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YOLO AS AN INVESTMENT STRATEGY

You only live once! Social media investors have banded together on unconventional platforms to drive up the prices of a handful of "meme stocks," seemingly without traditional evaluation of investing risks and rewards. They made headlines with their "short squeeze" of GameStop (GME), turning the struggling mall-based retailor into one of the largest companies on earth for a few days.

As they garner media attention, their tactics continue. While not the intended victim of the YOLO traders, will the efficient market hypothesis be a casualty of these events? The answer depends a lot on your definition of efficient markets. Perhaps long-term investors would be better served questioning the potential impact on their investment philosophy.

Eugene Fama (1970) defines the efficient market hypothesis (EMH) to be the simple statement that prices reflect all available information. The rub is that it doesn't say how investors should use this information. EMH is silent on the "correct" ways investors should use information and prices should be set. To be testable, EMH needs a companion model: a hypothesis for how markets and investors should behave.

This leaves a lot of room for interpretation. Should asset prices be set by rational investors whose only concerns are systematic risk[1] and expected returns? It seems implausible to link recent meme-stock price movements to economic risks. Rather, they seem fueled by investor demand to be part of a social movement, hopes to strike it rich with a lucky stock pick, or plain old schadenfreude.

There is a vast ecosystem of investors, from individuals investing in their own accounts to governments and corporations that invest on behalf of thousands. Ask investors why they invest the way they do, and you'll likely get a range of goals and approaches just as diverse. It's this complex system that generates the demand for stocks.

Another complex system fuels the supply of stocks. Supply and demand meet at the market price. People may contend that the market is not always efficient, or rational, **but the stock market is always in equilibrium**. Every trade has two sides, with a seller for every buyer, both of whom accept the price of the exchange is fair at that moment.

There are plenty of well-studied examples that show supply and demand at work. The huge increase in demand for stocks added to a well-tracked index often creates a run-up in the stock price. Some of this price increase can be temporary and reversed once the tremendous liquidity demands at index reconstitution[2] are met.

Index reconstitution is just one example; instances of liquidity-driven price movements happen all the time. It is well documented that liquidity demands can produce temporary price movements.[3]

Investors may wonder if temporary price dislocations motivated by users of r/WallStreetBets differ from those caused by changes to an index. Lots of buying puts temporary upward pressure on prices, which later fall back to "fundamental value"—it sounds familiar.

The more relevant observation may be that markets are complex systems well adapted to facilitate the supply and demand of numerous market participants.

There are many reasons people may be willing to hold different stocks at different expected returns. Can all those differences be explained by risks? Doubtful. To quote Professor Fama: "The point is not that markets are efficient. They're not. It's just a model."[4]

EMH can be a very useful model to inform how investors should behave. We believe investing as if markets are efficient is a good philosophy for building long-term wealth. Trying to outguess markets might be a quick way to destroy wealth.

It's true—you only live once. The good news is that investors can look to market prices, not internet fads, to pursue higher expected returns.

Theoretical and empirical research indicate higher expected returns come from lower relative prices and higher future cash flows to investors. Long-run investors can be better served by using markets, rather than chatrooms, for information on expected returns.

— Adapted from content provided by Dimensional Fund Advisors

Footnotes:

1. Systematic risk is the possibility of an investor experiencing losses due to factors that affect the overall performance of the financial markets in which he or she is involved.
2. Reconstitution involves the re-evaluation of a market index. The process involves sorting, adding, and removing stocks to ensure that the index reflects up-to-date market capitalization and style.
3. For example, see "Tesla's Charge Reveals Weak Points of Indexing" (Dimensional, 2021).
4. "Are Markets Efficient?"—interview between Eugene Fama and Richard Thaler (June 30, 2016).

