

March 2021

Game On for GameStop

The biggest news story in 2021 so far is the GameStop frenzy. If you have a hard time understanding this sensational scoop, you are not alone. It's not supposed to make sense at first glance but it's not unprecedented and quite understandable if we take a closer look.

So what happened with this flailing brick-and-mortar retailer that sells video games inside shopping malls?

For the first time in twenty years, market participants in early 2021 witnessed a remarkable revival in the day trading movement. Some may remember the emergence of free internet discussion boards such as Yahoo chatrooms in the 1990s. These chatrooms were full of penny stock promoters and rumour-mongering trolls. The relevance of Yahoo chatrooms will become clear as you read on.

With high-speed home internet and commission-free trading, an army of individuals congregated in the online forum Reddit to target certain stocks for investment. GameStop, one of the targeted stocks, saw its price climb dramatically in early 2021, followed by a quick collapse. In the aftermath, federal agencies such as the US Department of Justice are investigating potential market malfeasance.

The key aspect behind targeting stocks such as GameStop was a unanimously negative view of their future. The negative sentiment led institutional investors to build large "short" positions, which expect the stock price to decline. By borrowing these shares from others and then selling them onwards, many hedge funds were positioned to profit by buying them back at a lower future price — basically, the price goes down and they make gains. By early 2021, the collectively dour view on GameStop had resulted in more shares being shorted than were outstanding. If the shares moved upwards substantially, short sellers would be faced with an increasing loss on the trade, requiring them to either contribute more money to cover this shortfall or buy the shares back in the market to exit their position.

Noticing this potential, this band of Reddit traders collectively acted to purchase GameStop shares. A second factor exacerbated upwards action in the shares. Rather than buying GameStop shares outright, these Reddit traders focused their trading on call options instead (essentially, a right to own the share). These call options were a way of making an even bigger, more leveraged bet on GameStop moving higher. Once GameStop shares started to ascend, a technical reason triggered a self-reinforcing trend: the market-makers selling these derivatives to Reddit traders had to hedge their respective exposure by purchasing small amounts of GameStop shares. The rise in GameStop shares increased their exposure prompting more buying on their part.

And so, a dual force suddenly kicked into gear in early 2021. These option sellers were buying GameStop shares at the same time that short sellers were looking to close out their trades, creating a spiral upwards known as a "short squeeze." Before the action finally petered out, GameStop had risen from \$17 to \$450 in a matter of weeks, a remarkable 2,600% increase.

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In all of this stock buying, shorting, and options trading frenzy, completely ignored was the true value and fundamentals of the underlying businesses. The stock-shorting hedge funds, the call-buying Redditors, the video-gaming teenagers with Robinhood accounts and the like are making a bet on the stock price direction: this is speculation, not investing.

Markets are largely made up of, and influenced by, emotionally driven and biased individual investors. With this increase in the number of day traders, equipped with mass weapons of destruction — social media and high-speed internet combined with free trading accounts where you can buy fractional shares — we are likely to see more extreme market movements and baffling financial news stories. Speculative markets such as these are bound to produce more losers than winners. The gamification of investing could have serious financial consequences for many inexperienced retail investors who are investing their savings in the hopes of making a quick buck. It is more important than ever to focus on your portfolio's long-term financial health and stick to disciplined investing.

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