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Thoughts on GameStop

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We are hard pressed to recall a more interesting and public showdown than the unfolding short squeeze involving the shares of GameStop (GME).

Given the attention these events are receiving in the press (and not just the financial press), we thought a quick overview, with some editorial comments, might help. By way of background, GameStop has been a long time, mediocre, publicly traded retailer. The company has struggled for many years as a brick-and-mortar seller of video games, and in mid-2020 was a $3 stock, largely left for dead. While the shares rallied modestly in the second half of 2020, they ended the year at $19. Like many declining retailers, GameStop had gradually attracted the attention of short sellers. Short selling is an investment strategy intended to profit from a decline, rather than an increase, in share prices. A short seller who anticipates a decline will sell shares of stocks that he doesn't own in hopes of buying them back at lower prices in the future. When shares are sold but not owned, they must be borrowed from a shareholder who does own (or is long) the stock. This process can be repeated many times over, and was in the case of GameStop. The cumulative amount of shorting of a stock is reflected in the "short interest" for a company. As we entered 2021, total short interest in GameStop was approaching 140% of the total shares outstanding. This may seem hard to believe, and it should be impossible to do. The only way that more shares of stock can be shorted than exist is through "naked" shorting, or shorting that isn't secured by borrowed shares. This type of activity can only be described as rampant speculation, and it is the sort of thing that the SEC was created to stop.

Most of the short interest in GameStop was created by hedge funds, the very definition of sophisticated investors. The most important thing that any sophisticated investor understands about shorting a stock is that your potential losses are unlimited. This is quite different than the situation for a buyer of a stock. If you buy a stock and disaster unfolds, you can lose 100% of your money. It seems that some hedge funds forgot this very basic difference when it came to GameStop.

Had the stock price stayed flat or declined, this difference wouldn't have mattered. However, an online financial bulletin board at the Reddit website made sure it did matter. Because short interest data is publicly available, some of the users of the Reddit took note of the naked shorting. Individual posters began to encourage each other to buy shares of GameStop or buy options to endeavor to drive the price up. They succeeded. At its peak, GameStop approached $500 per share and was up more than 600% for the week! When a shorted stock's price begins to rise, a short seller is

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confronted with losses. If prices move up rapidly, the short seller's broker will generally require more collateral in the account to protect against the impact of those potentially unlimited losses. Alternatively, the short seller may be forced to buy shares back (further putting upward pressures on prices) to close their short position. This is a classic "short squeeze" where higher prices beget higher prices. This week, the moves became explosive as GameStop fluctuated by hundreds of dollars each day. Note that none of this had anything to do with business prospects for GameStop or its fundamental outlook.

Clearly, some hedge funds have suffered silently but not all of them did. The largest and most prominent casualty was a fund called Melvin Capital. At the beginning of the week, Melvin Capital was forced to seek a bailout of nearly $3 billion from two other hedge funds. Despite this bailout, retail demand for GameStop continues to send the price higher, likely wiping out the entire $3 billion advance. Hedge funds, as a group, always seem committed to free markets until the pain comes too close to home. The wild trading prompted calls across Wall Street, and the hedge fund universe, to put a stop to this outrageous behavior. Suggestions were made that the Reddit investors were colluding and manipulating markets. Demands were made to suspend trading in GameStop and allow the hedge funds to regroup. Robinhood, the online broker that pioneered zero commission trading, actually has limited the ability of their customers to buy shares of GameStop. Not surprisingly, this has created howls of protest that we think are justified.

As we write this saga continues to unfold. Much will be written and said about these events, and we suspect we are closer to the beginning than the end of this story. We would make the following observations:

- Free markets mean that market participants bear the risk of loss but are able to enjoy the fruits of their gains. There is a lot of righteous anger left over from the 2008 financial crises because of the perception that Wall St. privatized profits but socialized and avoided losses. We find this assertion difficult to dispute. For hedge funds to argue that they should be protected from markets when a combination of greed and sloppy risk management has left them vulnerable is the height of hypocrisy.
- We reject the argument that individual investors, operating in open chat rooms, are guilty of colluding to move markets. Social media continues to upend our world, and this is simply an extension on to Wall Street. Hedge funds that may have been accustomed to having an information advantage are quickly learning that they don't.
- There is a role for regulators. As fond as we are of open and free markets, there is no rational basis to allow naked shorting of stocks. Shorting of stocks can be valuable as a price discovery tool, but prudent regulatory policy would prohibit allowing short interest to exceed the free float of a given stock. This simple, macroprudential rule, would serve to make this sort of casino gambling masquerading as investing harder to execute.
- We never thought we would find ourselves in agreement with Alexandria Ocasio Cortez, but she was indignant about Robinhood limiting the ability of customers to buy shares of GameStop and we share her outrage. This moved reeked of collusion on Wall Street and seems to suggest an effort to protect sloppy hedge funds from the natural market outcomes of their reckless behavior. This shouldn't be allowed to happen again.

These events have shaken the markets and put investors on edge. We will continue to monitor developments and will share news and observations as the story develops. Please feel free to share your thoughts and questions with us and thank you for your continued trust and confidence.