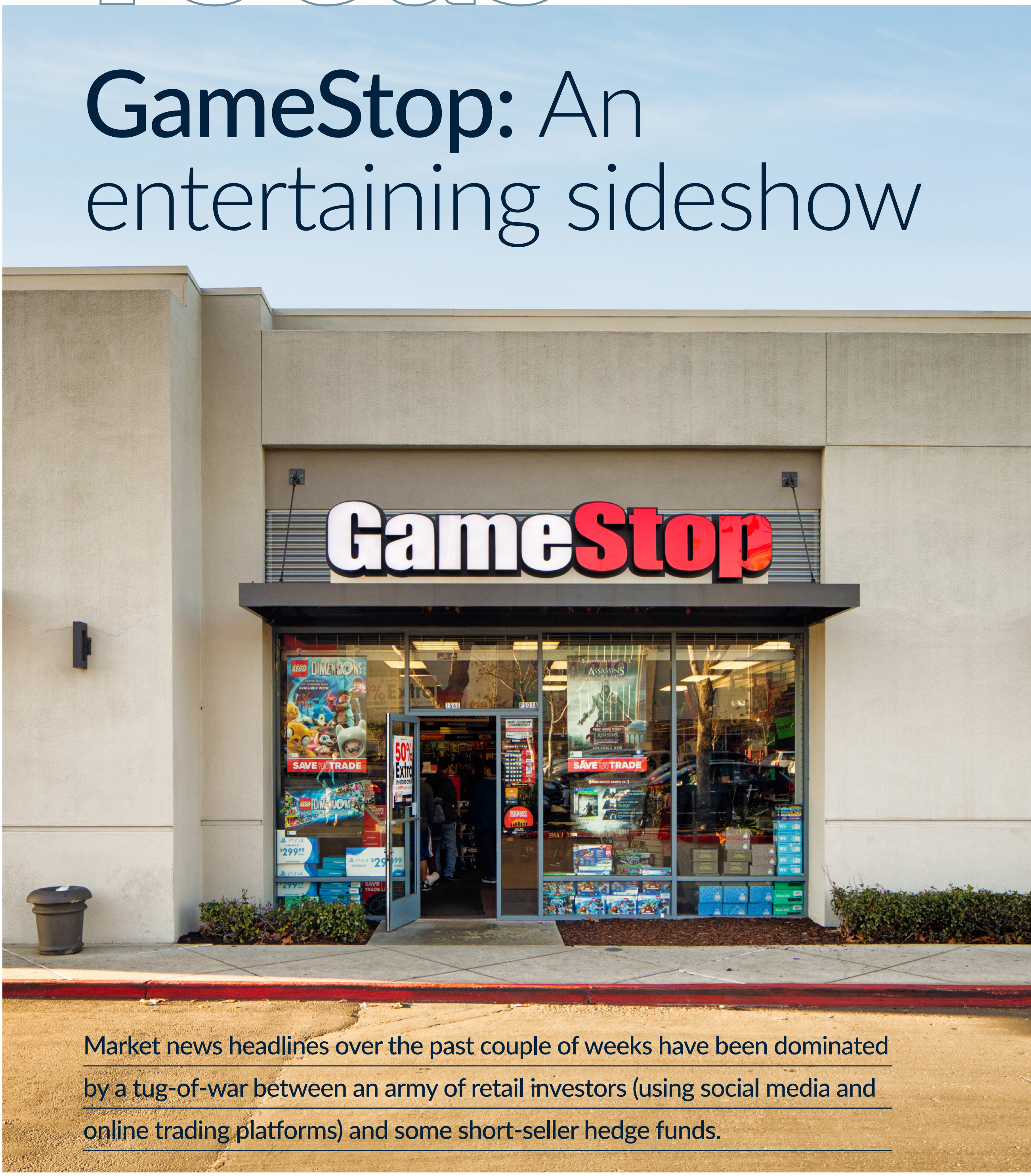
focus

GameStop: An entertaining sideshow



Market news headlines over the past couple of weeks have been dominated by a tug-of-war between an army of retail investors (using social media and online trading platforms) and some short-seller hedge funds.

FORSYTH BARR

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The short story is a group of retail investors thought it might be funny, virtuous, and maybe even profitable, to push up the prices of some small, heavily shorted stocks such as GameStop, AMC and Blackberry (or in market lingo, execute a "short squeeze"). The strategy worked and some hedge funds who had shorted these stocks experienced large losses. Whilst this is largely a sideshow to the broader market, affected hedge funds selling holdings to cover losses did cause some temporary market volatility. The impact was short lived. The retail crowd moved on to attempting a less successful short squeeze on silver. But there were some important lessons re-learnt.

