can avoid hitting position limits by spreading their assets across multiple futures contracts. But as they move further out on the futures curve, they risk pushing the prices of longer-dated, less-liquid futures higher, potentially increasing roll costs in the process. Also, the more of their assets these funds invest in longer-dated futures contracts, the less sensitive their prices will be to movements in Bitcoin spot prices.

In the event that Bitcoin futures ETFs hit absolute limits on their overall positions in Bitcoin futures contracts, there is a chance that they would be forced to stop issuing new shares. In such an event, the ETFs' prices could come unmoored from the value of their assets. There are precedents here: Both United Stated Oil Fund (USO) and United States Natural Gas Fund (UNG) experienced such dislocations in the past after their capacity to tap into their underlying markets via futures and other derivatives was tapped out.

How big is this risk for Bitcoin futures ETFs? It is difficult to say, as it depends on how much new money they rake in, how far out the curve they can spread it, other measures their sponsors may take to throttle inflows, and

whether the CME will be accommodative with its position limits, increasing them further as they just did at the end of September. Until there is more clarity, capacity concerns will linger.

There Are Better Options

Futures-based ETFs are a lousy option for long-term exposure to Bitcoin. Roll costs and fund fees will likely lead these funds' long-term returns to lag the performance of Bitcoin--probably by a wide margin. Capacity concerns and the potential for the ETFs' price to dislodge from their net asset values are a wild card to consider. All told, these funds are best left for the traders, who will gravitate to them based on Bitcoin futures' volatility (traders love volatility) and the fact that many of these funds will also have options contracts tied to them (BITO already does).

There are so many ways for Bitcoin believers to purchase Bitcoin directly, most of them far superior alternatives to buying futures-based ETFs.

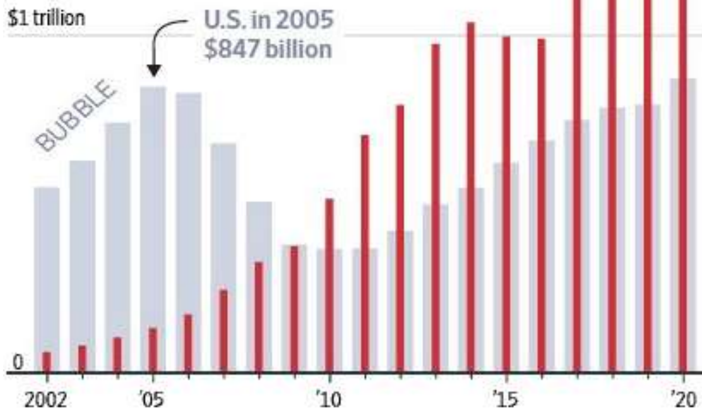
[1] Exhibits 1 and 2 exclude ETFs that were launched with significant seed investment.

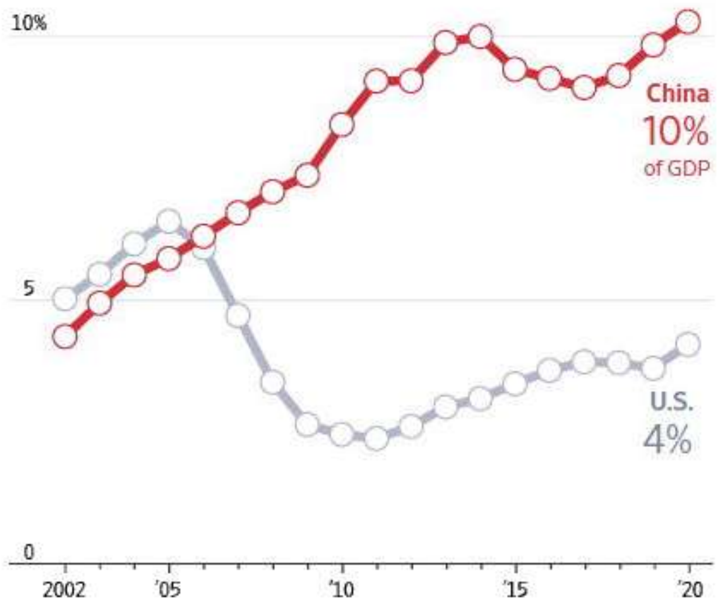
From October 4th's WSJ:

In terms of share of domestic output, annual investment in China's residential market over the past decade has dwarfed the U.S. housing bubble of the 2000s.

