

The story of GameStop, democratic investing and being caught by the mob

This is a story about what the frenzy of crowds can do when sufficiently organized and have little to lose. In January 2021, GameStop shares soared almost 2500%, or 25x your initial investment. Share prices rarely make headline news, but this time was different. The apparent driver being a group of trash-talking, meme busting millennials linked together through the wallstreetbets blog site. With losses in the billions and counting, there are several casualties who are likely still wondering how they were caught. This month we step through the surprising number of role players in this story, and try to figure out if there is anything we can learn from it.

Old School Retailer

GameStop traces its roots back to 1984 with the onset of the first consumer-based video games. Atari and Nintendo were among their biggest sellers, and over the years the business grew strongly, alongside the launch of products such as Sony's PlayStation and Microsoft's XBOX. The business ranks as the single largest creator of employment in the US in the 21st century when considering organic growth alone^[1]. With almost \$10bn in peak annual revenues and up to 50,000 employees, this is no backstreet small cap share.



With the onset of internet-based access to video games, GameStop fell into decline through the mid-2010s as customers no longer needed to visit their stores to purchase new games. Faced with a future similar to the DVD or cassette tape, GameStop's back was against the wall.

During this period, it seems a relatively small number of what we would typically call 'deep value' investors had started to invest in the share. Traditional fund managers, private investors and even some value-oriented hedge funds had built positions aiming to benefit from a recovery in their prospects.

While there may have been hope on the horizon, through the pending launch of the PlayStation 5 towards the end of 2020, as well as renewed interest by activist shareholders looking at a turnaround plan, for the most part the business was struggling and the vultures had started to circle.

Betting against GameStop

Although there were many investors backing GameStop to make a recovery, there were also other investors (mainly large hedge funds) betting against the stock, hoping that the share price would fall significantly. This is what is known as 'short selling' a stock.

'Short Interest' is a financial term used to describe the number of shares of a company being sold by the market, betting on a share price to fall. This means that when the share price falls, the investors who are 'short' can profit. We won't elaborate further at this point on shorting, other than to point out that for the short seller, their potential gains are capped (a share can only fall to zero, no further), while their potential losses are theoretically unlimited, beyond your initial capital investment (as a share price has no maximum value). It is a particularly high-risk form of investing, and usually the domain of hedge funds who promise to earn profits by making money irrespective of the direction of share prices.

The short interest on GameStop during the early part of January 2021 was around 140% of all shares in issue^[2]. This means that not only were investors shorting the share en masse, but they were shorting shares which had already been shorted by someone else. This is probably about as negative an investment community could be on a share, and GameStop at the time was the most shorted share globally at this point.

Such a massive short position is quite difficult to hide. It is also very difficult to unwind if you require it to. The value-oriented investors we spoke about earlier are generally going to sit on their hands and wait for their investment thesis to play through. In that scenario the business recovers, the share price recovers, and the hedge funds who are short lose out in an orderly fashion. The point is, they don't go out and attack the hedge funds who are short, because to do this they would need to go out and overpay for the share they already hold, at a price above what they are willing to pay. So, they rather let time be the arbiter of value.

While this all seems quite normal – there will be winners and losers on both sides of any share at any point in time – the market had not factored in the potential for a mob of swashbuckling day traders to band together.

Retail investors unite

Reddit is a blog site, where groups of individuals with common interests get together to chat about topics and express their opinions. The wallstreetbets 'sub-reddit' group was formed in 2012, and while most of the chat was around top picks and share ideas, from time to time there appears to have been attempts to work together to push individual shares to higher levels.



In this instance, with the 140% short interest, what seems to be a vengeful dislike of wealthy Wall Street fund managers, and lots and lots of small brokerage accounts acting together as one, the mob within wallstreetbets came together to 'squeeze out the shorts'. In plain English, this means that they could see that if they could start to push up the price of GameStop, this would force the hedge funds who are short to buy up the share (to reduce their short exposure and minimize losses), creating a virtuous circle which keeps forcing those who are short to pay up. This is known as a 'short squeeze', a terrifying, capital killing investment outcome, the outcome of which was billions of dollars of realized losses and counting for those who were short.

The enabler

Now it gets interesting. Robinhood.com is an online trading platform, populated with millennials (around 80% of their active members) with an average age of 26. The founders of Robinhood used to make a living designing software for the 'flash traders'^[3]. With Robinhood, it seems they decided to rather make their living routing the orders to the flash traders through a platform centred on 'democratising investing'. For the Robinhood traders, this meant free accounts, no deal execution fees and even (unbelievably) fractional ownership of individual shares. How do they pay their bills? By routing client orders to execution agents who pay what is politely termed a rebate, and more commonly known as a kick-back, a practice founded by Bernie Madoff. A murky area where it seems the client's best interest may not be front and centre.

