OPINION

Speculative stock mania has returned. It’s not going to end well

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We are back to the future. Meme investing, after taking a couple of years off, is back in fashion again.

GameStop, a heavily shorted stock, rallied sharply earlier this month, despite no news reports or fresh fundamental catalysts. It surged by more than 300 per cent between May 1 and May 14, hitting a 52-week high. The surge was said to be related to the popular Reddit retail trader Roaring Kitty and recent posts in his X account.

While the stock has relinquished much of those gains, it is still up about 100 per cent over the last month and poised for further big moves thanks to the attention it is getting from retail investors. And it is not just GameStop that rallied. AMC, a favourite stock, has also been getting a lot of retail investor attention, among others.

About 20 per cent of retail investors use social media such as Reddit and TikTok to make investment decisions by watching their favourite content creators, listening to their financial advice and following trends that are not backed by data, said Desmond Warren, senior PR associate with Prospero.ai, a website that uses machine learning for market signals.

As of February, the percentage of companies that had outperformed the S&P 500 ETF was 24 per cent, the lowest percentage on record (back to 1994). While the market breadth has widened in recent weeks, the current stock market rally has considerably narrower breadth than in the past as investors have loaded up disproportionately on the Magnificent Seven.

Investing is not a business where the guy with the best IQ wins. It is a business where the guy with the most patience, discipline and long-term perspective wins. That is, the person with the right temperament wins. They can be the best screener, the best valuator but if they panic, get greedy and impatient, they will never be good investors. In my opinion, discipline is discarded by retail investors when chasing big stock-market gains.

Blackrock carried out a study a few years ago where they show that while the average equity mutual fund in the U.S. made about 8 per cent annualized over the previous 40 years, individuals investing in these mutual funds made only 2 per cent. We know that retail investors are not good market timers. They panic at market bottoms (and sell) and become euphoric at market tops (and they buy). There is a difference between what they should do and what they do, and this leads to their long-term underperformance.

Academic studies show exactly this: that retail investors are uninformed, more vulnerable to the influence of psychological biases (such as herding, which is the result of response to fads or sentiment), market sentiment and attention-grabbing events, and tend to underperform.

Judging by retail investors' share of options volume (currently, most of Robinhood revenues come from the trading of options by retail investors), they are back to speculative stock mania as encouraging messaging from the U.S. Fed and sky-high stock prices ignite a euphoria among day traders.

So, it is not far-fetched to say that most retail investors are speculators (that is, seeking to make a quick profit from short-term stock price movements) as opposed to investors (that is, taking a long-term approach to managing our portfolios). On the other hand, according to the same studies, relative to individual investors, institutional investors are more skillful and sophisticated.

In their paper titled "In Search of the Origins of Financial Fluctuations," Xavier Gabaix and Ralph Koijen argue that "stock prices move because people do things independently of fundamentals." They explain that the amount of money entering the markets can have a large impact on share prices regardless of fundamentals. They do, however, conclude that, in the long run, prices return to fundamentals.

Corporate executives seem to agree that prices eventually return to fundamentals. Tech executives (the likes of Jeff Bezos, Mark Zuckerberg and others) are selling. According to MacNicol & Associates Asset Management Newsletter, insider selling in technology stocks hit the highest level in three years. Even beyond the tech sector, Jamie Dimon has sold US$159-million in JPMorgan stock. The Walton family sold US$1-billion worth of Walmart stock so far this year and Warren Buffett sold 1 per cent of his Apple holdings at the end of last year to mention a few.

In light of the speculative mania of retail investors, what is most worrisome is that the percentage of U.S. households owning stocks stands at 58 per cent, a record high by far,

as recent statistics compiled by the U.S. Fed show. And this is at a time when personal balance sheets are deteriorating with consumers adding debt as if there is no tomorrow.

U.S. credit card debt, for example, has surged over the last three years coming to more than US$1-trillion last July, an all-time high. The instant gratification society is at play here, where consumers like to buy products and services right away, letting the consequences come later. This also applies to stock buying as margin debt has skyrocketed in recent years.

The period of speculation and instant gratification will not end well. As renowned value investor Howard Marks has declared, “Much of the risk in investing comes not from the companies, institutions and securities involved. It comes from the behaviour of investors.”

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