IN DOLLARS

China in 2020 → $1.6 trillion





Positions

ARES - IVA System picks meet the Valuation criteria by being in the cheapest decile of PEG, or if unavailable, EV/EBITDA or EV/EBIT, and are considered fully valued at the 5th decile. We sold on 10/26 for all 3 clients @ 84.20:

CIO - an Office REIT was rated Trim with a buy under 13.5 by Forbes Real Estate Investor when we sold on 10/8 for all 3 clients @ 18.36:

HIBB - 2% positions in this IVA System pick were purchased on 10/8 for 5 clients @ 76.70:

Insider Buying:

Trade Date	No. Part	Participants	Net Sell (Shares)	Net Buy (Shares)
10/06/2021	1	Longo Michael		5,000
09/30/2021	1	Hubbard Linda		228
09/24/2021	1	Benck David		2,000
09/01/2021	1	Yother Alton		
07/15/2021	2	Blahnik Ron, Benck David		4,200
07/02/2021	1	Hubbard Linda		790
06/30/2021	2	Hubbard Linda, Aggers Ja...		174
06/28/2021	1	Knighten Benjamin		1,250

Brett Jensen's Oct. 8th analysis:

Summary

- After a blow-out quarter and an upwardly revised fiscal 2022 forecast, shares of sports apparel and merchandise retailer Hibbett, Inc. (HIBB) have fallen some 20%.
- Concerns about inventory being impacted by supply chain issues and tough future comp store sales are to blame.
- With robust sales momentum for all things sporting goods related, an aggressive share repurchase program, and insider buying, Hibbett merited a deeper dive.

Company Overview:

Hibbett, Inc. (HIBB) is a Birmingham, Alabama based sports apparel and merchandise retailer with ~1,080 brick-and-mortar locations in 35 states under three banners plus ecommerce site www.hibbett.com. The company sells athletic footwear, apparel, accessories, and team sports equipment from leading brands, including Nike and Adidas, with a shifting emphasis on fashion and a focus on the Gen-Z demographic. Hibbett was founded in 1945 as Dixie Supply Company and went public in 1996, raising net proceeds of $32.9 million at $3.16 per share, after giving effect to four three-for-two stock splits. Shares of HIBB trade just over $75.00 a share, equating to a market cap just north of $1.1 billion.

The company operates on a 52- or 53-week fiscal year (FY) ending on the Saturday nearest January 31 of each year. FY21 ended on January 30, 2021.

Hibbett's model is based around operating in underserved markets, defined as two or less competitors (such as Dick's Sporting Goods and Foot Locker) within a fifteen minute drive of one of its properties. Currently, ~70% of Hibbett's locations fit this criterium. All of its brick-and-mortar retail properties are leased and are located primarily in the South with Alabama, Georgia, Louisiana, Mississippi, Tennessee, and Texas acting as home to approximately half its storefronts. Nearly three-fourths of the stores are situated in strip-shopping centers featuring a big box retailer such as Walmart.

Hibbett has built out its footprint through clustered expansion, whereby it opens new stores within close proximity to existing locations to leverage logistics, marketing, and merchandise selection for specific local markets – all while trying to maintain its focus on underserved markets. The company has also made investments (owing to the pandemic) in its omni-channel offerings, including ecommerce, curbside pickup, and ship to store. It has also updated its Hibbett Sports locations to enhance the customer experience both visually and digitally.

Although Hibbett operates under one reportable segment it features three store brands. Hibbett Sports is the flagship banner and by far the largest, with ~888 properties. In 2018, the company purchased 136 City Gear stores for a consideration of $88 million (plus earnouts) and has since expanded the brand to ~174 locations, which includes the rebranding of some former Hibbett Sports properties. The company also runs 18 Sports Additions stores, which are primary focused on selling athletic footwear.

