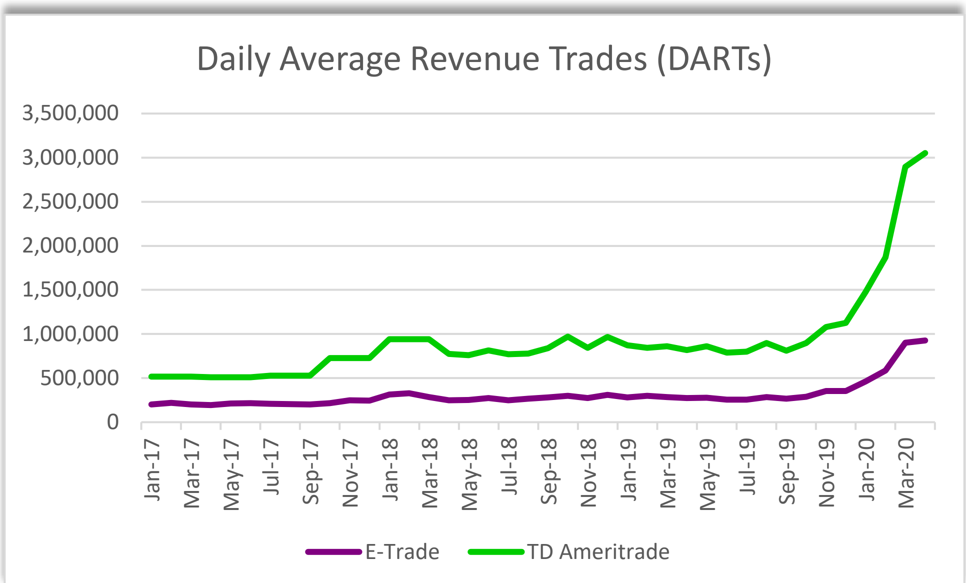
Rise of the Quarantined Day Trader

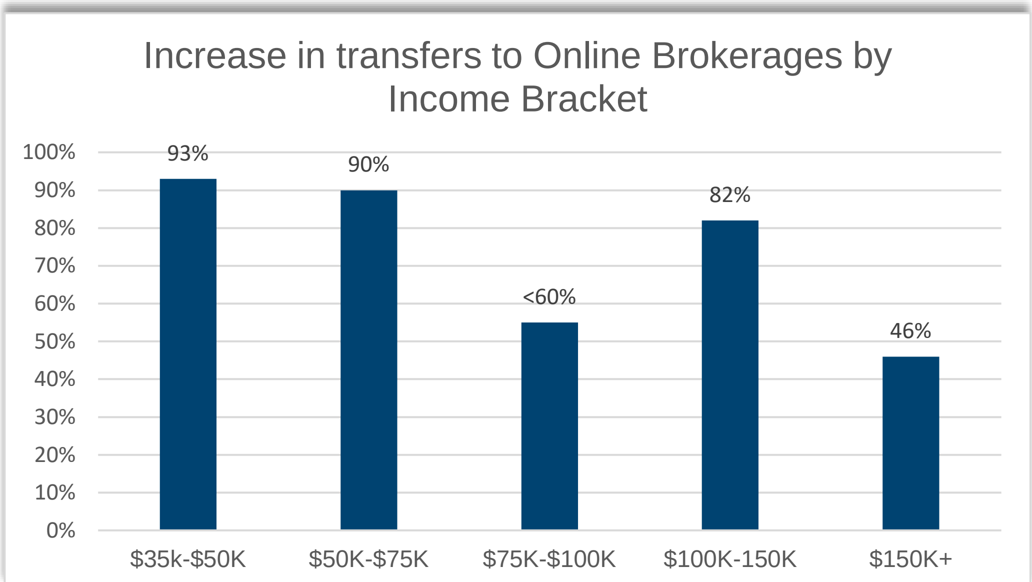
In October of 2019 Charles Schwab, the online stock trading broker, cut commissions to zero on all stock and ETF trades. In the ensuing days and weeks, almost all online brokerages dropped commissions to zero, creating ideal conditions for frothy trading activity and higher volatility once COVID forced shelter in place. This created a perfect storm to form a new class of retail 'day-traders.'



