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THE COFFEE CAN PORTFOLIO

MEMECRAFT 2.0
And other games people play

"I welcome the increase in retail trading, the idea of the stock market being a place with wide participation. Economists can't tell people they shouldn't get some fun."

~ Hendrik Bessembinder, business professor

"If you're in investing for excitement, you're a damn fool."

~ Jack Bogle, index fund pioneer

As human beings competing for scarce resources and attractive mates, we naturally gravitate towards games. At a young age we match our skills with those most suitable, but also bring us the highest rewards. Some excel at sports while others feel more comfortable with creative or intellectual pursuits. Still others thrive in the realm of charm and personality, a prelude to the dating game.

This process – developing and exploiting our own unique talents – prepares us for adult life in which we enter the global division of labor, i.e. get a job and build wealth.

The game of investing

If your goal is to accumulate wealth and grow and protect it over time, you have no choice but to play the investment game. Sitting on the sidelines or complaining that "the game is rigged" is not an option. Of course, you may hire a professional to do the heavy lifting, but even so, you still need to know *how* to hire a professional.

There are two objectives of the game: first is survival. As Meb Faber, founder of Cambria Investment Management, says, "It is hugely important to protect your portfolio by having a broad allocation that will survive in any market environment. In the end, the only thing that matters is you can't lose all your chips. Because then you can't get back to the game." The second objective: identify and exploit opportunities for profit. The challenge is to strike a balance as hiding under a rock risks certain death (a reality lost on the proponents of zero Covid). According to the Latin proverb, "Danger can never be overcome without taking risks."

The pursuit of profit requires a special set of skills. As the great Austrian economist, Ludwig von Mises, explained in his magnum opus, *Human Action*:

> Entrepreneurial judgment cannot be bought on the market. The entrepreneurial idea that carries on and brings profit is precisely that idea which did not occur to the majority. It is not correct foresight as such that yields profits, but foresight better than that of the rest. The prize goes only to the dissenters, who do not

> let themselves be misled by the errors accepted by the multitude. What makes profits emerge is the provision for future needs for which others have neglected to make adequate provision.

There is a wealth of information in this quote, but the key phrase is "foresight better than that of the rest." As investors, we don't need to accurately predict the future, just do a better job than the other players in the game. Like the joke about being chased by a bear, "I don't have to outrun the bear; I just have to outrun you."

As Charlie Munger put it, "You don't have to be brilliant, only a little bit wiser than the other guys, on average, for a long, long, time."

Of course, investing is a lucrative game which attracts highly skilled players. What chance does the average person have against titans of finance with armies of analysts combing through terabytes of data?

For starters, let's not play where we're at a clear disadvantage: the short-term. Unless you possess an extraordinarily rare skill, trading is akin to gambling: In the long run, the house always wins (market makers like Citadel and brokers like Robinhood).

We have a much better chance betting on the long-term. The future may be uncertain, but at least this part of the game gives us a fighting chance because no one has a crystal ball. The trick is to find competitive edges.

Competitive edge

"To outperform over time, managers must find edges that enable them to earn excess returns. We believe that we have real edges as a firm, such as our truly long-term focus and flexible investment mandate (including holding significant cash balances). In today's frenetic marketplace, these edges seem more enduring than ever. Most of our competitors feel intense pressure from their clients to generate short-term performance and have trouble maintaining a truly long-term perspective, whether in bad markets or good. They also operate with partnership structures and a client base that restrict their investment mandate."

~ Seth Klarman, founder of The Baupost Group

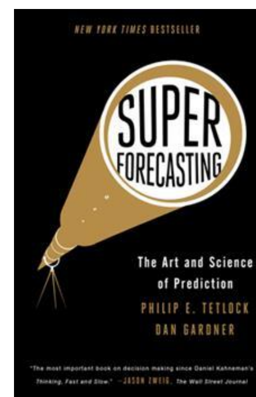
Klarman can certainly back up this statement: His hedge fund has compounded its partners' capital 20% annually since 1982. His 1991 book, *Margin of Safety*, is considered a classic among value investors. Now out of print, a hardcopy will cost you $1,733 on Amazon.

How far should we try to gaze into the future? I suggest at least 10 years. In addition to long-term focus, there are plenty of other ways for investors to gain an advantage:

<u>Specialist</u>

Gain deep knowledge in a specific area. Know your circle of competence and stay within it. "Stick to what you know."

