

In Defense of Taking Profits

“What is truth?”

– Pontius Pilate

“Reality is that which, when you stop believing in it, doesn’t go away.”

– Author Philip Dick (“Blade Runner” and “The Man in The High Castle”)

“SPACs are a reprehensible instrument, and by definition highly speculative.”*

– Jeremy Grantham

**For more on SPACs and Mr. Grantham, please see the ending footnote*

Typically, the reaction to one of my *EVA*s is like the sound of one-hand clapping. That was definitely not the case with last week’s [“Take Profits!”](#) edition.

The feedback I received ranged from emphatic agreement to shocked disbelief and everything in-between. Some even felt the title was alarmist; which I guess the notion of taking profits might be considered in a ~~full-blown-bubble~~ bull market like we have on our hands today.

It’s for this reason I’m doing something I almost never do: Write a follow-up piece to a just-published *EVA*. I’ve done two-parters before but those have always been intentional, which is not the case with this one.

The first order of clarification business is to explain what I believe “Take Profits!” means: realizing gains, not getting out and going all, or even mostly, to cash. What makes much more sense is to emulate what Target Date Funds do in this regard. These are the popular 401(k) vehicles that invest according to a projected retirement point (the target date) like Target 2030, Target 2035, etc. The closer to the retirement/target date they get, the less they hold in stocks. (Note: even for a Target Date 2021, these funds hold considerable stock exposure; this created much consternation during the 2008/early-2009 bear market, the last one that persisted long enough to truly terrify investors.)

Target Date funds are diligent about maintaining their asset mix. Thus, if that is 50% stocks and 50% bonds, they will re-balance back to those levels, should their allocation deviate much from those targets. Accordingly, when the market falls hard, as it did last March, they will become underweight stocks and need to buy to get back in-line. This may have been a supporting factor in why the market turned on a dime this past spring (though, I’m convinced it was the Fed’s announcement to buy corporate bonds and bring down yields and credit spreads that was the true tide-changer).

But it also works the other way after a big up-move, such as we saw in the last two months of 2020. If they are now around 55% to 60% in stocks, they become forced sellers. Based on the trillions these funds control, this is significant.

This approach is also a reasonable one for all investors to follow. Instead of the typical annual rebalancing, it makes more sense, Evergreen believes, to adjust whenever a portfolio’s mix gets

skewed too much one way or the other. Logically, if the situation is pressing enough, it's even better to take action before the end of a quarter.

For example, in mid- to late-March Evergreen was buying hand over clenched fist during the selling maelstrom and forced liquidation that month. (The latter occurs when leveraged investors get margin calls and are required to sell positions; this was happening on a mass basis last spring—until the Fed rode to the rescue with its limitless resources.)

But, as I wrote last week, Target Date funds are likely to be major liquidators of stocks this month, though it's possible they have already completed at least some, maybe most, of their rebalancing. If they are poised to sell, will that trigger the correction I'm anticipating? Maybe, maybe not. January is also a month when there are considerable in-flows into the markets from year-end bonuses and retirement plan contributions. However, those may be on the paltry side this year due to economic conditions and weak profits. Further, stock buybacks, which have been the primary source of market inflows over the past decade are likely to remain subdued.

If it was just the threat of Target Date fund rebalancing, I would be only mildly concerned. But when you combine that with the frenzied pace of insider selling, the equally febrile conditions of the IPO market, the incredible vertical moves in green energy stocks, the proliferation of "blank check" entities known as SPACs, the total mania in the call options market, and the extreme levels of greed versus microscopic fear readings, it makes me willing to stick my neck out like Marie Antionette on the guillotine that a sharp correction is a high-odds call.

(In fairness, one of the near-term risks I brought up, the GOP losing control of the Senate, turned out to be a non-event. My suspicion is that, had it hung onto one seat and maintained a majority, the market would have risen on that news, too. Personally, I believe the Democratic victory increases the odds of an inflation problem later this year due to the likelihood of another trillion or so of near-term deficit spending, with potentially trillions more later this year and next, funded by the Fed's magical money machine.)

Judging by some of the reactions to last week's missive, maybe I did too good a job of making my case for a serious reckoning. And perhaps I should have written, as I have so many times, that I see this as a two-tier market, one split between what I have often called the COPS (Crazy Over-Priced Stocks) and the CUPS (Crazy Under-Priced Stocks). Yet, there are a lot more COPS than CUPS around these days, thanks to the monster rally the latter have had since the vaccine announcement in early-November. Because Evergreen has been persistent buyers of the latter, we are most pleased by this development.