Covid Impacts and Share Price Surge

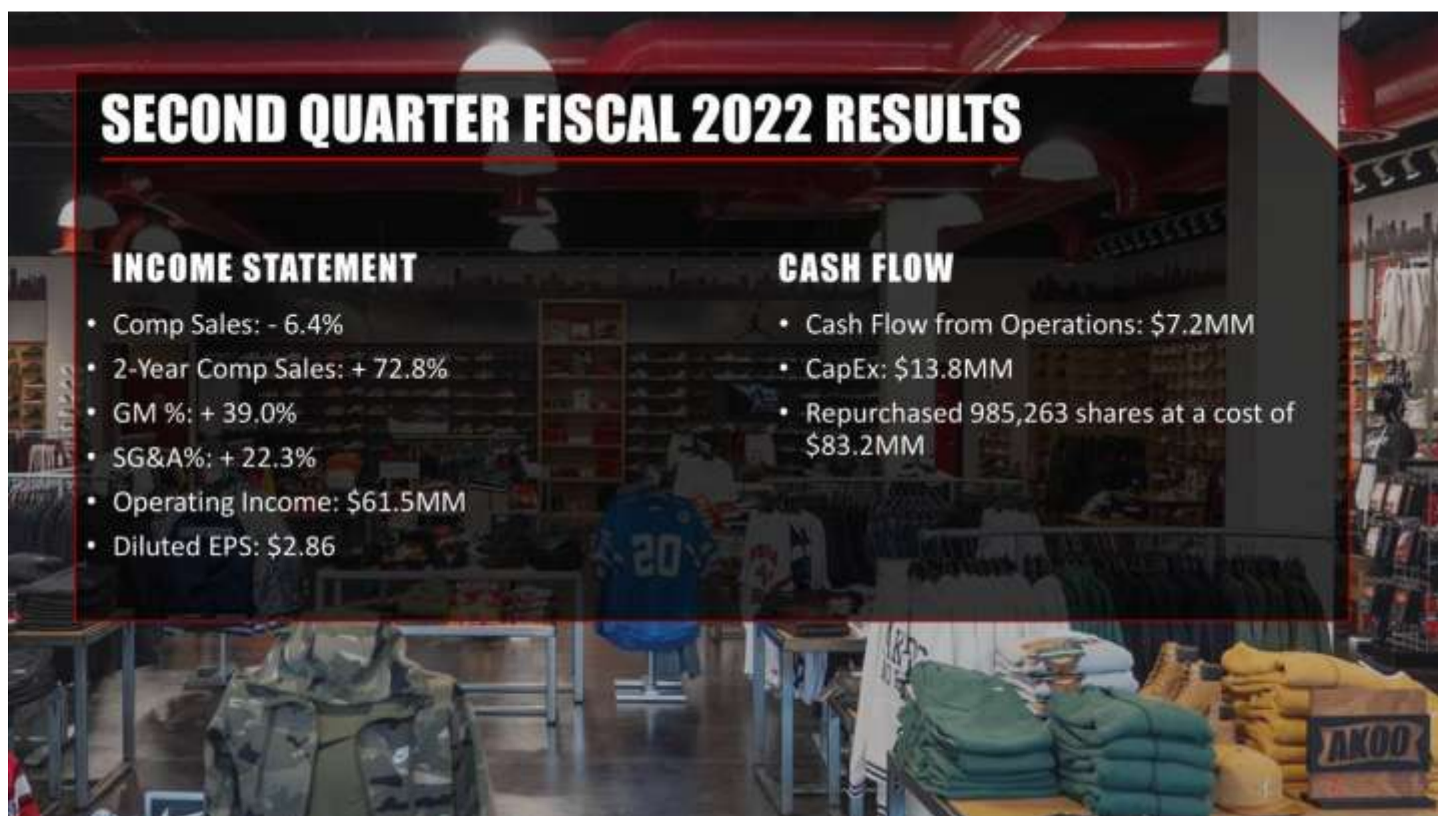
Like every business in the U.S. Hibbett was impacted by the pandemic, especially in its 1QFY21 quarter, which encompassed the months of February, March, and April 2020. During that time, the company's stores were open for ~60% of selling days – offset somewhat by an 80% increase in digital traffic – causing a 19.5% downdraft in comps and compelling it to enact precautionary measures, such as drawing down the $50 million available on its credit line and suspending its share repurchase program.

Business sprang back to life in 2QFY20. With nearly every one of its locations opened for business, the company experienced exceptionally high comps (up 79.2% overall year-over-year) due to pent-up demand (aided by the first round of stimulus checks) and people working from home dressing more casual, as well as the permanent closure of competitors (such as Stage Stores) in some markets. Owing to this sharp turnaround, Hibbett returned the $50 million to its lenders, leaving it debt-free at the end of 2QFY20.

The company's stock has enjoyed a rather remarkable run. After essentially trading between the mid-teens and the mid-20s for a period encompassing mid-2017 to early 2020, shares of HIBB plummeted during the pandemic-induced selloff, trading below $8 for a brief time in March 2020. They then rebounded – really skyrocketed – as demand for its merchandise did not abate, with the company posting comps of 21.2%, 21.9%, and 87.3% in the quarters subsequent to 2QFY21, respectively. This led to the company resuming its share repurchase program in December 2020 and paying is first ever recurring quarterly dividend ($0.25) in July 2021. Its stock reached an all-time high in August 2021, touching $100 a share during the two days prior to Hibbett's 2QFY22 earnings press release of August 27th.

