

The Importance of Owning Individual Common Stocks

June 13, 2022

One of the risks of investing during a long-term bull market accompanied by record low interest rates is the probability that speculators will buy more stocks using leverage or borrowed money. As the bull market roars on, more of these opportunists can outperform broader markets and attract even more investors that drives stock prices ever higher. When one or more events lead to a change in sentiment from bullish to bearish, all those trailblazers can become a burden on the market. One example of a change in sentiment this year has been the Fed's commitment to raise interest rates that likely sent some risk takers who were heavily leveraged to the exit door. As a result, volatility increased on the downside as investors raised cash that resulted in further selling. This problem is magnified by withdrawals from risky mutual and exchange-traded funds. The biggest hazard lies in funds that have done extremely well by speculating in securities that have little fundamental value in terms of earnings or a record of paying dividends.

Over the past couple of years, several large financial institutions have launched esoteric actively managed exchange-traded funds that utilize leverage by up to 3 times! The timing of the introduction of these new funds could not be worse because their short-term records are likely to be abysmal as they have no long-term returns to fall back on. For the riskier of these funds, withdrawals tend to increase and fund managers must sell securities to meet those withdrawals. Unfortunately, as the liquidations increase, the remaining shareholders suffer a greater loss because less liquid securities must be sold at lower prices. In some cases, funds must be closed and bankrupted with whatever is left going to shareholders.

This type of downward market volatility is driven by these dodgy circumstances, not by stock market fundamentals. Investors who own individual common stocks and not actively managed funds can weather such short-term volatility and can benefit from subsequent stock market rallies once the speculators have been forced out of the market. Owning individual stocks means owning a representation of the individual company that cannot be taken away by a failing fund or other investment vehicle that is forced to liquidate.

The current stock market condition is reminiscent of the past failure of hedge funds on a grand scale. We have seen several speculative funds and fund companies that have experienced declines of well over 50% this year. Many of the dicey stocks that these funds purchased have fallen by more than 70%. At the same time, strong companies with proven earnings and dividend payouts have experienced substantially less volatility and are positioned to do well once the outlook for the stock market improves. Investors who are concerned about current market weakness should take a step back and review their individual stock holdings to insure they are invested in companies that have a favorable long-term outlook. For investors in passively managed index funds, the risk is limited to overall stock market risk as such funds do not make speculative investments nor use leverage. Keep the Faith. Faith is the Spirit!!