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STAYING DISCIPLINED AS SPECULATION HEATS UP

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Signs of speculation in today's markets

As the world continues to grapple with Covid-19, global equity markets staged a stunning comeback in the second quarter. The Canadian stock market booked its best quarter since 2009, European shares enjoyed their best quarter in five years, and the S&P 500 Index posted its largest quarterly percentage gain since 1998. While the rally has lifted everything from beaten-down energy stocks to apparel retailers to big technology firms, worrying signs of speculative mania led by retail investors have started to emerge in pockets of the market.

Since March, zero-commission online brokerages in the U.S., that cater to small investors, have seen record spikes in new accounts and trading volumes. Much of the money going into new trading accounts is from government transfers to workers idled by Covid-19, who are betting on the wild ride of stocks. Liquidity supplied by retail investors has found its way into the market in an unprecedented way, and has created levels of speculation not seen since the dot-com bubble.

In the oil market, U.S. crude prices plunged to negative \$40 at the end of April, partially because of a big sell-off of West Texas Intermediate (WTI) futures contracts by USO, the U.S.'s largest oil ETF, which had attracted large inflows from retail investors. According to Robintrack.net, which follows the number of users holding each asset on the online trading platform Robinhood, there were a record 220,905 user accounts holding the USO fund at the end of April – almost 30 times more than two months earlier. The CME Group, the derivatives exchange, became concerned about USO's dangerously large position, after it amassed a quarter of the WTI futures contracts due to be delivered in June, and ordered USO to scale back. At this point, furious trading ensued, and WTI price volatility was exacerbated to an extreme level.

In derivative markets, speculative excess in U.S. options trading surged to its highest levels in at least 20 years. Small traders bought to open tens of millions of call contracts in June.

In equity markets, even though bankruptcy filings are running at the fastest pace since 2013, stuck-at-home traders speculated on big price swings following Chapter 11 bankruptcies for names such as car renter Hertz, oil driller Whiting Petroleum, retailer J.C. Penney and shale pioneer Chesapeake. Many of these companies' share prices surged after the companies filed for bankruptcy. Hertz's stock bounced nearly seven-fold in three days in early June, erasing all its post-bankruptcy losses, before crashing again later.

All this is not to say that there is a full-blown mania in the markets, but share price gains in the recent reopening rally were driven primarily by multiple expansion, which pushed the S&P 500 Index's forward P/E to nearly 22x, the most expensive since 2000. The "buy the dip" mentality was strengthened by the belief that fiscal and monetary support has created a floor for risk assets, which helped to create high levels of speculation in some parts of the market. If the economy does not rebound in a V-shaped manner, as equity performance suggests, there is the risk that trailing fundamentals will pop the speculative bubble. In such an environment, comprehensive investment solutions involving actively managed investments with a focus on value and quality; proper diversification and asset allocation strategy may be better options for retail investors than going after hot stocks.

The importance of active management and asset allocation

With a passive approach, also known as indexing, investors seek to replicate a portfolio that holds all the securities, in the same proportion, as the index. In today's market, top five S&P 500 stocks (Microsoft, Apple, Amazon, Facebook and Google) comprise over 20% of the index and the same five tech titans carry about 40% weight in the Nasdaq Composite Index, which has been setting new highs even as the other broad indexes remain below records. The narrow breadth and high dispersion have lifted equity market concentration above the Tech Bubble peak:



Source: Bloomberg as at June 30, 2020

Passive investment is betting on the market's structure and shape which is not as robust as suggested by the level of the index as the market is narrowed and propped up by a handful of mega-cap blue-chip names.

On the other hand, active management focuses on strategies that may be forgone by passive management by investing in high quality stocks that exhibit solid fundamentals with attractive valuation and strong potential for returns. It manages risks by avoiding overvalued securities that may be vulnerable to a correction if they fail to generate enough fundamental earnings strength to justify elevated valuations. The sharp decline in market breadth is usually a bad signal for speculation and future market's return. History shows time and again that a high level

of speculative activity has a strong tendency to lead to negative returns. That is why active management is worth more investors' attention, particularly in today's market when the power and pace of the recent equity market rebound stand in contrast to the murky economic and political backdrop, leading to worries that asset prices may be dislocated from fundamentals.

For a multi-asset portfolio, asset allocation is one of the most important factors in the performance equation. Good asset allocation practice can improve a portfolio's risk-return profile, because while a portfolio's return is the weighted average of the returns of each asset, a portfolio's volatility will be lower than the average of the individual volatilities, so long as the correlation of each pair of assets is low. This is the free lunch of diversification. Active managers are also able to respond to changes in the markets and the economic cycle by tactically adjusting the allocation of their portfolios to reduce volatility and improve results.

Empire Life's Emblem portfolios represent the collective wisdom of our investment team's views, offering actively managed portfolios to help investors meet their financial objective. As a group, retail investors often get caught up in the emotion of investing, and let fear and greed dictate their actions. During bouts of market volatility, sound financial advice can be key for clients, helping them overcome emotional investment bias and stick to actively managed portfolios that are constructed with proper asset allocation, based on a client's investment objectives, risk tolerance, investment horizon and overall financial situation.

We thank you for your continued support.

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