GameStop (a Primer on Short Squeezes)

With some regularity, but not every year, the markets serve up something wholly unexpected, something that didn't even seem possible. And we're not referring to the occasional nasty correction or even a pandemic. Remember last year when the price of oil briefly and spectacularly went negative, or the Flash Crash back in 2010? Mostly, thankfully, these events take place on the periphery of what we consider suitable investments, or are so brief as to not do lasting damage, and we don't believe this one will either. But we thought you might have an interest in hearing a straight forward explanation, or at least an attempt at one, for this latest unusual episode: GameStop.

GameStop (symbol GME), for those of you who are unfamiliar, is a bricks and mortar retailer of video games, consoles and accessories. This is not a business you would start today. The internet and the Microsofts and Amazons of the world have completely upended its business model. Its survival is in question. As such, it has attracted the attention of investors enthusiastically betting on its demise, and a common way to do this is to 'short' or 'go short' a stock. It's arcane, but here's the briefest of explanations. To short a stock, you borrow the stock from another investor (all handled seamlessly by clearing firms) sell it, pocket the proceeds, and at some point buy it back ('cover' your short), thereby returning the borrowed shares. So if you short a stock at $10 and you cover at $3, you make $7. Many veteran investors, including some big hedge funds, thought GME was a bankruptcy--going to $0, and some were massively short the stock. But you can also lose money if the stock rises above where you shorted it. In fact, there is no limit to the amount of money you can lose. If you short a stock at $10 and it goes to $100 and you cover, you lose $90. If it goes to $500, well, you get the idea—catastrophic losses are possible. And there are also inflexible collateral requirements for shorting. So if your short goes against you (rises), you will be forced to post more collateral. A potentially terminal situation, if you are really wrong. And one last very important point, if too many of the shares of a company are short (there's no magic percentage, but an unusually large number of GameStop shares were short) a rising stock price can accelerate the price rise, sometimes shockingly so, as shorts are forced to buy (cover their shorts) to limit their losses. This is called a 'short squeeze', and GME is the new poster child.

Part of this story is probably an accident of timing. Retail investors have surged into the equity market as stocks have risen relentlessly and trading costs have collapsed. New trading platforms like Robinhood, offering easy access to the markets and no commissions, have garnered millions of small accounts eager to pile into whatever is working, and these days it doesn't take brains to find what's working. According to CNBC, Robinhood's trading app was downloaded hundreds of thousands of times a day at the end of last week. That's a staggering number, and it reeks of a day-trading frenzy.

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GameStop (A Primer on Short Squeezes) *continued*

GameStop's stock spent most of 2020 around $5, but in August it began to move. By the end of September it was $10, and by the end of the year it was $20. And at some point, around this time, the story caught fire on social media, especially on the online investor forum WallStreetBets, where the dominant narrative became a muddle of David vs Goliath and inequity and revenge. In any case, retail investors (the little guys) sought to crush the hedge funds by pushing the stock higher. On January 22, the stock crossed $80, briefly; four trading days later it hit $480, intraday, before it began its inevitable fall—all short squeezes end. We can only speculate on how this particular episode came to be so enthralling and emotionally charged, but it massively energized the Robinhood day-traders and an ordinary short squeeze became an epic one as the hedge funds were forced to buy into the frenzy (cover their shorts), taking massive losses, one notably requiring billions to stay solvent. And time may reveal other wounds.

Now, a couple of important points need to be emphasized. As we stated earlier, GameStop was massively shorted, as were a few other distressed companies such as AMC Entertainment (think movie theatres). In fact, it has been reported that GME's short position was greater than its tradable stock. This is highly unusual (perhaps technically illegal) and exceptionally dangerous, as it could (and did) result in a violent surge. As you might imagine, hedge funds are usually quite cagey with the disclosure of their long and short positions to prevent others from taking advantage. But in this case, it seems clear that the exceptional short positions in some of these names was well understood. And it's quite possible that other sophisticated investors were also involved, with motives not necessarily aligned with the primary parties. Again, there's probably more to this story, possibly including questionable activity.

And now the end…so far. This all seems to have come to a head last Thursday when Robinhood and several other brokerages had to limit purchases of GME. Clearing houses, the essential guts of trading, have sophisticated models for mitigating trade default risk, and they can demand more collateral (extremely expensive collateral under these circumstances) if risks are sufficiently unbalanced. Such was apparently the case after last Wednesday's wild ride, and collateral requirements forced the purchase limits. At this point the shorts had apparently capitulated, having bought back (covered) what they needed to stop the bleeding, and the little guys couldn't buy enough anymore to keep it going. Trading restrictions have since relaxed, but…GAME STOP. Bad puns aside, will the GameStop spasm be just another footnote in the tale of early 21st century markets, or will it be a part of some larger narrative? To us, it feels like an extreme example of a normal short squeeze, but there are mounting excesses evident in corners of the markets. Deep breath, and on to the next news cycle!

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