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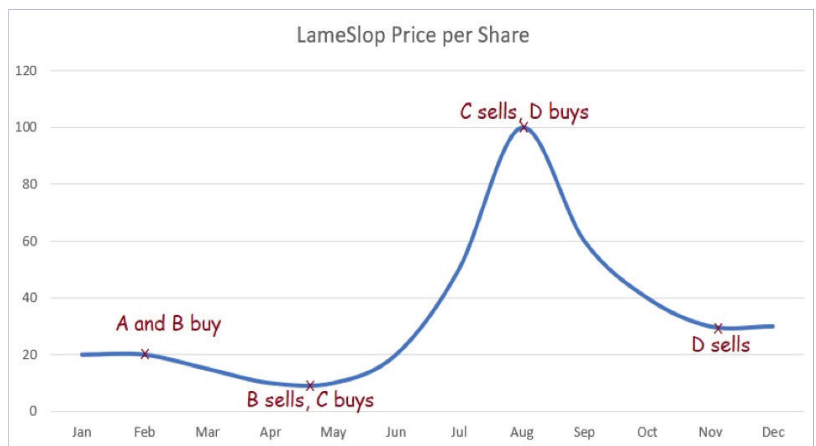
TRADING INTO STOCK FRENZIES: A LESSON IN GAMBLING

This is the story of four investors and a fictitious company completely unrelated to one in the news recently, LameSlop. LameSlop stock is selling at $20 per share in January, and investors A and B both buy it. They both believe the stock will go up in value.

Over the next couple of months, the stock drifts down in price. When it hits $10, investor B decides to "cut his losses," and sells. Investor C gladly scoops up the shares because she believes the stock is due for a rebound.

A short time later, LameSlop takes off! Over the next few weeks, the share price rockets up to $100! Investor C is glad to take a monster profit and sells her position to investor D, who thinks the big rally has just started.



The frenzy that drove LameSlop shares up dies off, and the price tumbles back down, settling off around $30 per share. Bitterly disappointed, Investor D sells.

Here's an easy question: Who made money? If you said Investor C, you get half credit.

To summarize: Investor B bought at $20 and sold at $10. He took a 50% loss. Investor D did even worse, in at $100, out at $30, a 70% loss. Investor C did OK—a 900% return in about four months!

But someone else made money too! Remember Investor A? They got in at the beginning at $20, held firm as the stock sank, kept invested during the big spike, and even though they were still holding to the end, they are now sitting on a 50% gain at $30.

Is 50% as good as 900%? Of course not. But the better question is, what did Investor C do better than Investor A? Was she skillful to predict the price would go up and then get in and out of the stock at the right time?

It's worth pointing out that when Investors B and D bought in, they also thought the price was going to go up. Which brings us to an important rule of investing: **No one buys a stock because they think it will go down in value**!

I don't know—maybe there are some people who invest with no intention of making money. I've never met one of those people, so based on my experience, I'm going to have to conclude people select specific companies to invest in because they think the price of the stock is going to rise.

All four investors in our scenario did. Investors B, C, and D went one step further and tried to time their entry and exit. All three had the same strategy: Buy low, sell high. (I didn't say it was a sophisticated strategy.)

It turns out Investor B was half right. He bought low. But he didn't buy at the lowest and got scared when the price fell. He bought low, sold lower. Not a good investment strategy.

Investor D was wrong on both his entry and exit. He bought high and sold low, and got slaughtered.

And then there's Investor C, in low and out high, perfectly executing the strategy!

Nothing is clearer to me than this: Three investors using the same strategy, one wins big and two lose big. What distinguishes Investor C? Luck. Just dumb luck. Without the benefit of being able to see the chart in advance, C just happened to guess right … twice.

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Guessing isn't a sustainable investment strategy. There's no reason to think Investor C has any better chance of guessing right on her next stock pick as any other investor.

Investor A, on the other hand, had a different strategy. Buy and hold. Allow their investment in LameSlop and hundreds or thousands of other companies to grow over time. Not be concerned that this one stock may fall in value because any or many of their other investments may rise in price.

And history tells us that over time, the value of a large basket of investments will grow. Maybe not at the rate of a SpaceX launch, but good enough to construct a solid lifelong financial plan around.

The difference between Investor A's strategy and the others is it is completely implementable and controllable, with the luck factor removed. When people compare the stock market to gambling, my usual answer is "Yes, I agree. Depending on your strategy."

If you follow a strategy that will likely lose money, you're gambling. With an academically derived strategy that gives you a good chance of making money over time, you're not.

—Steve Tepper

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