Third Quarter 2021 Commentary

September was the stock market's worst month since March 2020, with most major market averages down between 4% and 5%. However, for the quarter just ended, the S&P 500 still posted a positive return of 0.6% against the Dow Jones Industrial Average's 1.5% decline. The third quarter of 2021 was the sixth consecutive quarter of positive returns for the S&P since the depths of the coronavirus panic of early 2020. Will that streak continue? Or does September's drop portend dark clouds on the market's horizon?

Do the continuing disruptions to the global supply chain caused by COVID mean that businesses will continue to struggle in the near term? Or does the imminent approval of the Pfizer vaccine for 5-11 year olds mean that we can finally start easing off on the latest round of COVID restrictions due to the delta variant? With fast food restaurants nationwide advertising starting pay at nearly $20 per hour, not to mention starting bonuses, will American businesses ever be able to hire workers and still make a profit again? Or is that just a sign of a healthy rate of inflation working its way through the system?

Given the ever-present uncertainty of market conditions, it's no wonder that we have seen ample evidence this year of those two overarching sentiments that comprise the yin and yang, push and pull on financial markets. Of course, we are talking about fear and greed.

No, Gordon Gekko, Greed Is *Not* Good

The S&P 500 index is up about 16% this year, through the end of September. That's a fairly standard rate of return for our nation's primary equity benchmark. A touch higher than average, maybe, but well within the bounds of reason.

But what have the best-performing stocks been this year? Near the top of the list would be used video game retailer Gamestop (GME) and cinema operator AMC Entertainment (AMC). COVID and the great digital migration have combined to wallop these two industries hard, yet somehow GME is now about ten times higher than where it was at the end of 2020, and AMC is up nearly twenty times. What in the world?! Industry analysts, and even the companies' own management teams, believe that it will take years for them to return to their pre-pandemic levels of profitability. But we wonder what that even means. For the three-year period from 2017-19, AMC lost around half a billion dollars, cumulatively, which was pretty good in relation to the full one billion lost by GME in that same time period. And that's what they're trying to get back to?

So what's going on here? We believe the answer is a simple get-rich-quick scheme. In the first part of this year, some speculators started buying stocks of beaten-down companies such as GME, AMC, and others. Then they went online and started touting these stocks. Other market participants noticed those posts and began buying the stocks, too. That sent the prices higher, which caused more people to notice, which caused more people to buy, and so on. As people noticed others around them getting rich quickly by owning these stocks, they didn't want to miss the train so they hopped on board too. It's an exhilarating ride while it lasts, but alas it never goes on forever.

Most of these so-called "meme" stocks have come crashing back down to earth in the ensuing months, but somehow GME and AMC have so far withstood the forces of financial gravity that will eventually catch up to them. We believe that, in due time, these stocks will be added to the long list of other former high-flying assets like the tulip bulbs of the 1600s or the Beanie Babies of the 1990s.

We believe there is a similar dynamic working in other corners of the financial system. Market participants notice that the prices of some particular asset (e.g., cryptocurrencies or, the latest fad, non-fungible tokens) rises quickly, they don't want to get left behind, so they buy too, further driving up the price, and so on. Without a tangible economic foundation undergirding these assets, though, it's just a game of musical chairs. Eventually the music will stop, and it could be a rather bumpy landing for those still playing.

Fear is Greed in Disguise

So if greed isn't a good motivator for investors, perhaps fear would be a better guiding light? Should we all be listening to "Rich Dad, Poor Dad" author Robert Kiyosaki when he says that the "biggest crash in world history" is going to happen sometime this month? Well, that does sound kind of scary. And that book he wrote in the '90s was quite good, and helped a generation of people learn to take control of their personal finances. But, then again, he did predict the same sort of thing in 2016. And then again in 2017. And in the summer of 2020.

Also, fellow perma-bear Harry Dent in February 2021 said that the U.S. stock market would decline 40% in April. But then in March 2021 he amended the timeline of his prediction and said that it would happen by the "end of June." However, he also amended the scope of his prediction and said that it would be the "biggest crash ever." Neither of those happened, though, so in early July Dent said that, sometime in the next three months from that point, most equities would fall by 80%. We're now a little more than three months past that statement, and things are still chugging along.

It should be obvious that we do not hold these market prognosticators in very high regard, but we'd like to dwell for a moment on the implications of the gloom-and-doom they are purveying. Obviously, fear sells, and these people want to sell more newsletter subscriptions. But what exactly would their hypothetical readers plan to do if they actually believed this malarkey? Presumably, the sequence would go something like this: I hear about an imminent crash from an eminent pundit, I sell all my stocks, the crash happens, I wait for the dust to settle, then I buy back in at the bottom and laugh all the way to the bank.

In other words, it may feel to these would-be crash-avoiders that they're trying to protect their families' wealth, but really it boils down to the fact that they want to have more money at the end of the game than the "suckers" playing the game alongside them. Or in fewer words, it's simply greed. It looks a little different than the meme stock/bitcoin/get-rich-quick greed that we're accustomed to, but it's greed nonetheless.

"Bulls Make Money, Bears Make Money, Pigs Get Slaughtered"

So if we shouldn't let our investment actions be dictated by either fear or greed, how then should we proceed? This is a theme we return to time and again, so we imagine you could probably write the ending to this letter as well as we could. But we'll go ahead and spell it out, anyway.

"Investment is most intelligent when it is most businesslike," wrote Benjamin Graham so long ago. This is what we aspire to. We don't wonder if a crash is coming in the next quarter, and we don't try to guess what the next hot-ticket stocks are going to be next month. We look at how many lattes Starbucks has sold the last few years, or how many vehicles Carmax has moved off its lots, or how many ads Google and Youtube have served up, and then we try to imagine how those things might proceed over the next 5 or 10 years.

We then try to determine whether those values mean that we should be buyers or holders or sellers of the applicable stocks, and then we act accordingly. We try to size our positions prudently, so that we never lose too much on the inevitable stinkers that find their way into any portfolio, but so that we also can feel a substantial benefit when some stocks outperform our expectations.

Yes, there will be bumps in the road. Every now and then a swift 20% decline comes along, like it did in the fourth quarter of 2018. Rarer than that, but more painful, are the swifter 30% drops like we experienced in the first quarter of 2020 when the coronavirus locked us all down. However, even with such setbacks, many of our clients have slowly and patiently watched their portfolios under our stewardship double or even triple or more over the long haul. We believe that kind of slow and steady progress is the best way forward through the uncertainty.

Thank you again for your trust, and we look forward to reporting to you again early next year.

Sincerely,

FELIPE

Felipe Garcia, CFA
Chief Investment Officer
INKWELL CAPITAL LLC

Aaron

Aaron Byrd, CFA
President
INKWELL CAPITAL LLC