Beware of becoming overly specialized. This can lead to focus illusion, a.k.a. tunnel vision. Many deep experts have made some real bloopers over the years.



<u>Generalist</u>

Become a generalist in a specialized world. Cast a wide net and adopt a flexible mandate. Wharton management and psychology professor Philip Tetlock conducted a comprehensive 20-year study of

forecasters and found that generalists ran circles around specialists. The worst forecasters tend to be one-trick ponies.

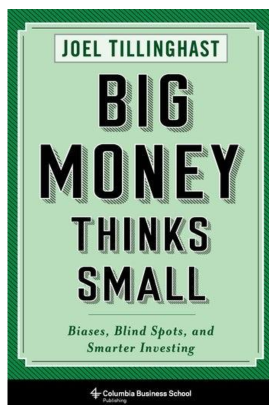
Contrarian

Avoid the crowd and beware simple narratives that go viral. Reality is rarely black and white. Look for truth in nuance. Do not fall prey to "errors accepted by the multitude" and heed Seth Klarman's advice: "Over the long run, the crowd is always wrong."

RULE #7:
AVOID THE CROWD AT ALL COSTS.

Bottom feeder

Find niches too small for the giants. Small cap stocks are ripe for mispricing, especially with trillions of dollars flowing into large cap index funds and heavy asset concentration in fund behemoths like BlackRock and Vanguard. Size has its disadvantages in the investment business.



The "think small" principle applies to other businesses as well. E.g., dollar stores have found fertile ground in which to thrive amidst retail redwoods like Walmart and Target (see discussion of Dollar Tree under "Company Updates").

Economist

The mainstream investment community is heavily biased towards economic intervention. Austrian economics, which sees the world through a non-interventionist lens, better models reality and provides an appreciation for the downside of money printing and economic stimulus. Sound economic theory can also help identify winners and losers from various interventions. For example, lockdowns, cheap credit and red tape clearly help large, publicly-traded companies at the expense of small businesses.

Historian

Most people are either ignorant of history or misled by historians. As cultural critic George Santayana warned, "History is a pack of lies about events that never happened told by people who weren't there." Correcting these falsehoods requires effort (and an Austrian lens), but the view can be worth the climb. Remember, "errors accepted by the multitude" create opportunities. History rarely repeats, but often rhymes.

Futurist

As Peter Drucker said, "The best way to predict the future is to create it." Most edges in this game involve experience and accumulated wisdom, whereas technology favors youth. Peering into the future requires imagination, what Albert Einstein referred to as "the preview of life's coming attractions."

Political agnostic

Wall Street leans to the left politically and struggles to identify with conservatives and libertarians. As such, its members tend to underestimate trends in the U.S. such as increasing gun ownership and migration away from progressive cities, or the potential destruction to consumer brands from promoting contentious social justice narratives.

Copycat

The good news is that we don't need to compete directly with legendary investors like Warren Buffett, Seth Klarman and Ron Baron. Instead, we can try to emulate them. Most publish shareholder letters openly available. With disclosure laws and 13F filings, it is easy to follow their holdings, especially those with low turnover. (See table of "Like-Minded Investors.")

Of course, everyone has their own unique talents. Instead of blindly copying others, better to incorporate some of their moves into your game; develop your own competitive edges and distinct investing style.

Youthful exuberance

After 12 years of paying outsized rewards, the investment game has attracted a new breed of player: young, brash and eager to play by a new set of rules. In mid-June, a *Bloomberg Businessweek* article titled, "The FOMO Economy," captured the prevailing mood:

> It's not just crypto: It's stocks such as those of AMC Entertainment Holdings, GameStop, and Tesla that are beloved on Reddit and Twitter, and it's the houses and condos being snapped up almost as soon as they list. The pressure to keep up with neighbors, friends, and social media meme lords who seem to be in the process of becoming wealthy – or, at least, talking about it – can feel unbearable.

Even conservative firms like Fidelity Investments are catering to teenagers, allowing children as young as 13 to open trading accounts. Fidelity added 1.6 million new customers under the age of 35 in the first quarter, up 223% from a year earlier. A June 14 *Barron's* cover story offered some words of caution:

> Teaching financial history is a worthy goal, and teenagers – inspired by social media and meme stocks – may be eager to learn. But giving a trading app to kids might be like handing over the keys to a Porsche, without even a learner's permit… Financial-technology apps for the young raised $344 million in financing last year, according to Crunchbase, up from $98 million in 2019.

