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INNOVA
ASSET MANAGEMENT

INVESTMENT MANAGEMENT INSIGHTS FOR PROFESSIONAL FINANCIAL ADVISERS AND THEIR CLIENTS

SPECULATION MAY BE POPULAR BUT LONG-TERM INVESTING PRINCIPLES ENDURE

After years of central banks pumping up markets by cutting rates and printing money, speculation has become entwined with investing.

Speculation has a place – at the racetrack or casino – but it's not investing, even if it has paid off for many in recent times.

Speculation is defined by short-term payoffs and high risk – both of which have been masked by a long period of supportive market conditions.

But those conditions are quickly changing. Inflation is rising, pushing up interest rates from historic lows, making it crucial to identify speculative activities that can quickly become destructive.

WHAT IS INVESTING?

Investing is about recognising the future cashflows and value of an investment, then buying them today to allow the cashflows to compound over time. When there is no cashflow – as happens with many speculative investments – the value is simply what someone else will pay for it.

Younger investors in particular have flocked to these type of investments: crypto-currencies, 'unique' digital art known as **NFTs**, as well as highly leveraged, complex securities that often trade on sentiment.

Meanwhile, the share prices of certain loss-making companies have surged because of brand recognition or because they were promoted by finfluencers (unregulated social media financial influencers) or in forums.

About 435,000 Australians placed their first online trade in 2020, according to research firm Investment Trends. Almost half (49%) were aged between 25 and 39, while 18% were under 25 years old.

Most of these first-time investors have yet to experience an extended market downturn. The quick recovery from the COVID-19 crash in early-2020 underpinned a growing appetite for risk rather than educate about its dangers, promoting a culture of "day trading" or "YOLO'ing" without stressing the necessity of the relationship between risk and return in any capital market.

SPECULATIVE 'ADVICE' IS EVERYWHERE

The relationship between risk and return is a fundamental part of investing. There is no way to get rich quick without huge risk.

Unfortunately when markets trend up across multiple asset classes over years, it's easy to mistake luck for skill. Finfluencers have been able to ride this wave by pushing unregulated and, at times, conflicted advice.

About one-third (33%) of 18- to 21-year-olds say they follow at least one finfluencer on social media, according to a survey by **ASIC**[1]. Almost two-thirds (64%) say they changed their financial behaviour because of a finfluencer.

While some finfluencer advice is generic, such as budgeting, others wade into personal advice by promoting speculative investments such as cryptocurrencies, affiliate-linked products and courses, or by giving specific stock tips.

Online communities and message boards can also turbocharge a speculative frenzy. This came to media attention with the Reddit 'WallStreetBets' saga which saw "meme stocks" like GameStop and AMC post (very temporary) stratospheric returns.

Similarly, some stocks and cryptocurrencies rallied last year based on tweets by personalities such as Elon Musk rather than fundamentals.

There are no short-cuts to long-term investing success and if advice seems too good to be true, it probably is.

TRADING BASED ON A WORD

As the decisions of central banks have increasingly driven markets since the 2008-09 Global Financial Crisis (GFC), many investors now analyse their every word. The RBA and US Fed statements can move markets, as happened recently and to a larger degree during the 2013 Taper Tantrum.

It should simply be another small data point for investors to consider in the overall bigger picture. Guessing central bank actions based on a few words is a far less certain path than analysing data and making evidence-based decisions based on probabilities.

A robust portfolio can withstand temporary volatility, guiding capital through the short term to deliver long term returns.

Shocks such as the Temper Tantrum may have seemed painful at the time, however quality assets continued to appreciate, and robust portfolio construction has seen investors survive these interruptions to the market's regularly scheduled march upwards.

POTENTIAL VERSUS FUNDAMENTALS

The technology sector is another example of the impact of speculation. Many investors bought the promise of "transformational technology" even as many of these tech companies posted large, ongoing losses.

Some of their business models, such as buy now-pay later (BNPL) sector, were effectively built on expectations that interest rates would never rise. The BNPL sector is now suffering as rising rates drive up bad debts.

There are tech companies that are highly profitable, such as Apple, Alphabet, and Microsoft. These are clearly real businesses with a future that can be valued, however valuation still matters.

Many of these companies were trading on valuations of 40 to 70 times earnings. This makes it significantly harder for investors to generate a healthy return.

[1]22-054MR ASIC issues information for social media influencers and licensees | ASIC - Australian Securities and Investments Commission. (2022, April 13). Retrieved from https://asic.gov.au/about-asic/news-centre/find-a-media-release/2022-releases/22-054mr-asic-issues-information-for-social-media-influencers-and-licensees

LEVERAGED, COMPLEX SECURITIES, AND CRYPTO-CURRENCIES

In the years leading up to the GFC, many investors began trading highly leveraged CFDs, which were promoted in popular publications of the day. Those investors were badly burned when the GFC hit.

Today, CFDs and similar complex securities are back in vogue. They make significant profit for platforms because of high trading volumes compared to traditional buy and hold share strategies.

However, the reality for investors is often worse than gambling. Trading platform eToro has warned its CFD traders that “you may lose more than your initial investment” and that “67% of retail investor accounts lose money when trading CFDs with this provider”.

This shows how little investors understand what they’re trading. There are other assets that are similarly mis-understood, such as crypto-currencies and NFTs. They are impossible to value because they produce no cashflow.

Investors end up playing the “game of the greater fool” – hoping someone else is willing to pay more than they did for the asset. That’s not investing – that’s gambling – and like the **tulip craze** of the 1600s, can collapse if sentiment changes.

This is already playing out, with a notable example being the attempted sale of an NFT minting Jack Dorsey’s original tweet. It was once purchased for $US2.9 million but received a poultry highest bid of $US13,940 after being listed for sale above $US48 million. Such is the risk of speculating on an asset that is “worth only what the next person will pay for it”.

Successful long-term investing requires patience and sticking to the fundamentals. It doesn’t require high risk quick bets – a consistent approach is far more likely to pay off as the power of compound interest delivers over time.

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Dan Miles is the Managing Director & Co-Chief Investment Officer of Innova Asset Management. Innova is a boutique risk-focused portfolio manager that has been managing client portfolios since 2010. Innova was founded on the principles of providing robust and research-intensive insights to help investors meet their financial goals. The firm focuses on managing the multi-faceted nature of investment risks for clients.

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