Source: Companies' 10k

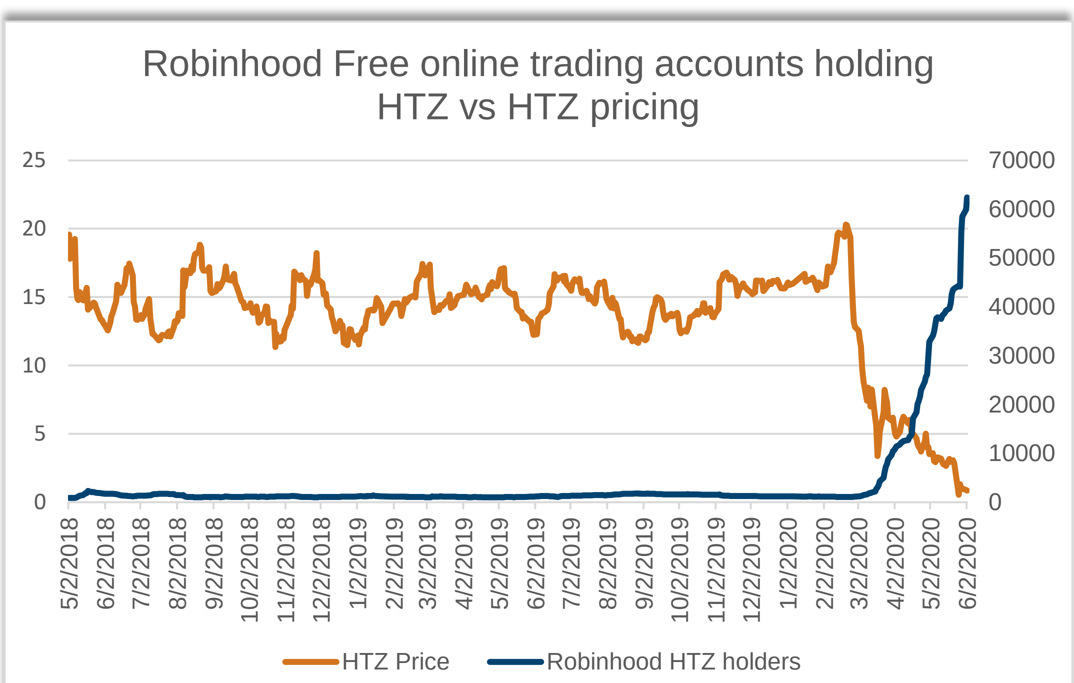
Trading activity has exploded since the implementation of zero cost commissions in October 2019

Unfortunately for the 64% of Americans who gamble on sports, shelter in place scraped the regular distraction as seasons were cancelled or pushed out, leaving a void to be filled by other risk-taking endeavors. According to Forbes, almost 30% of Americans used at least some of their $1200 stimulus checks to buy stocks. The daily volatility, in which the market was moving 2% or more in either direction, created an unprecedented environment for those looking to fill the void of sports gambling. Many of the higher beta names were seeing daily moves of 10% or more on a regular basis. This is a tactical day trader's market, not a strategic investor's market. Attempting to navigate these wild swings is a losing proposition over the long term. Envestnet reported that approximately 90% of smaller online brokerage accounts made transfers in during the first quarter of 2020.



Stimulus Checks are being spent playing in the stock market, source: Envestnet.

Further, Robinhood, the original online zero commission trading platform, and their tool Robintrack provides account holders for any stock graphed over time. This is an alternative data source we reference to check investor base (investor type buying/selling) to better understand investor sentiment in certain stocks. We see the largest changes in ownership in stocks that have low per share values (<$5 per share) and have widely known consumer facing businesses.