Laurence Steinberg, professor of adolescent psychology at Temple University, adds high time preference to the list of concerns:

> Teens tend to be more short-sighted and focused on rewards than adults, and more likely to ignore the costs. If you put people in a brain-imaging scanner and show them piles of money, you see the reward center light up more in adolescents than adults.

(Personally, I think the professor gives adults too much credit. Goose the stock market with trillions of dollars of newly printed money and their reward centers light up just as well.)

Just four weeks later, as the retail buying frenzy intensified, *Barron's* struck a less cautionary tone with its cover story, "Meme Stocks Defy Gravity:"

> The collective efforts of millions of retail traders – long derided as "the dumb money" – have successfully held stocks aloft and forced naysayers to capitulate.

The article offers a window into the psyche of the meme stock crowd:

> For retail traders, the method isn't always scientific. The action is sustained by a community ethos. And the force behind it is as much emotional and moral as financial. New investors say they are motivated by a desire to prove themselves and punish the old guard as much as by profits… Some link the meme-stock movement to continued mistrust of big financial institutions stemming from the 2008 financial crisis.

26-year old Matt Kohrs quit his job as a programmer to stream stock analysis seven hours a day on YouTube and trade stocks. With the help of earnings from ads from 350,000 followers, he can earn roughly as much as his old job. Says Kohrs,

> Wall Street brought our economy to its knees, and no one ever got in trouble for it. So, I think they view this as not only can we make money, but we can also make these hedge funds pay.

Win-win!

Who are the bad guys?

"If it sounds too good to be true, it probably is."

Today such commonsense wisdom is lost on many young traders in a toxic cocktail of greed, envy, anger, resentment, desperation, nostalgia (for dying brands like GameStop and AMC), techno-utopianism, historical revisionism and economic illiteracy. They see profit as loot stolen from the laborer by the entrepreneur: win-lose. The greater one's net worth, the bigger the thief. Trading in packs and holding on for dear life ("HODL") is a way to tilt the game in their favor and even the score. As *Barron's* explains, "the bad guys are the short sellers, the market makers, and the Wall Street elites, in that order."

At first blush, the short seller is an odd target for the virtue-signaling millennial trader. The shorts have been completely run over by a 12-year bull market fostered by the infinitely deep pockets of an omnipotent Federal Reserve. This is the ultimate David vs. Goliath story, yet the emaciated short seller is being conflated with the Wall Street fat cat.

In fact, the short seller is a key price discovery agent, playing the role of skeptic and sleuth, and helping keep valuations in check. Jacob Rappaport, head of equities at StoneX Financial, says "Voting with dollars and putting money to work shows conviction and helps the retail investor find true value. Eliminating the mechanism to make a bearish investment does not make for a more efficient market."

My father, Phil Duffy, who is very well-read in history and economics, warns, "The role of the short seller is socially significant. His removal leads to more malinvestment over time and more victims."

As for market makers, the young guns have a strange way of expressing their ire. These amateurs are playing right into the hands of high-frequency traders like Ken Griffin, James Simons and Steven Schonfeld. Last year Virtu Financial, the only publicly-traded

market maker, saw its revenue double and operating income soar seven-fold (before pulling back in the 2nd quarter of this year). Last December, Schonfeld paid a then-record $105 million to buy a 70,000 square foot mansion in Palm Beach, Florida.

Rotation game

"A market does not culminate in one grand blaze of glory. Neither does it end with a sudden reversal of form. A market can and does often cease to be a bull market long before prices generally begin to break."

~ Jesse Lauriston Livermore

Gambling is the order of the day and the casino is standing room only. Many have turned into compulsive gamblers, which means gravitating to riskier games and refusing to leave the casino until they're flat broke. When the blackjack table shuts down, they move to the poker table, and when that stops working, they make their way to the roulette wheel.

Speculative activity this year has been a case study in the casino effect:

Late January: The first round of meme stock mania reached its zenith, led by GameStop. GME hit an intraday high of $483 on January 28 before plunging 92% in 14 trading days. The stock has since rallied with a second wave of meme stock buying, but remains 59% below its peak.

Mid-February: Neomania reached its crescendo, led by Tesla and ARK Invest (founded by the guru of this cycle, Cathie Wood). ARK Innovation ETF (ARKK) is 24% off its intraday high set February 16. Initial public offerings peaked at the same time: the IPO Renaissance ETF (IPO) is 15% below its all-time high.

