

# Special Commentary

## What to Make of the Recent Short Squeeze

February 5, 2021

Last week, we witnessed a rare occurrence in equity markets: the short squeeze, “where heavy stock buying forces short bettors to buy shares of the stocks to limit their losses, therefore increasing the stock price even more.”<sup>1</sup> It’s an ironic twist that those who would bet against the company’s success must buy shares in the company to avoid their own failure. In this case, the company was GameStop, a business that by any measure has been declining in recent years, and one that has given fundamental investors no reason to believe it will be able to reverse that trend. The surge in GameStop buying activity was triggered by a virtual flash mob of Reddit users who leveraged the power of social media to launch a crusade against their perception of “the establishment” (in this case, hedge fund managers). Melvin Capital, a hedge fund that was short GameStop, reportedly lost 53% in January, requiring a \$2.75 billion infusion to stabilize the firm while famous short-seller Andrew Left of Citron Research publicly announced it will no longer publish short reports. The incidents garnered immense media coverage and left many wondering what the lessons or implications were. Here, we’ll offer our perspective on the events and what they could mean for long-term, fundamental investors.

### Fertile Ground

We believe conditions were ripe for an event of this nature based on two broad trends we’ve observed recently—the gamification of trading and the liquidity boom.

#### *Gamification of Trading*

- **Mobile Apps:** The advent of super easy-to-use mobile phone applications has removed friction from trading. Apps like Robinhood have been designed to maximize the release of dopamine with virtual confetti, colorful interfaces, and constant notifications. The stimuli are akin to what one might encounter in a casino.
- **Zero Commissions:** Robinhood, funded by venture capitalists looking to support the next category-killing company, was built on a payment-for-order-flow revenue model. Market makers such as Citadel Securities execute the trades while paying Robinhood for information about which stocks its users are buying and selling. This led the retail trading businesses (e.g., Schwab, E\*Trade, TD Ameritrade) to cut commissions to zero on stock trades. As a result, fractional shares and penny stocks have become much more pervasive, and the frequency of trading has exploded.
- **Global Pandemic:** The pandemic brought wide swaths of normal societal entertainment to a standstill while people are expected to stay home as much as possible. With less sports to bet on and more free time at home, the number of consumers opening retail trading accounts has skyrocketed.
- **Social Media:** In an age where consumers are accustomed to sharing intimate moments with both friends and strangers, it comes as no surprise that retail traders share and boast about big wins and losses across social media platforms such as Reddit, TikTok, and others.

#### *Liquidity Boom*

- Coordinated central banks have cut interest rates to zero or sub-zero around the world, sparking an appetite for riskier assets as yields compressed.

---

<sup>1</sup> Wall Street Journal, <https://www.wsj.com/articles/gamestop-stock-reddit-and-robinhood-what-you-need-to-know-11611960243>.



# Special Commentary

- Central banks have also put trillions of USD equivalents into the financial system via extraordinary quantitative easing measures. These measures have vastly outpaced that of the last Global Financial Crisis.
- While there was relative fiscal conservatism following the GFC, the pandemic has not elicited the same fiscal response. Extraordinary stimulus—measured in trillions not billions—has been disseminated with expectations of more to come. Debt forgiveness, direct-to-consumer stimulus checks, and targeted industry bail outs are features of these stimulus plans.
- While many Americans were in desperate need of stimulus checks, it is also likely excess stimulus made its way into the accounts of many retail trading enthusiasts.

## Lighting the Match and Dousing the Fire

Markets exist as a place to transact—buy or sell assets, sell shares, raise capital—or to speculate. Markets are a key element of a capitalist economic system, as they provide pricing signals that aid in the efficient allocation of scarce resources.

Hedge funds run many types of investment strategies and play a role in price discovery, which includes short selling. Hedge funds with a market-neutral strategy, otherwise known as long/short or absolute return strategies, typically buy (go long) higher-quality assets they believe are worth more than the current value. They sell (borrow shares and sell short) assets they believe are more structurally impaired and worth less than current values. When it starts to become certain that a company has either a bleak or magnificent future, it can lead “crowded shorts” or “crowded longs.”

In the case of GameStop, shares were heavily shorted, reportedly higher than 100% of the available shares to buy in the market. High-profile hedge funds such as Melvin Capital and notorious short-sellers Citron Research were part of this crowded trade. Retail traders were already armed with near-frictionless trading ability, but the addition of a social media platform (Reddit) added a populist-like uprising in the markets aimed at “taking down greedy hedge funds.” GameStop (GME) was no longer a fundamental investment but rather a speculative bet coordinated by Reddit raiders, likely joined by other investors, and hoping to cash in on a short squeeze.

In the shorter term, the Reddit raiders may win some battles by organizing and going long heavily shorted companies with an impaired future. Over the longer term, as Ben Graham (the author of *The Intelligent Investor*) said, the market is a weighing machine, and many of these companies are likely to see their values revert to the bleak economic reality that was previously cast on the shares.

While regulators and politicians have weighed in on the GameStop phenomenon, it was the Depository Trust & Clearing Corporation (DTCC) that drove the retail brokerages to stop the raiders’ pillage of extended short positions. The extraordinary volatility of these stocks and related derivatives drove the DTCC to mandate higher capital requirements to access their settlement services. After negotiation and \$700M+ in incremental collateral, Robinhood managed down the overall exposure through effectively forced selling of underlying client positions while temporarily limiting new buy orders.

## A Fundamental Perspective

As quality-focused, long-term investors, we were not rattled by the GameStop firestorm. We remain steadfast in our view that stock prices should follow earnings and cash flow, reflecting the market’s perceived value of a given stock based on a company’s ability to prosper.



## Special Commentary

---

In the case of GameStop, it is a mall-based, omnichannel retailer in the video game business. Its business model was built on the value of buying and selling pre-owned gaming consoles and game cartridges in exchange for credit towards new games and devices. As next-generation gaming systems moved towards digital downloads, and newer games turned towards mobile interfaces, the GME model has struggled to adapt. Revenue peaked in 2011 while margins have collapsed. The company has been shrinking over the last three years with growth in the range of -15% to -20%. GME also relies on a heavily indebted capital structure, which increases the probability of bankruptcy if the company continues to suffer from sales and profit declines. It's clear to us that the company is more likely moving toward obsolescence than being on the cusp of a rebound.

As always, we rely upon both quantitative and qualitative analysis to determine whether a company warrants consideration in our investment portfolios. Should further extreme volatility occur in the equity markets due to the dynamics we discussed, we stand ready to capitalize on any dislocations we see between a company's value and stock price.

---

*All market pricing and performance data from Bloomberg, unless otherwise cited. Asset class and sector performance are gross of fees unless otherwise indicated.*

*The opinions and analyses expressed in this newsletter are based on RMB Capital Management, LLC's ("RMB Capital") research and professional experience, and are expressed as of the date of our mailing of this newsletter. Certain information expressed represents an assessment at a specific point in time and is not intended to be a forecast or guarantee of future results, nor is it intended to speak to any future time periods. RMB Capital makes no warranty or representation, express or implied, nor does RMB Capital accept any liability, with respect to the information and data set forth herein, and RMB Capital specifically disclaims any duty to update any of the information and data contained in this newsletter. The information and data in this newsletter does not constitute legal, tax, accounting, investment or other professional advice. Returns are presented net of fees. An investment cannot be made directly in an index. The index data assumes reinvestment of all income and does not bear fees, taxes, or transaction costs. The investment strategy and types of securities held by the comparison index may be substantially different from the investment strategy and types of securities held by your account.*