Robinhood 

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#YOLO

"Be fearful when others are fearful and be greedy when others are greedy." - Bryan, UCLA freshman



This Robinhood platform created a perfect world for wallstreetbets members to day trade, speculate and perform other activities with loose associations to investing, such as trading cryptocurrencies. Small account sizes, no dealing costs and the ability to trade fractions of shares meant that the equity market truly was a home for the masses to try their hand.

By the 22nd of January, the frenzy had started to build, and GameStop shares had started to move. Relatively slowly at first but ending the day 50% up. The next few days saw the mob hit its stride, forcing the short squeeze by bidding up the price of the share from around \$40 to a high point of \$483 within the week. At this point, wallstreetbets was adding millions of new users, newspaper headlines were trying to keep up with the action, and hedge funds were scrambling to cover their losses.

Melvin Capital, a poster child for hedge funds, was one of the largest funds caught in the stampede. With a large short position, their losses quickly amounted to billions of US\$, to the point where they needed to shore up the business by taking on new investors (on friendly terms, apparently) to the tune of \$2.75bn. One of these was a business called Citadel Securities, a Chicago based financial services giant who in turn was also a significant beneficiary of much of Robinhood's deal flow^[4]. At the same point, Robinhood itself was creaking, as the massive amount of trade volume, through both physical share transactions as well as those based on derivatives, meant that they started to create a systemic risk event for the financial markets. Robinhood was forced to halt trading on certain shares, including GameStop and several others caught up in the mileu. Robinhood's shareholders needed to step in to prop up the business, fronting up \$1bn overnight to stabilize the business and appease regulators.

While wallstreetbets had done the damage, they couldn't finish the task. The suspension of trading across Robinhood and a range of other similar online discount brokers, meant that the mob couldn't push through to the extent they might have. Feeling unfairly treated, and against the ethos which binds them ("democratized investing"), the rally cries are now hinging on topics like '*class action*'

and 'payback'. In particular, the anger shown towards the wealthy investment elite demonstrates their frustration with being sidelined in an industry they thought they had just cracked.

So, who are the winners and losers in this story?

It is quite clear who the big losers are. Firstly, the hedge funds who had sold short. Known as the 'smartest' of fund managers, they did not foresee what a frenzied mob could bring to their door. In future, it is hard to see hedge funds acting as though they hold all the cards. We also know now that the market is not always as efficient as we are told.

Secondly, the wallstreetbets traders. While there is no doubt that a wide range of participants (investors?) made good returns – some as young as 14 it seems – there will also be a large number who bought in late and have suffered substantial losses. This is nothing new and is a common trend in equity markets. Strongly rising asset prices attract money like no other, irrespective of what it may be worth.

Robinhood.com, the enabler in this story, seems to have come out on top. They may need to win back the favour of their adoring day traders, but they have already signed up an additional \$2.4bn in February from new investors who see this venture as The Next Big Thing.

The stockbrokers are rejoicing as trade volumes have set new records (stockbrokers tend to make their fees from trade volumes). This despite the fact that players such as Citadel seem to be on both sides of the trade: receiving deal flow from Robinhood and paying healthy rebates; but also involved in bailing out Melvin Capital, the main target of the short squeeze in the first place.

The value investors have made a packet. You could say they were fortunate to get their unlock in this way, but it is quite normal for short sellers to create a hangover on a share price to start with before the recovery comes through. Despite the fact that GameStop has fallen back to around \$60 at time of writing (down 88% from peak!), investors have tripled their money since the start of the year, potentially more if they sold on the way up which is quite likely.

Finally, GameStop itself. How did they fare? It is quite easy to see them as the victim of a faddish action which had no grounding or relevance to the fundamentals of their business. This may well be true. But they did buy back 34% of the company at around \$5 in 2019, and their share price has tripled this year.

So, what lessons can we take from all of this?

Hopefully the most obvious one is to ensure you are distinguishing between investing and speculating. Much of the activities described above relate to speculating, but investing is where we focus our attention to help compound wealth over time. Secondly, it is a great lesson to make sure you are aware of your own blind spots. In this case the overconfidence and consequences this brought for the hedge funds who thought their position was unassailable. Patience is a third lesson. While many individuals have made profits in this story, it is likely that a greater number have lost. This takes us back to basics, that investing requires good fundamental grounds, plus the addition of time to create the right long-term results.

Footnote: there will be formal enquiries into this event, and we may see stricter regulations as a consequence, which could have other implications for investors. What will be interesting though, is to see who was behind the huge purchases of share in the week before this drama unfolded. Was it the frenzied mob who really caused this to take place, or was it perhaps a less exciting, but no less significant player, quietly acting on the sidelines with the same agenda? Time will tell.

^[1] Capital markets and job creation in the 21st century, Jerry Davis.

^[2] A short interest greater than the total shares in issue is possible, as shares can be loaned out and shorted multiple times.

^[3] Flash trading is a form of deal execution which uses speed to get ahead of the queue, mostly at the expense of the client. For a good read, see 'Flash Boys' by Michael Lewis.