Where I did call for a bloodbath last week was in stocks like QuantumScape, which I singled out as an example of truly absurd valuation. At the time I started writing "Take Profits!", right before Christmas, it had a \$48 billion market capitalization (for non-experts, this is calculated as number of shares outstanding times the market price). On Monday of this week, it plunged 33% and, despite an 18% rally on Tuesday, its market cap is now down to \$21 billion, a 56% decline from where it was trading when I wrote it up (reminder: this is a company with zero revenues and a promising, but unproven, battery technology). In my mind, a 56% value reduction certainly qualifies as a bloodbath, particularly since that played out in a couple of weeks.

When it comes to the CUPS, and the far more numerous reasonably priced stocks out there (i.e., these can longer be considered Crazy Under-Priced Stocks), the downside is much, MUCH less. Those are the issues that Evergreen mostly buys and holds for its clients. (Full disclosure:

we do manage an aggressive growth portfolio that contains several high-growth, high-P/E issues.)

Further, last week I called for a correction, not a bear market. In fact, I specifically wrote I didn't think we'd have a true grizzly until the Fed was in a rate-hiking frame of mind and that such an attitude shift was not remotely near-term. However, should this correction be a deep one—and sometimes those happen despite an easy-money environment—there will probably be collateral damage to even under- and fairly-valued securities.

If I had to hazard the most likely sequence I see unfolding, it would be:

1. A sudden decline fairly soon that takes the COPS to the woodshed;
2. Followed by another rally led by those companies that are the biggest beneficiaries of economic normalization (i.e., the Virus Victims, particularly, those whose stocks are still depressed);
3. An upside inflation surprise later in 2021 or early 2022 that puts the Fed in a serious bind.

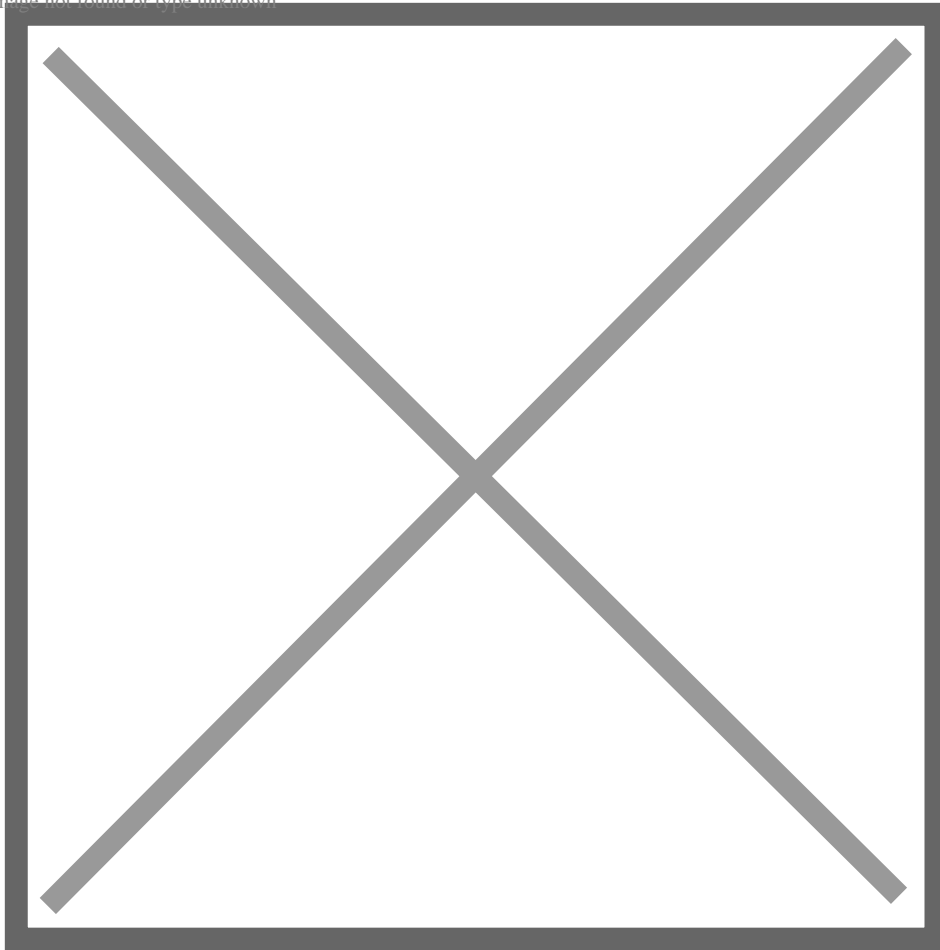
It's the third phase that concerns me. The Fed is already dropping hints that it will tolerate 3% inflation. Perhaps *it* might be ok with that but I'm not sure the financial markets will be, particularly the fixed-income complex. Rising inflation is its mortal enemy. And I'm also not sure that inflation will top out as low as 3%. Please remember that I haven't been worried about inflation since the early 1980s, as I've written before.