Celebrity SPACs (shell companies with the purpose of acquiring a private business) were also the rage. The Defiance Next Gen SPAC Derived ETF (SPAK) is down 35% from its intraday high set on February 19.

April-May: Bitcoin hit its high April 14 while the total market cap of global digital currencies peaked at $2.56 trillion on May 12 (now $2.08 trillion). Despite a furious rally since the July 20 lows, Bitcoin, Ethereum and Dogecoin remain 24%, 26% and 61% below their highs respectively.

Many commodities have retreated since May. Most dramatically, lumber futures hit a record $1,711 per thousand board feet on May 10, nearly four times pre-Covid levels. They have since gone into the wood chipper, down 71% to $491.

June: Meme stock mania, round 2, took the speculative baton in May, led by AMC Entertainment. The beleaguered theater chain briefly sported an enterprise value of $40 billion on June 2, well above its pre-Covid valuation of $6 billion… despite an 84% plunge in revenue. The stock is now 39% lower.

August: At the end of July, Robinhood Markets made its debut, quickly capturing the meme crowd's fancy and ringing the bell on a $67 billion valuation August 4. The stock is since down 42%.

As the popular averages set new high after new high, the retail investor continues to take losses. In fact, his speculative winning streak ended in mid-February. Last week, individual stock new lows exceeded new highs by over 400, the most since April, 2020. Such deterioration below the surface masked by an ongoing bull market is known as "bad breadth" and is often seen as a red flag. In fact, the current case of halitosis has few comparisons: 2000 (tech bubble), 1972 (Nifty Fifty bubble) and 1929 (Roaring '20s). None of these ended well.

Conclusion

Legendary American football coach Vince Lombardi was purported to quip, "If it doesn't matter who wins or loses, then why do they keep score?" Yes, the games people play have scorecards, but the competitive process is win-win, lifting *all* players and driving human development and growth.

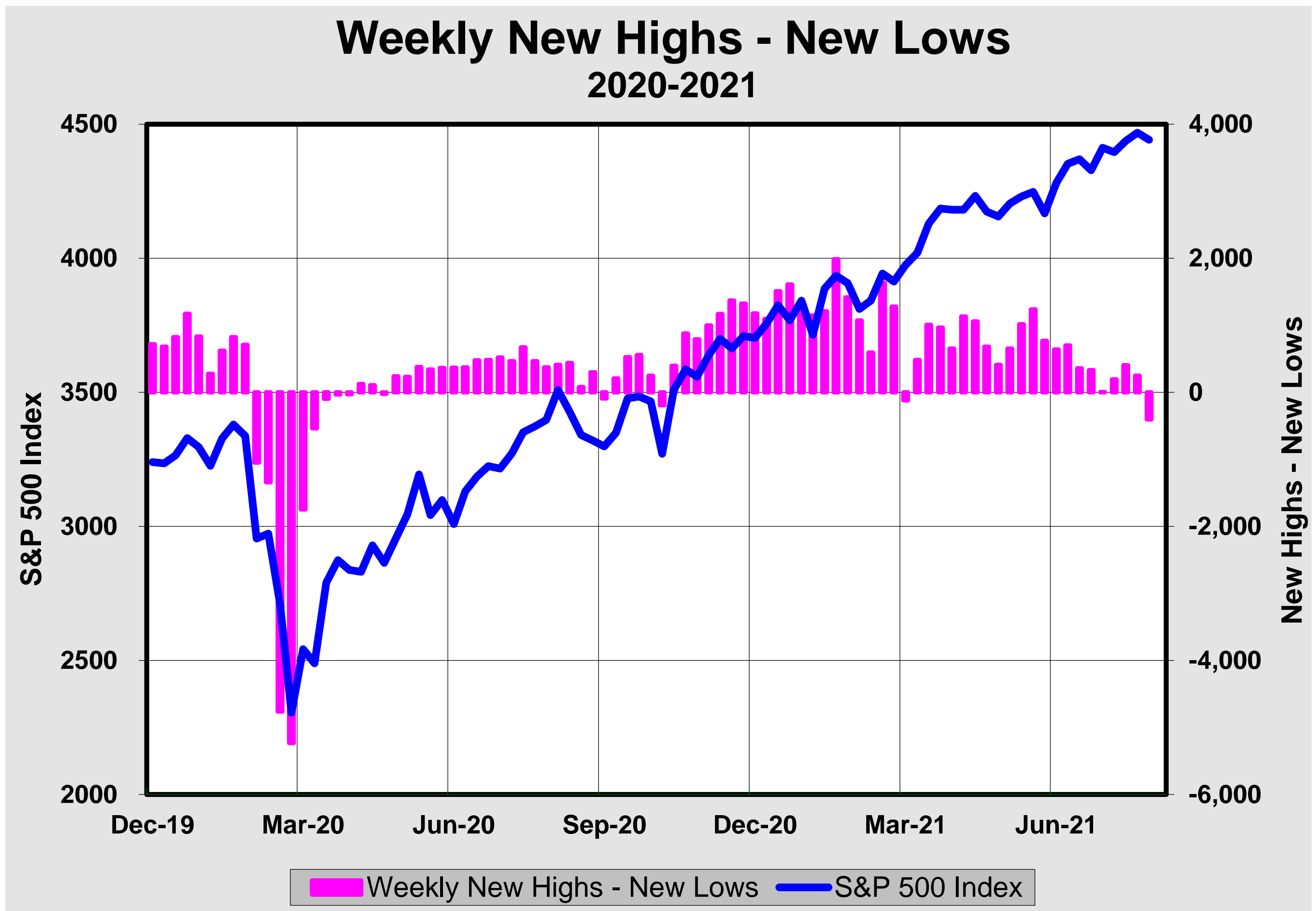
Capitalism is a competition to serve the consumer. As Mises so eloquently stated, "What makes profits emerge is the provision for future needs for which others have neglected to make adequate provision."