^[4] These are orders to buy and sell shares.

data provided by Reuters and Datastream

MARKET REPORT

31/01/2021

		3m	YTD	1yr	3yr pa	5yr pa	10yr pa	5yr Vol1	10yr Vol1
LOCAL MARKET INDICES									
FTSE/JSE All Share Index (ALSI)	ZAR	21.2%	5.2%	14.5%	4.8%	8.1%	10.4%	15.2%	13.3%
FTSE/JSE SA Listed Property	ZAR	29.3%	-3.2%	-34.6%	-18.8%	-8.5%	3.6%	25.5%	20.5%
SA All Bond Index (ALBI)	ZAR	6.6%	0.7%	8.1%	8.5%	9.6%	8.6%	8.1%	7.8%
SA Cash Index (SteFI)	ZAR	0.9%	0.3%	5.1%	6.5%	6.9%	6.3%	0.3%	0.3%
Balanced Benchmark	ZAR	14.0%	3.0%	10.8%	7.0%	8.1%	10.9%	10.5%	8.8%
SA Inflation (1 month lag)	ZAR	0.4%	0.2%	3.1%	4.0%	4.6%	5.1%	1.3%	1.3%
GLOBAL MARKET INDICES BASED TO USD									
Global Equity (Datastream World)	USD	16.5%	-1.0%	16.0%	8.9%	14.0%	10.1%	14.8%	14.0%
Emerging Markets Equity (Datastream EM)	USD	21.0%	3.1%	28.3%	4.8%	15.4%	4.6%	17.3%	17.8%
Global Property	USD	11.8%	-0.6%	-5.7%	3.5%	7.0%	6.7%	14.7%	14.7%
Global Bonds (Barclays Global Bond Index)	USD	1.6%	-1.3%	7.0%	3.9%	4.2%	2.2%	5.4%	5.0%
Global Cash	USD	0.1%	0.0%	0.5%	1.7%	1.5%	0.9%	0.2%	0.2%
MAJOR INDICES BASED TO RANDS									
FTSE/JSE All Share Index (ALSI)	ZAR	21.2%	5.2%	14.5%	4.8%	8.1%	10.4%	15.2%	13.3%
Global Equity (Datastream World)	ZAR	7.9%	1.5%	16.4%	17.9%	12.7%	18.6%	16.9%	14.5%
Emerging Markets Equity (Datastream EM)	ZAR	12.1%	5.6%	28.8%	13.4%	14.2%	12.6%	14.4%	13.4%
Global Property	ZAR	3.5%	1.9%	-5.4%	12.0%	5.8%	14.9%	16.7%	14.4%
SA All Bond Index (ALBI)	ZAR	6.6%	0.7%	8.1%	8.5%	9.6%	8.6%	8.1%	7.8%
Global Bonds (Citigroup)	ZAR	-5.8%	1.2%	7.3%	12.5%	3.1%	10.0%	16.3%	14.5%
COMMODITIES									
Gold (US Dollars)	USD	-1.2%	-2.1%	17.1%	11.5%	10.7%	3.4%	13.5%	16.0%
Gold (Rands)	ZAR	-8.5%	0.3%	17.5%	20.6%	9.5%	11.3%		
CURRENCIES									
Rand / Dollar	ZAR	7.4%	-2.5%	-0.4%	-8.2%	1.1%	-7.7%	17.0%	15.5%
Rand / GBP Pound	ZAR	1.6%	-2.9%	-4.5%	-7.0%	1.7%	-6.0%	17.7%	14.7%
Rand / Euro	ZAR	3.4%	-1.8%	-10.0%	-7.3%	-1.2%	-6.4%	15.3%	13.6%

Spot Rates		29-Jan-21	Latest Quarter	1 Year Ago	5 Years Ago	10 Years Ago	20 Years Ago
CURRENCIES							
Rand/US\$	Rand	15.05	14.69	15.00	15.90	7.18	7.88
Rand/GBP	Rand	20.68	19.88	19.76	22.55	11.50	11.48
Rand/EUR	Rand	18.29	17.97	16.62	17.20	9.84	7.24
RATES							
Libor 6m \$	US\$	0.22	0.26	1.75	0.86	0.45	5.38
Repo Rate	Rand	3.50	3.50	6.25	6.75	5.50	12.00
Prime	Rand	7.00	7.00	9.75	9.75	9.00	14.50
All Bond Index Yield	Rand	9.63	9.62	9.50	9.56	8.62	9.74
COMMODITIES							
Gold (\$/oz)	US\$	1,858.01	1,897.77	1,586.70	1,117.15	1,332.16	263.00
Platinum	US\$	1,110.00	1,068.00	959.00	866.00	1,781.00	608.00
Oil (Brent Crude) \$	US\$	55.95	51.89	58.23	34.30	99.46	26.82
INFLATION							
SA Inflation	%	3.1	3.1	4.5	6.2	3.8	9.4