Without going into detail on the potential inflation risk (I'll cover that more in-depth at a later date), suffice to say that I believe that the current immense bubble in highly speculative securities will meet its maker when inflation surges...if it does. Even if it doesn't, something will come along that tanks the bubble stocks and also pops the "bubbllette" in many more staid issues (such as an old-line consumer products company selling at 60 times earnings). History is clear that true bubbles never have a Frank Capra ("It's a Wonderful Life") ending.

So, is this a true bubble? In my mind, there is no question but, just as was the case over twenty years ago, not everything is caught up in it. When the tech bubble of that era burst, the S&P was cut in half from 2000 to 2002 but the stocks that were neglected during the dot.com mania actually held up very well through that long and painful bear market.

If I'm right about inflation, the best places to be in the stock market are likely the resource-based issues, with gold miners looking particularly appealing. In that regard, I think the following chart, showing the multi-year breakout by commodities, to be one of the most important visuals I can relay to you.

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Source: Bloomberg, Evergreen Gavekal

As far as the bubble question, let me share two viewpoints from a couple of the most successful investors of all-time. First up is Warren Buffett's long-time partner, Charles Munger. Mr. Munger just turned 97 so he's been through a few market cycles. He's also a billionaire in his own right. Here's what he had to say recently:

"This has been unbelievable. There's never been anything quite like it. We're in very uncharted waters. Nobody has gotten by with the kind of money printing now for a very extended period without some kind of trouble. We're very near the edge of playing with fire."

When he was asked if stock market returns would be sub-par over the next decade, this was his reply:

"Yes. Because so many people are in it and the frenzy is so great. The systems of management, the reward systems, are so foolish that I don't think it's going to work at all. I think that the returns will go down, yes. In real terms, the returns will be lower."

Along similar lines is a newsletter penned earlier this week by Jeremy Grantham, age 82, one of the living legends of the money management industry and a legendary bubble-buster. While

he's often early, he has done an admirable job of shielding his investors from the fall-out caused by speculation run amok. Here are some brief excerpts from his missive but I would encourage serious investors to go to the GMO website to [read the full essay](#):

Waiting For The Last Dance - The Hazards of Asset Allocation In A Late-stage Major Bubble

The long, long bull market since 2009 has finally matured into a fully-fledged epic bubble. Featuring extreme overvaluation, explosive price increases, frenzied issuance, and hysterically speculative investor behavior, I believe this event will be recorded as one of the great bubbles of financial history, right along with the South Sea bubble, 1929, and 2000.

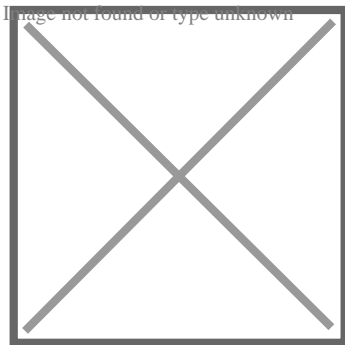
These great bubbles are where fortunes are made and lost – and where investors truly prove their mettle. For positioning a portfolio to avoid the worst pain of a major bubble breaking is likely the most difficult part. Every career incentive in the industry and every fault of individual human psychology will work toward sucking investors in.

But this bubble will burst in due time, no matter how hard the Fed tries to support it, with consequent damaging effects on the economy and on portfolios. Make no mistake – for the majority of investors today, this could very well be the most important event of your investing lives. Speaking as an old student and historian of markets, it is intellectually exciting and terrifying at the same time. It is a privilege to ride through a market like this one more time.

The single, most dependable feature of the late stages of the great bubbles of history has been really crazy investor behavior, especially on the part of individuals. For the first 10 years of this bull market, which is the longest in history, we lacked such wild speculation. But now we have it. In record amounts.

There you have it: Wild speculation in record amounts, which is one of the key points I was attempting to make last week. Like me, Mr. Grantham* is recommending focusing on the parts of the market that this wild bull rampage has left behind, though, again, a number of those have been romping lately, too. Bargains are much harder to find, but they're still out there. If I'm right about a correction soon, that job will get considerably easier. Until then, raising SOME cash strikes me as not just prudent but almost foolish to fail to do.

*The older I get, the more irony I find in life. One of the most ironic aspects of the current bubblemania, in this case involving SPACs, relates to Mr. Grantham. Even though he has been a fierce critic of the structure of these "blank check" vehicles – which on average lost money for investors from June of 2019 to June of 2020, even as the NASDAQ rose 30% – he has received an accidental windfall from one SPAC. A \$12 million investment he made years ago in what became a SPAC, which then merged with the aforementioned Quantumscape, briefly became worth over \$600 million. This caused him serious embarrassment which may have eased somewhat now that it is down to around a mere \$250 million.



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