

GameStop: It's not just a game

As I am sure most of you will have seen in the news, just as the pro Trump assault on the US capital abates we see another assault on a different US institution, this time it's Wall Street.

For the first time in history, and only possible through the connectivity of the internet, a group of retail investors with trading accounts at a small online brokerage firm called "Robin Hood" have banded together to buy the equity of a company called "GameStop". GameStop is a little known company in the US which sells video games (akin to Blockbuster). The only notable thing about the stock is it's currently the target of hedge funds who are betting against the company by going short the stock.

Shorting is essentially borrowing the stock from another person or institution and selling it straight into the market. Should the hedge fund research prove right and the company goes bust the stock will be worth a fraction of its value. All that's left to do is buy the stock back at a fraction of the price and deliver back to the institution who lent the stock originally. The profit in the short is keeping the difference between the high price you originally sold the stock for vs the low price you had to buy it back at. The risk to this type of strategy is the stock you have chosen to bet against rallying - meaning you have to buy

it back at a higher price rather than a lower price. This is called a "short squeeze".

Now, when you simply buy a stock you know your maximum loss is how far the stock has to fall before it gets to zero. The lethality in shorting a stock is there is no limit to how high a stock price can go which means your loss gets bigger and bigger ad infinitum the longer you choose not to buy the stock back and the losses can be eye watering.

What we see before us is a group of retail investors talking in a virtual chat room run by a company called "Reddit" about deliberately buying a stock which the hedge fund industry has bet against or "shorted". The intention is, with enough investors from the chat room buying the stock, it will rally and thus hurt the hedge fund betting against that stock. And boy did GameStop rally! The stock was up over 900% in a matter of days. This caused the mother of all "short squeezes" resulting in the hedge funds panicking and being forced to buy the stock back at a price some 900% higher which again forced the price even higher!

The reason why this is a watershed moment in stock markets is because a group of investors with little to no trading experience have marshalled themselves into a force which has managed to inflict multibillion dollar losses on the hedge fund industry, still widely regarded as the elite in finance or the "smart money".

Whilst this is fascinating to be watching, I couldn't be happier our clients are on the sidelines and nowhere near GameStop stock or the hedge funds who have shorted it. Anything that rallies 900% in a few days that hasn't found the key to eternal life is in a bubble and sure as eggs are eggs it's going to come back down when investors realise the underlying company isn't worth anywhere near the price it's trading at. Specifically, realistic analyst estimates value GameStop at $13 a share when it's actually trading at $193. As Jordan Belfort (the real wolf of Wall Street) commented when interviewed about this, "the shorters are rarely wrong".

Whilst most of us won't be involved in this rollercoaster, it's a good case study into the hidden threats of passive investing. As GameStop's share price rises 900%, so does the size of the share it takes in the index (Russell 2000) and thus some ETFs will need to buy more of the stock at this lofty valuation in order to keep replicating the index. This actually exacerbates the share price deviation and locks passive investors into this stock when it does eventually correct.

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