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summaries

SIGMA INVESTMENT COUNSELORS

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UNINTENDED CONSEQUENCES

Recent market volatility, both up and down, can give anyone pause. The massive moves in market values on a daily basis for stocks is difficult to wrap one's head around. Whether it is Tesla's value being larger than all the other car companies combined, the $55 billion increase in the value of Salesforce.com in one day, Apple's climb to $2 trillion in market capitalization, or the recent technology rout resulting in the top four tech companies losing $640 billion in market capitalization in three days, it becomes difficult to fathom.

Some of the factors that have contributed to this volatility include legislation, advances in technology, historic lows in global interest rates and the removal of brokerage commissions. Throw in a global pandemic changing people's daily activities and voila, you have a combination of seemingly unrelated events coming together to affect the contours of the U.S. stock market landscape.

In the late 1990's and early 2000's, corporate accounting scandals by Enron, WorldCom and other companies roiled the financial markets. In an effort to regain investor confidence, Congress passed the Sarbanes-Oxley Act in 2002. The goal was to make public company disclosures more reliable and accurate through a series of new laws and regulations. This included a greater transparency in reporting financial results and accompanying data as well as expanding the duties and penalties for corporate boards, executives, auditors and lawyers.

An unintended consequence of the Act was the prohibitive costs for smaller companies to comply with these rules. After a frenzy of initial public offerings in the mid 1990's, the number of public companies peaked around 8,000 in 1996. From 1996 through 2019, the number of U.S. public companies shrunk by 46%. While compliance for smaller firms was amended in 2019, there is less supply [of stocks]. At the margin, this increases market volatility.

Congress passed the Dodd-Frank Act in 2010 to prevent another systemic financial crisis like we experienced in 2008. While some provisions of the Act have been repealed, many restrictions placed on the 10 largest banks in the US remain in place. This includes the elimination of proprietary trading desks. This decision did reduce some inherent risk within these banks. Yet, proprietary trading desks can play an important role in the capital markets, providing necessary liquidity and market stability during periods of market uncertainty. Thus, market volatility increased as this activity was phased out.

Importantly, developments in technology have helped facilitate individuals to be active market participants. This includes platforms such as the popular smart phone app Robinhood which facilitate on-line trading. Robinhood has no required minimum dollar amount to open an account or place a trade, and makes it easy to transfer money in and out of the account.

Added to this is the elimination of trading commissions and the ability to buy fractional shares of companies. While the price for one share of Amazon is well over $3,000, the ability to buy a fraction of a share for as little as $5.00 allows

buyers to participate at a much reduced investment size. Making the public markets more accessible to individual investors is important. The unintended consequence of easy access and no commission costs is, to the untrained eye, a risk/return trade off which appears quite attractive. Overlaid on this is the current pandemic, where many new investors are quarantined and have too much time on their hands. Investing helps fill this void. Again, at the margin, all this contributes to market volatility.

As markets and economies ebb and flow, so do the factors impacting valuations. For example, record low interest rates have caused the discount rate to fall, which increases the value of a company's cash flow and hence its valuation and share price. Low interest rates have also resulted in low bond yields, enticing investors to buy equities instead. With recent market strength, combined with the "fear of missing out", aka FOMO, many novice investors are piling into the market with unrealistic expectations.

Moreover, there is a growing dichotomy with some companies reporting record sales and operating margins while competitors are going out of business. Perhaps the best example of this is the comparison of Amazon, Walmart and Target versus the likes of J.C. Penny, Macy's and a growing list of other retailers filing for bankruptcy. The pandemic has allowed the "haves" to pull forward demand that was not expected for 5-10 years. As expected, the share price of the "haves" are soaring while the "have nots" are not.

There will always be events and unintended consequences impacting markets. The sheer number of events impacting markets all at once has caused market indigestion which has revealed itself in the market volatility we are currently experiencing.

History has shown that the equity market is quite resilient and can adapt and adjust to both transitory and more permanent market forces. As this occurs, we believe the current volatility will dissipate until history repeats itself with new unintended consequences and black swan events.

All comments and questions are welcome.

Denise Farkas, CFA
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Disclosure: The views in this publication are as of September 2020 and are for informational purposes only and do not represent any recommendation of any particular security or strategy and should not be considered investment advice. The publication is prepared for educational purposes and the information presented has been gathered from sources believed to be reliable.

Please remember to contact Sigma Investment Counselors if there are any changes in your financial situation or investment objectives

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