MARKET UPDATE

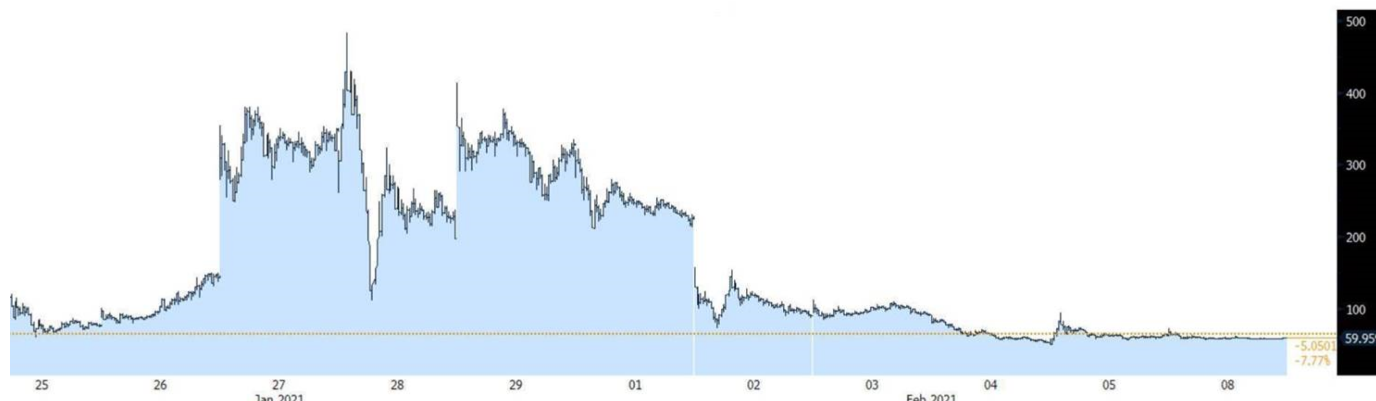
Winter 2021

RUNNING WITH THE HERD

With recent events that have unfolded in equity markets, we thought it may be helpful to share our view of what happened. The last few weeks, the company GameStop, a brick & mortar retailer that sells video games, made global headlines across all media outlets as the stock jumped for no apparent fundamental reason. Within two weeks, the stock went from $20 to $500, in the process costing "short sellers" of GameStop (and other stocks) billions of dollars in losses, many of which were hedge funds. These hedge funds that were "short" the stock, were betting that the share price would decline precipitously and the company would soon be out of business. GameStop has posted annual losses for years as the industry has undergone massive changes in retail buying habits: today, video games can be purchased on computers, PlayStation, or Xbox, rendering GameStop's utility in marketplace obsolete, similar to what happened with Blockbuster and VCR rentals. As you might imagine, the underlying business fundamentals have caused the stock to languish for years: Back in 2013, GameStop's share price was over $50 and at the beginning of 2021 it was $6. Despite GameStop's issues, the stock recently soared from $6 to ~$500.

So why & how does one "short" a stock? As mentioned above, a hedge fund shorts a stock when they think the share price is going to go down. In order to execute the trade, they must borrow shares from an investor that currently owns the stock and pay them an agreed upon interest rate for borrowing them. Then, they sell the shares they have borrowed; the goal being to buy those shares back at a lower price. For example, a fund sells a stock at $20, the stock goes down, they buy it back at $10, and return the borrowed shares, making ~$10 per share profit less borrowing costs. Shorting stocks is extremely risky because it can lead to unlimited losses, through borrowing costs and share price market action. Switching around the example above, should a hedge fund short 1 million shares of company at $20, and the share price goes to $1,000, the fund loses $980 million ($980 per share in losses x 1 million shares) plus borrowing costs. With regard to the GameStop trade, as the share price increased rapidly it became too expensive (between losses & borrowing costs) for hedge funds and institutional investors that were short millions of shares to maintain their positions. Many were forced to "close" their positions to mitigate losses and avoid bankruptcy in certain cases, thus the term "short squeeze." In order to close their positions, they had to buy back millions of shares of the stock, which sent the share price even higher, ultimately up to ~$500 share. During all of this trading activity nothing changed in the underlying business fundamentals for GameStop, but it was because of the confluence of two events; large short positions and massive retail buying which created the short squeeze, sending the share price up 80-fold.

GAMESTOP PRICE CHART, JANUARY 25, 2021 - FEBRUARY 8, 2021



Interestingly, a secondary risk has seemed to have arisen as a consequence of all this "herd investing" through social media. Often times, hedge fund managers will tweet or appear on financial news channels disclosing their "buys & shorts" in the hope of attracting others to get into the market and follow suit, moving the share prices in their favor and assisting them to attain their desired outcome. However, GameStop proved to be the exception; the strategy of shorting a stock and encouraging others to follow suit backfired on many hedge funds. In January, they lost a collective ~$6 billion and they themselves got caught in a "short squeeze." How? The retail investor forced those losses by leveraging social media, blogs, and various message boards, many of which contained individuals unhappy with "Wall Street Titans" taking advantage of the "little guy." The most prominent of these message boards was Reddit's Wall Street Bets forum, where millions of people joined together and began buying millions of shares of GameStop acting as a "collective herd." For perspective, two weeks ago, this Reddit message board had ~1.75 million users, today there are over 8.75 million users. The "herd investing" through social media worked until it didn't; today, GameStop trades under ~$50, nearly 90% off last week's highs, leaving many, both institutional & retail investors alike, with significant losses. The share price dropped so quickly for two reasons: First, as hedge funds closed out their positions, there became fewer natural buyers of the stock. At the same time, many retail investors sold their stock as it appreciated booking gains. Combined, the number of buyers for this failing company eventually dried up, plummeting the stock back to more recent levels. In our view, this is not the end of this type of trading activity, which fuels volatility. We think it is likely we experience more of this trading behavior in the months to come. As always, if you have any questions please do not hesitate to contact us at 401.228.7799.