Several years ago, Steve Forbes, described profit as a "moral force:"

> How does an economy advance? It advances with new knowledge. Where does knowledge come from? Through constant experimentation by entrepreneurs in the marketplace. Look at Silicon Valley. Look at Peter Thiel. He says eight out of ten ventures, even with great brains like his, will fail. Only two out of ten, maybe one out of ten, will really be successful.
>
> So, profit is essential if you're going to have a growing economy.

As disciplined long-term investors, we should welcome amateurs to the poker table, especially those who fail to grasp the critical roles of profit and entrepreneurship. As Nassim Taleb wrote in *The Bed of Procrustes*,

> The characteristic feature of the loser is to bemoan, in general terms, mankind's flaws, biases, contradictions, and irrationality - without exploiting them for fun and profit.



ROBINHOOD IPO

Gamblers bet on the casino

"What we are witnessing is a massive transformation taking place across financial markets, driven by the intersection of technology, democracy and finance, and one that is ushering in an entirely new era of financial participation and market dynamics."

~ Vlad Tenev, Robinhood Markets CEO

"We're pretty excited about the increased participation of retail investors in the equity market."

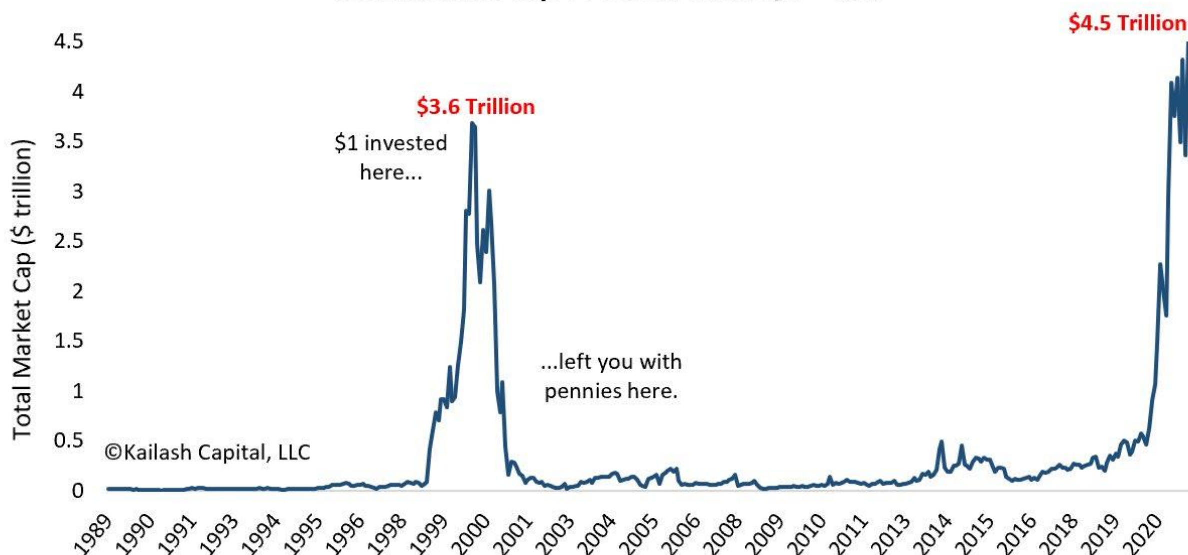
~ Katie Koch, Goldman Sachs Asset Management