2QFY22 Results and Outlook

On the surface, the quarter looked like an unalloyed success, with Hibbett reporting GAAP earnings of $2.86 a share on net sales of $419.3 million versus $2.38 a share on net sales of $441.6 million in 2QFY21. These results blew away Street estimates by $1.86 and $107.7 million, respectively. Even though comps were down 6.4% (-3.8% brick-and-mortar; -20.4% ecommerce), they were competing against the unprecedented



performance of 2QFY21 and were still up 72.8% (64.5% brick-and-mortar; 153.3% ecommerce) compared to the more 'normal' 2QFY20. Furthermore, the overall two-year comps for 1HFY22 were up 63.4%, signaling a seismic shift in demand for athletic wear.

On the strength of its quarter, the company raised its FY22 outlook a second time in five months. After predicting flat comps in March 2021, management's forecast now calls for mid-teen comps. GAAP earnings outlook, initially set at $5.25 a share, is now projected at $11.25, both based on range midpoints. And despite the challenging comps going forward, management guided investors to mid-to high single digit positive comps for 2HFY22. The company is also taking advantage of its robust cash generation by increasing its capex spend in FY22 to $70 million from a previously forecasted $47.5 million to facilitate organic growth opportunities (through enhanced customer experiences both in store and online) and infrastructure projects to enhance distribution.

However, shares of HIBB sold off 9% in the subsequent trading session and are now off 22% since the earnings report. There are three undercurrents at play. First, is the 'buy the rumor, sell the news' dynamic, where a preponderance of traders are long before the earnings report, meaning few are short. As such, there is no short coverers to sell shares to post-earnings, precipitating the decline.

Along those same lines, it appeared as if a few larger investors were attempting to use the good news as a liquidity event, with the stock up nearly 1,250% over the prior 17 months leading into the earnings report. What may have prompted their pivot was the negative 6.4% comp, which served as a reminder that the nosebleed comps of the prior four quarters (averaging 52.4%) are not sustainable and tough ones are on the horizon.

Third, was a statement by the CEO Michael Longo on the call in which he stated, "Inventory remains under pressure due to increased sales volume and supply chain disruption." He expected inventory to remain elevated 2HFY22 versus 2HFY21 but down versus 2HFY20 levels. For reference, inventory per store on July 31, 2021 was $200.7K versus $169.0K a year prior, yet it was still down significantly from $244.2K two year previous.

Longo also expressed confidence that Hibbett's supplier relationships would allow it to procure necessary inventory. But with reports of Nike implementing price increases with effect in calendar 2022 and cancelling spring orders with certain retailers (presumably due to restricted quantity impacted by supply chain issues), some investors might have believed that confidence misplaced.

Balance Sheet & Analyst Commentary:

With that said, the company is in excellent financial stead, holding cash of $176.8 million and no debt as of July 31, 2021 after spending $120.5 million on share repurchases (~1.5 million shares), $14.8 million on additional inventory, and $3.8 million on its first dividend during the first half of its fiscal year. It has $515.9 million remaining on its stock buyback authorization, or slightly less than half its market value.

Despite the recent decline, Street analysts are fairly sanguine on Hibbett's prospects. In fact, three of the five firms proffering commentary over the past year raised their price objectives for the stock after the 2QFY22 earnings report. Collectively, they have three buys, one outperform, and one hold rating and a median price target of $110 per share. Their 3QFY22 consensus calls for EPS of $1.45 on net sales of $359.3 million.

Both CEO Longo (5,000 shares at $70.08) and General Counsel David Benck (2,000 shares at $74.34) have used the recent weakness as buying opportunities, purchasing shares in the past three weeks.

Verdict:

With the pullback since its August earnings report, Hibbett is now trading at 6.8x FY22E EPS and .67 price-to-FY22E sales. These metrics include a modest 1.3% dividend yield and an aggressive share buyback program that has removed 1.7 million shares (11% of total) from circulation since December 2020. It can be argued that it trades in line with its peer group (with the exception of Dick's, which commands a 9.4 P/E and a .91 price-to-sales ratio) but more to the point: Bank of America's spending report of September 21, 2021 indicates that demand for sporting goods and apparel are still very robust with sales up 8.6% year-over-year for the week

ending September 4th and 10.6% for the week ending September 11th – instructive, considering the extremely tough comps ahead for Hibbett after a spectacular FY21. ...