What is short selling?

Short selling is selling a stock you don't own. The short seller needs to borrow the stock from someone who does own it and pays that owner to do so. When you're short a stock, you make money if the stock price falls and you can buy it back at a lower price. You lose money if the stock price rises. Short sellers can provide an important balancing force in markets, and, in the past, have uncovered frauds, Ponzi schemes, and other management deceptions.

What is a "short squeeze"?

A short squeeze typically occurs when short sellers, who had bet the price would fall, for some reason (e.g. unexpected good news from the company, or a jump in the share price) are forced to buy the stock to cover their shorts. The larger the number of short sellers, the greater the potential buying pressure. If the number of buyers, including short sellers, is large enough, a short squeeze can cause a stock's price to skyrocket. This is what happened with GameStop.

The story of GameStop

GameStop is a struggling bricks-and-mortar video game retailer. It operates around 5,500 stores across North America, Europe, Australia, and New Zealand under the GameStop, EB Games, ThinkGeek, and Micromania-Zing brands. GameStop's revenue has nearly halved, from US$9.6 billion in 2012 to US$8.3 billion in 2019 and an expected US$5.3 billion in 2020. Probably not surprisingly, a significant number of investors believe that physical video game retailers are heading the way of Blockbuster, i.e. toward extinction. The short interest in GameStop was considerable.

The story goes that at some point, a group of retail investors, who congregate on social media platform Reddit's WallStreetBets forum, decided that the short sellers were wrong and GameStop was undervalued at around US$5 a share. Somehow this morphed from an investment view that GameStop was cheap, to a widespread strategy to buy the stock no matter the price and squeeze the short sellers.

The short squeeze strategy was widely successful. Retail investors flooded in. At one

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point GameStop was the most heavily traded stock in the world. GameStop's market cap bottomed at US$180 million in April last year. It had already jumped to US$1.3 billion at the end of 2020. But in mid-January it started to surge, and at its peak on 27 January it closed at US$23 billion or US$348 a share, up over 12000% or 120x versus its 2020 lows.

On that same day the frenzy helped US stock exchanges see a record 23.6 billion shares traded. Australian company GME Resources' share price jumped +29%. Why? Its stock market ticker, GME, is the same as GameStop's.

Obviously investors who owned the shares could have made a lot of money (if they sold – GameStop's share price has since dropped over 80%). WallStreetBets users posted screenshots of their huge gains. Those that were short the stock saw big losses. Melvin Capital, a hedge fund that had shorted GameStop, had to get a US$2.75 billion bailout. But it wasn't only retail winners and hedge fund losers. There are numerous reports of fund managers who owned GameStop going into the short squeeze making huge returns.

Fuelled by their GameStop triumph, the WallStreetBets army pursued a number of other short squeezes. Some were successful, but not to the magnitude of GameStop. There are very few stocks out there that are as heavily shorted as GameStop was.

THE METEORIC RISE AND FALL OF GAMESTOP'S SHARE PRICE

Source: Thomson Reuters, Forsyth Barr analysis

What can we learn from GameStop?

GameStop has grabbed headlines – (whilst not 100% accurate) it's a David and Goliath story of how an army of small investors with user names like "dumbledoreRothIRA" and "Coldcutcombo69" beat the professionals. The good news for those wanting to know more (at least the Hollywood version) is that Netlflix is already planning to make a movie about it.

The reality, for most, is probably less exciting. There will be those who, through good luck or good management, made a lot of money (the biggest winners were actually some professional money managers). But most short-term investors are not successful.

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According to research from stock trading platform eToro, around 80% of day traders (people who buy and sell investments within a short period of time) lose money over the course of a year. And the median loss is a very large -36%! Not surprisingly, they also found more than 75% of day traders quit within two years.

Other research from academics out of the University of California and Washington University concludes that the stocks most popular with the retail investor "herd" on any given day, on average, deliver significant losses over the following month.

This reinforces the message from legendary investor Benjamin Graham: "In the short run, the market is a voting machine ... but in the long run, the market is a weighing machine." In other words, in the short term share prices can move around for many reasons that are disconnected from a company's valuation. These can create opportunities to enter or exit investments at favourable prices. But over the long term, share prices largely reflect a company's underlying worth. For long-term investors, GameStop-type tales are mostly just an entertaining sideshow rather than something that should meaningfully impact investment decisions.

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