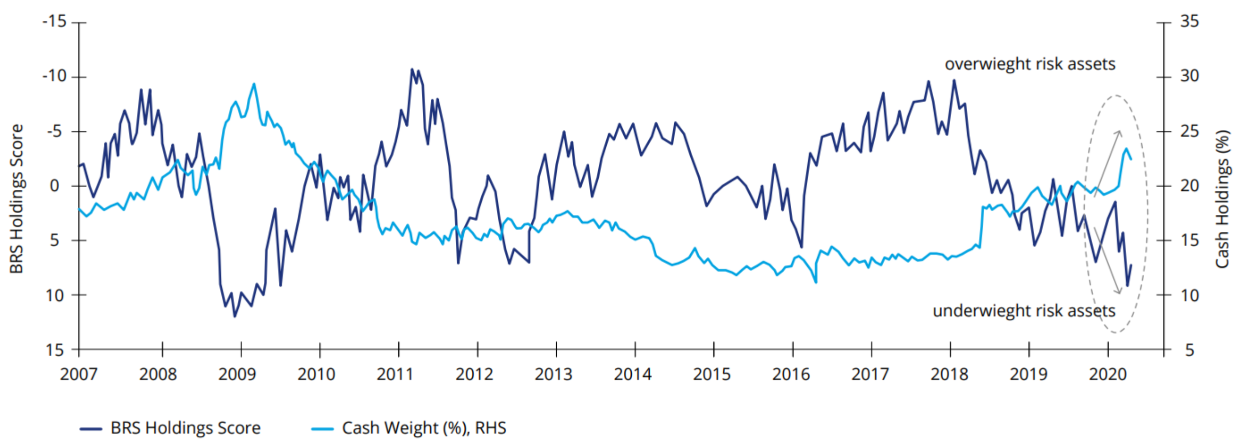
Source: Robintrack

The blue line shows the number of Robinhood accounts holding HTZ, while the orange line shows the share price

We have noticed a peculiar trend in recent months, namely situations where the outcome takes on a ‘black/red’ payoff structure, similar to gambling. For example in the case of Hertz, where the number of Robinhood accounts owning HTZ shares have increased by 29% *since the company filed for bankruptcy!* While Hertz may emerge from bankruptcy, we doubt the newly minted shareholders from Robinhood fully understand the implications bankruptcy has on valuations on each class of security. Nor have they done the analysis to determine both the probability of survival and amount of residual equity value typically involved when investing in companies after bankruptcy declaration. They seem to be chasing a buy low/sell high day trading philosophy based on little more than hope and good fortune.

For us, this increases our confidence that a portion of the recent rally is a function of retail trading dollars, opposed to institutions ‘buying the dip.’ Consistent with that thesis, recent cash levels among institutional investors is near all-time highs at 5.7%, according to Bank of America. Statestreet’s Behavioral Risk Scorecard (BRS) to Cash ratio for institutional investors has diverged to levels not seen since the financial crisis. This is indicative of a level of skepticism we ascribe to broad market valuations here at Brookmont.

Figure 2: Institutional investor holdings across risk assets & cash



Source: State Street Global Markets. Multi-asset scores for flows and holdings represent the number of risk factors indicating risk seeking behaviour less the number of risk factors indicating risk averse behaviour.

What does this mean for the market going forward? We believe that the development of zero cost trading platforms will continue to amplify volatility. Since online brokers dropped commissions to zero, the average closing value of the Volatility Index (VIX) has been 39% higher than the average over the last 16 years, and since January 1, that number jumps to 79%. For momentum and trend following strategies this is a dangerous dynamic, signals become blurred, increasing the risk of overtrading. Fortunately for us, here at Brookmont, our strategies are the antithesis to those of trend followers. As a function of our proprietary Dividend Score and enduring Investment Process, Brookmont portfolios tend to exhibit lower volatility than the market.

BROOKMONT CAPITAL MANAGEMENT

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