On July 19, Robinhood Markets (HOOD) issued 55 million shares at $38/share, raising $2.1 billion. Not quite 5% of the IPO shares were sold by existing shareholders. After a lackluster start, HOOD spiked to as high as $85/share, briefly giving Robinhood meme stock status and a market capitalization of $67 billion, or 37 times sales. At the top of the 2000 tech bubble, the leading discount broker, Charles Schwab, fetched nearly 13 times sales.

2000 tech bubble, Charles Schwab:
2-year revenue growth = +45%/year
Peak price-to-sales = 12.8

2021 everything bubble, Robinhood Markets:
2-year revenue growth = +175%/year
Price-to-sales = 23.2
Peak price-to-sales = 36.9

While the 2000 version of Schwab couldn't match 2021 Robinhood for revenue growth, that growth was nonetheless impressive… and as it turns out, unsustainable. Annual revenue at Schwab peaked at $5.8 billion in 2000, then dropped one-third over the next three years. The high-water mark wouldn't be passed until 2014.



Source: Kailash Capital; Data from 4/30/1989-6/30/2021

Discount brokers have an uncanny knack for issuing shares to the public. Charles Schwab made its debut in 1987, seven months before the October crash. E*Trade and Ameritrade took advantage of the retail driven New Economy boom of the late '90s. Interactive Brokers almost perfectly top-ticked the 2007 credit bubble.

Discount Broker IPOs

Company	IPO Date	Years Since Founding
Charles Schwab	Mar-87	16
E*Trade	Aug-96	14
Ameritrade	Mar-97	22
Interactive Brokers	May-07	29
Robinhood Markets	Jul-21	8

The Robinhood IPO gives us a unique look at the market's youngest and most aggressive retail investors. Their actions, as any seasoned observer of investor behavior would expect, tend to be emotional and self-defeating. Robinhood's customers have gone from extreme caution at the March, 2020 stock market low to uber-aggressive, a period in which the S&P 500 doubled:

Assets under custody, Mar-20:
Equities = 70.5%
Cryptos = 2.5%
Net cash = 24.0%

Mar-21:
Equities = 80.4%
Cryptos = 14.3%
Net cash = 2.7%

Jun-21:
Equities = 71.1%
Cryptos = 22.2%
Net cash = 4.3%

After the close on August 18, HOOD reported quarterly results for the first time as a public company. Trading in options and cryptocurrencies accounted for 58% of revenue, up from 48% a year earlier. Over 60% of crypto trading revenue came from Dogecoin, which started as a joke. After the earnings release, Dan Nathan, regular guest on CNBC's Fast Money, remarked, "This looks like a gaming stock."

Market maker Virtu Financial may be signaling the end of the retail investor boom. Virtu reported a "remarkable quarter" with record revenue of just over $1 billion in Q1, but saw a 46% plunge in Q2.

One key to the investment business is securing permanent capital, i.e., customers with a long-term horizon (low time preference). As my good friend Tony Deden likes to say, "The trouble with the investment business is when it becomes a business."

To the optimists, Robinhood is building a lasting franchise, attracting lucrative customers at an early age. But what happens if this latest bout of speculative insanity ends in tears? Will the meme stock mob chalk it up to experience and move on? Or will they swear off stocks forever and blame the enablers for ruining them?

RULE #12:

THE RETAIL INVESTOR IS ALWAYS LATE TO THE PARTY.

The Coffee Can Portfolio

Kevin Duffy, editor
West Chester, PA

The Coffee Can Portfolio is part diary, part wisdom gained from over 40 years in the investment game meant to be shared with others. Trust me, I've made every mistake in the book. That doesn't mean you need to repeat every one of them. Failure is unavoidable, an essential part of the learning process. Embrace it!

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One goal in writing this letter is to build a network of smart people following a similar process. If you have feedback, a topic you'd like discussed, or an investment insight you'd like to share, drop me a note!

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