Weekly Digest

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The Tiger Kings of 2021

Just when people were hoping that they had seen the back of social media's oversized influence on financial markets with the departure of Donald Trump from the White House, last week provided evidence that there are several unpeeled layers to this particular onion. I refer, principally, to the almost-overnight sensation that is GameStop, an American video game retailer whose share price increased by more than ten-fold in the space of just a few days, leaving many a veteran of the stock market slack-jawed in disbelief, and one hitherto low-profile hedge fund nursing several billion dollars' worth of losses. Surely Michael Lewis is already writing the preface to his next exposé of the financial markets.

Last week I briefly referred to the "gamification" of financial markets represented by the enormous growth in retail participation, especially in the United States. Until last week, this cohort's influence on markets had mainly been to bid up the prices of shares at the sharper end of the Technology sector, often on a leveraged basis through the purchase of out-of-the-money call options or by buying on margin (i.e. only putting up a percentage of the purchase price with the rest being borrowed). In many ways this "democratisation" was seen as not necessarily a bad thing, with small investors now able to buy fractions of a share of listed companies with no frictional trading costs.

Some of this activity was increasingly accompanied by the rallying cry of "YOLO" - because everything needs a catchy acronym these days – which stands for "You Only Live Once". The sentiment behind this is that a canny (or lucky?) punt on a stock can transform one's life. If the stake money is a recently received stimulus cheque from the government, then so what if you lose it? Slightly more serious if it's the college fund that you have been saving for years, but apparently worth the risk to, say, secure a deposit on a first property. Claims of people using their parents' life savings are more worrying.

So far, so reminiscent of past speculative booms, generally supported by ample liquidity and a compelling narrative of growth and the rewards of backing disruptive technologies. But the latest chapter is quite different. GameStop is the antithesis of a growing disrupter – in fact, it's very much the disrupted, as sales of video games have migrated online, or into cloud-based subscription models. In 2013, its share price hit a high just shy of $60. It bottomed last April at $2.80, and had recovered by the end of 2020 to $19. Not a bad bounce for anyone who caught it, but nothing compared to what was to come in January. Nothing much happened until the 13th, when trading volume shot up from a daily average of around 10 million shares to 150 million and the share price rose 50% in a day and 100% in two days. After a week of relative calm, volumes popped again to as high as 200 million shares, and on the 28th of January it hit an intra-day high of $469… before crashing to $126 just eighty-

three minutes later as trading was suspended on certain platforms. It ended the week at $328. I feel tired just typing that!

So what was going on, and, perhaps more importantly, how might it affect more conservative investors (such as us)? I'm not sure we will ever get right the bottom of this, but the current narrative is that this was an exceptionally well-conceived and targeted "short-squeeze".

I am going to let regulators and lawyers opine on whether or not any laws might have been broken. An individual or small group identified that there was huge short position in GameStop, meaning that a number of investors (for which read hedge funds) had sold shares in the company that they did not own. To cover this position the hedge funds had borrowed shares from people who did own them. In aggregate, there appear to have been more shares shorted and borrowed than there were shares in the company. Hence the attractive "set-up" for the squeeze. One particular hedge fund, Melvin Capital, had a very large short position in GameStop relative to its own assets under management.

There has been a lot of moralising about shorting stock in the wake of this episode. Remember that it was banned in some jurisdictions in the case of, for example, banks' shares during the financial crisis. Hedge funds managers are often characterised as evil schemers, hell-bent on destroying companies to make a profit. That's a bit of stretch, to say the least. While there might be the odd outlier, as there is in any walk of life, what they are trying to do is to buy and sell shares based on their estimate of intrinsic value and to profit from that. Whereas a long-only investor might just not own a share they don't like, underweight it against an index, or even buy a put option, the hedge fund will take a short position. Sometimes the shares go up, but, even then, as long as they go up by less than the long positions, profits are still to be made. It's a long-established model of relative value assessment, and tends to be well scrutinised by regulators. It usually goes wrong because the manager makes a poor judgement call on their positions. It's fair to say that many long/short equity hedge funds have struggled to generate decent returns since the financial crisis, for a host of reasons ranging from volatilty-suppression by central banks to a lack of understanding of the technology boom (or at least of the markets' willingness to value it at ever-increasing levels). That's business.

Back to GameStop. It's fairly clear from the volume and initial price moves that the instigators of this short squeeze were getting on board early. But the real money was to be made in recruiting a new army of buyers to drive the share price even higher. That is where social media comes in, notably Reddit's wallstreetbets (r/wsb), an online investment forum. There was already plenty of market activity, but which mainly involved chasing up shares of companies with potentially bright futures ahead of them, not behind them. Again, all very reminiscent of the 1999/2000 Tech Boom. I recall an awful lot of exceptionally well-informed comments from that era on sites such as The Motley Fool, and I believe that there is also some great stuff on these online forums today.

