REGISTERED INVESTMENT ADVISOR

DENEWILER

Capital Management Inc.
1600 Stout Street
Suite 1690
Denver, CO 80202

303.832.7475 / 888.808.7475
Fax 303.832.7484
greg@growmydollar.com
www.growmydollar.com

Feb. 23, 2021 No. 356

OBSERVATIONS ON THE MARKET

By Greg Denewiler, CFA

If you load too many animals onto the ARKK at one time, bad things can happen. It was designed for two by two, not billions at a time. ARKK is one of the investment funds of ARK Investment Management and results recently have been nothing short of spectacular. Cathie Wood is the CEO and chief investment officer of ARK and has achieved celebrity status in a very short period (less than a year). Last year the fund returned 150%, so the media is more than happy to feed this mania. It appears that Cathie Wood is more than happy to give them the story they want; that she has figured out how to turn lead into gold. In the investment world, when you have a five-year track record of 54% per year, that is the equivalent of turning lead into gold. It is one thing to say that you were fortunate (lucky) and just happened to be in the right sector and own the right stocks at exactly the right time. It is an entirely different matter to lead investors to believe that you can continue to deliver 20% plus returns into the future. If you look at what that implies, you quickly realize the odds of that happening are close to 0.

First, her mantra is that she understands “exponential growth” and that her companies are experiencing exponential growth that is not well understood. Clearly, she has been on to something, however, her portfolio’s top holdings have an average price of 100 times what they earn, and of the top ten, eight are not even profitable. (For a reference, you pay $23 for $1 of earnings for the S&P 500) If she does achieve 20% growth for the next five years, her current portfolio would then be valued at more than 200 times what they earn. The alternative is she must find some new candidates that can repeat her previous success. If you follow market history, nobody pulls that miracle off. Let us give her the benefit of the doubt and believe her explanation of why she thinks so can pull this off. The one problem with success is that it can be your own undoing. She achieved her track record with $11 billion total in assets in all her funds in 2020, she now has $60 billion. That means she must either find a lot more of those exponential growers or buy into larger companies.

A second problem is just basic financial theory. It suggests that risk is not directly proportional to return. What it means is that a portfolio that has an expected return of 10% has more than twice the volatility of a portfolio that only has a 5% return. When you bump the expected return to 20%, volatility goes through the roof. This is a principle that is easy to forget when things are good, however, it is a very important concept to understand, or it can really cost you. Here is the proof if you have any doubts. Since February 12th, the S&P 500 has declined by 1.8%, the ARKK fund is down 11.5% as of midday on the 23rd. This does not mean the fund cannot ultimately have a good year, however, do all these new investors really understand what they are getting into? Probably not because Cathie Wood has a very strong argument as to why she is different than all the rest. Knowing what you own applies to the 10-year Treasury note as well.

If you had purchased a 10-year Treasury note on January 1, 2011, the yield to maturity was 3.45%. Guess what, you did not earn 3.45%! Yield to maturity assumes you can reinvest those interest checks at the same 3.45% rate. That did not happen. The current rate is 1.35% on 10-year notes, and of course short rates are virtually 0. A compounded rate of 3.45% on $10,000 is $14,037 in 10 years. Just earning the interest checks equals $13,450. You might think this is a trivial difference, but it does have larger consequences. Six months ago, the 10-year Treasury note had a yield of .6%. The irony is that you will most likely earn more than .6% over the 10-year period. However, if you had purchased that bond six months ago, it would now have a value on your current monthly statement of about 6% less than you paid for it due to rising interest rates. It will take years to get back to even, not exactly a risk-free investment.

The allure of exponential growth has been around for a long time. The first major financial bubble is believed to be the Tulip Mania in 1637. At one point a tulip bulb was thought to have sold for 10 times the annual income of the average person. A virus caused the colors to split on the plant’s pedals forming multiple streaks of beautiful colors creating surging demand. The exact details of the mania are debatable, but the chart shows how that story is thought to have ended.