Key Questions

Should Investors Race with Tesla or Hit the Brakes?

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Following the herd can be tempting, but history tells us that this is a fool's game. Instead, investors need to remain rational and disciplined and trust the process.

In recent weeks, many investors have taken note of the parabolic rise in shares of Tesla, Inc. (NasdaqGS:TSLA). Typically, when a stock rises at such a meteoric rate, there are reasons other than underlying fundamentals fueling the surge. Usually, one or both of the following contributors play some role in such a run-up: 1) a short squeeze, and 2) fear of missing out (FOMO), or what some may describe as herding behavior.

In the 1990s, former Federal Reserve Chairman Alan Greenspan coined the phrase "irrational exuberance" to describe the overconfidence that investors occasionally exhibit while losing sight of an asset's true underlying value. During the dot-com bubble, many investors seemingly suffered from FOMO. Stocks in general, and technology stocks in particular (many of which had no earnings to speak of, e.g., Pets.com and its sock puppets), rose at an exponential clip before ultimately crashing and contributing to the US economy's fall into recession. Investors who lacked discipline in their investment process suffered catastrophic losses as the tech equity bubble burst.

Fast forward to today, where a company like Tesla has seen its share price more than triple since October. Evidence can lead one to conclude that short sellers (those who bet on stocks declining) were overly bearish and apparently fell victim to a short squeeze.

A short squeeze is when short sellers capitulate on their bearish views on a company because its underlying fundamentals start to improve or a positive catalyst for the stock unfolds. In this scenario, short sellers are forced, in some cases mechanically, to buy shares at ever-higher prices to cover their positions, leading to higher demand for the shares and in many cases, unrealistically higher stock prices. This effect can spiral upward as margin calls occur and stop-loss orders are activated.

As it relates to FOMO, investors could also be chasing returns and driving the share price higher. However, history is replete with examples of investors following their emotions and suffering bad outcomes later. Given that Tesla surprisingly turned a profit in its most recent quarter and Tesla's short interest remains high at nearly 18% as of February 5 after peaking at 36% last June, it's fair to conclude that both issues are at play to some degree and are driving the stock higher.

Consider that Tesla's stock price was $231/share on October 4 and peaked intraday at $969 just four months later on February 4. While stocks often rise when prospects for sales, free cash flow, or earnings growth improve, this type of seismic move in a company's share price is more typical of such factors as a short squeeze or overly emotional investors who do not want to miss participating in further expected outsized returns.

In our view, neither represents any type of disciplined investment process or strategy that leads to long-term success. But it does beg the question, “Why not Tesla?”

The simple answer is that at Key Private Bank, we follow a quality-biased investment approach. A key pillar of this process is our preference for companies that exhibit some, if not all, of the following qualities: 1) consistently positive free cash flow, 2) solid returns on invested capital, 3) relatively low leverage, 4) attractive relative valuations versus a stock’s peers and historically versus itself, and 5) a management team focused on generating returns for its shareholders.

We do not believe that Tesla falls within our quality mandate as specified above. Further, we continue to remain disciplined at a time where many may find it tempting to ignore or suspend their process and take on excessive risk in hopes of capturing outsized investment returns. Such an approach, we believe, has served our clients well in the past and will do so in the future.

For more information, please contact your Key Private Bank Advisor.

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