Clever analysis is not restricted to well-paid Wall Street or City professionals.

But the lure of easy gains is not easily ignored, and there was a further incentive dangled before the masses – to get one over the establishment, "stick it to the man", or bring down an evil hedge fund. In fact, why not let's destroy capitalism… while making some profits from its death throes? It is perhaps an underlying sign of the times how quickly this evolved into a social movement akin to revolution, yet with not a pitchfork in sight and conducted from the sofa. How 2020s is that? Of course, much of this characterisation is developed from the posts and comments of a limited, but highly vocal, number of participants. And traditional media just loves a good soundbite from which to create a huge story. In reality, at either end of the trading barbell are probably a relatively small number of canny fundamental traders and a small unruly mob (think of the few hundred people who stormed the US Capitol, who quickly came to represent 330 million people – well, maybe half of them). In the middle (the bar, if you like), are those who fancied a punt and came along for the ride.

Even so, the aforementioned hedge fund, Melvin Capital, while not exactly reaching a sticky end, did lose several billion dollars and had to receive a capital injection from other hedge funds to stop it

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unravelling completely. It may or may not survive in its current form, but there is an element of "live by the sword, die by the sword" about this tale. If one shorts a stock, there is unlimited liability to the downside if the shares go up. Volkswagen briefly became the world's largest company in 2008 as a result of a short squeeze, delivering losses estimated at $30bn to the hedge fund community. And that was just from a 12% short position (although fewer than 6% of the company's shares were available to buy in the open market).

For now, we will have to park Melvin in a siding and move onto the wider ramifications. Melvin is not systemically important, and certainly not Long-Term Capital Management, the hedge fund that might have blown up the system in 1998. That fund also lost around $4bn, but it was the extent of the leverage of its positions and the cascading effect it might have had on other financial institutions that necessitated a bail-out.

There definitely was some fall-out in wider equity markets last week, but it is deemed to be containable. Given the success of the GameStop trade, every other highly shorted stock was also seen as vulnerable to a squeeze. Cue hedge funds trying to close short positions in those names, closely followed by opportunistic investors trying to make a quick buck from the move. And then the computers kicked in, spotting increased activity and an upward trend in the share prices which they were programmed to follow. Suddenly, with losses accruing on the short book and volatility rising more hedge funds were forced to sell some of their winning long positions. This resulted in what might have been the biggest "degrossing" day of all time. Certainly there are investment banks that have reported it as such based on their own clients' experience.

Thus major indices took a bit of a tumble, with the S&P 500 falling 3.3% over the week, the FTSE 100 -4.3%, and the MSCI All-Countries World Index -3.6%. More a flesh wound than a mortal blow. We don't believe that this incident, per se, undermines the economic case for remaining committed to our equity investments, although it does give us pause for thought about the effects of speculative behaviour, the side-effects of effectively free money, and the increasing influence of social media platforms.

Intriguingly, the r/wsb crowd has already identified its next trade, which is a short squeeze on silver. While there are some indicators that show large short positions in this precious metal, they appear not to account for balancing positions elsewhere in the system, and so it might come to naught. But the price has already moved from $25 to $30. Of course, there is a compelling accompanying narrative here too, involving protection from future inflation and/or the demise of fiat money (see Gold or Bitcoin for details), or just the huge demand potential from the solar panel industry, soon to be boosted by the Biden administration. "To the moon", as they say on Reddit.

It's probably worth trying to tie this back to fundamentals to finish. Warren Buffett (who himself caused a big squeeze in silver in 1997) reminds us that "Price is what you pay; value is what you get". We never forget that one. And then there is Buffett's own mentor, Benjamin Graham, with his all-weather favourite of mine: "In the short run the market is a voting machine; in the long run it is a weighing machine". Finally, John Maynard Keynes: "Markets can remain irrational longer than you can remain solvent" – a reminder to all leveraged investors exposed to unlimited liability. I suspect that GameStop and Melvin Capital will be the Tiger Kings of January 2020. A compelling distraction from other woes, featuring a cast of colourful heroes and villains. And yet, in retrospect, you won't really remember what all the fuss was about. Still, I can't wait for Michael Lewis's book and the inevitable feature film.

Last week's Economic Highlights

FTSE 100 Weekly Winners

Company	Change
Pearson PLC	13.7%
Hargreaves Lansdown PLC	3.5%
Ocado Group PLC	3.2%
British Land Company PLC	2.0%
Kingfisher PLC	1.7%
Diageo PLC	1.4%
RSA Insurance Group PLC	-0.3%

FTSE 100 Weekly Losers

Company	Change
Prudential PLC	-15.9%
Rolls-Royce Holding PLC	-10.9%
Imperial Brands PLC	-10.9%
Whitbread PLC	-10.7%
JD Sports Fashion PLC	-9.9%
Avast PLC	-9.8%
M&G PLC	-9.8%

FTSE 100 Index, Past 12 Months

Source:FactSet

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