THE Wealth REPORT

RETAIL TRADING FRENZY: LESSONS FROM GAMESTOP

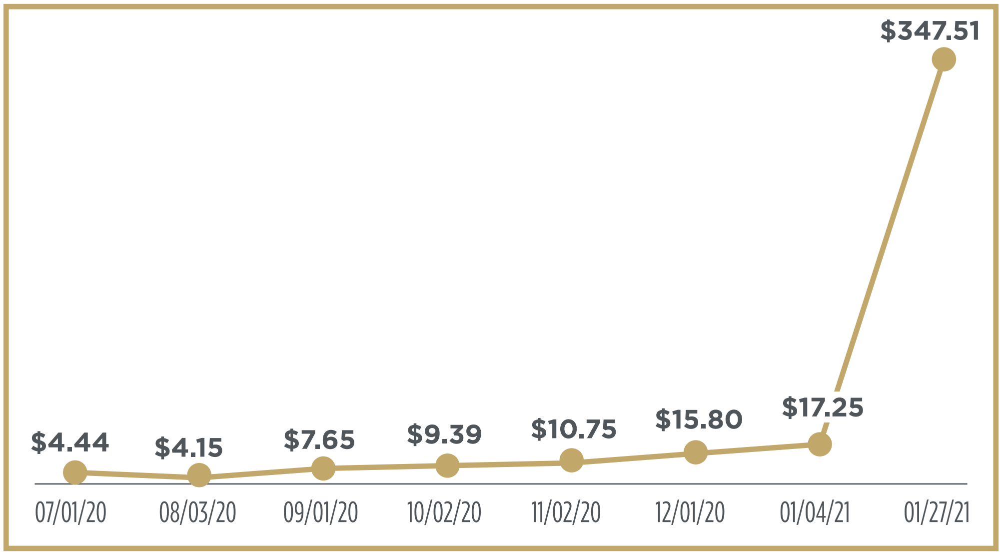
Overview

Starting on Jan. 25, 2021, the stock market witnessed an extreme trading frenzy driven by a relatively small number of stocks. It began with GameStop, a struggling brick-and-mortar retail chain, which last summer was trading at around $4 per share.

GameStop has been a lackluster stock for much of its history. Since the company went public in 2002, GameStop shares experienced only a few brief spikes and had never traded above $63 until last month. The accompanying graph gives you an idea of what its six-month performance looked like before January:[1]

In the stock market, there are generally winners and losers. For every investor who buys low and sells high, there is an investor buying high — not knowing if that stock price will climb higher.

GameStop (NYSE: GME): July 2020 – January 27, 2021[1]



This price hike was driven by a group of retail investors who recognized that GameStop (GME) shares have long been a target for short sales among Wall Street hedge fund managers. Using social media to encourage individual investors to start purchasing GME shares, a buying frenzy ramped up the price within a matter of days. The main social media website used to encourage the buying spree is called Reddit.

What Is Reddit?

Reddit is a crowd-sourced information and commentary website. It hosts a wide range of subject-specific discussions on message boards, one of which is led by amateur traders dubbed "WallStreetBets."

These retail investors use the online community forum to discuss stocks they buy and sell. In early January, the discussion began to focus on GameStop, which was a popular retailer for many young adults who grew up purchasing their games and video equipment at local stores.

However, most people these days purchase their games from online resources, which they can download and begin using immediately without having to leave home. This has hurt GameStop revenues in recent years, so its stock price basically plateaued and has remained in the $4 to $20 range, with little upside potential. What got the attention of these Reddit forum members, however, was that a large percentage of the company's shares were "short" positions.[2]

How "Shorting" Works

Most investors make money by purchasing shares at one price and then selling them at a higher price. Shorting is designed to do exactly the opposite.

To short a stock, an investor borrows shares of that stock "on margin." This means he puts a fraction of the current value of those shares (e.g., 10%) into a brokerage margin account, and the rest of the value is basically considered a loan from the broker. During the period in which the investor buys on margin, he pays interest on the outstanding loan.

Shorting is buying a stock the investor believes will drop in price. First, he borrows shares from a brokerage and then immediately sells them for cash. However, he can delay having to return the shares or repay the brokerage until later. If the stock price falls, as expected, the investor then buys back his position at the lower price and returns the shares to the brokerage. He pockets the extra money he made between selling them at one price and buying them back at a lower price. For example:

- Sell 100 shares of borrowed stock at $8 per share *(profit: $800)*
- Buy back 100 shares when the price drops to $5 per share *(cost: $500)*
- Return 100 shares to the brokerage and pocket the $300 profit

However, this strategy can be risky. Should the stock's price increase rather than decrease, the investor may have to buy back those shares at a higher price in order to return them to the lender — in which case he'd take a loss on the deal.

- Sell 100 shares of borrowed stock at $8 per share *(profit: $800)*
- Buy back 100 shares after the price rises to $10 per share *(cost: $1,000)*
- Return 100 shares to the brokerage and take a loss of $200

The investor can wait to see if the price will drop again, but the problem is that as the value of those shares increases, the borrower may have to add more money to his margin account to cover the increased value. Also, he incurs the risk of the share price rising even higher, which means he could lose even more money.

As the share price continues to increase, investors who shorted the stock will start to buy it back in order to cut their losses — only this tends to increase the price even more. Those who do not buy the stock back early enough in the cycle may end up owing a lot more money to the brokerage.

"Ultimately, what is a stock worth? The only answer is, what another guy will pay for it. It's that simple. If someone wants to pay you $480 for GameStop, well then, that's the price." [3]

The GameStop Gambit

Investors on the Reddit forum noticed that short-sellers had taken big positions in GameStop. That's when they devised the plan to drive the price up so that those short-sellers would likely sell to minimize their losses. This is called a "short squeeze," and it also serves to drive share prices even higher.

What made the scheme remarkable is that social media allowed small investors to collaborate on a strategy designed to create demand for a stock and artificially enhance its share price. The more people who invested in the stock, the higher its price climbed. As the rising market got the attention of the media, more traders bought into the play. GameStop even got a boost from Tesla CEO Elon Musk, who tweeted out to his 42 million followers: "Gamestonk!!" with a link to the WallStreetBets message board. The Reddit forum tripled its membership to 6.5 million in just that one week.

This coordinated campaign enabled small individual investors to benefit using the traditional investment strategy. They bought the stock when the price was low and then sold it when the price skyrocketed, thus pocketing substantial gains. Hedge fund managers with shorted stocks found themselves holding high-priced shares they couldn't — or didn't dare — unload.

The buying frenzy wasn't limited to GameStop. Savvy traders began purchasing other heavily shorted stocks that have suffered during the pandemic, such as AMC Entertainment and Bed Bath & Beyond.[4]

Clearinghouse Rules

Remember the bit about investors having to keep a certain amount of cash in a margin account at their brokerage? The same holds true for brokerages. The clearinghouses that facilitate trades require brokerages to hold a certain amount of reserves to ensure they can pay out gains on shares sold.

Because the buying frenzy was sudden and explosive, some of those brokerages had to halt trades for certain stocks in order to bolster those reserve requirements. This left some investors in the lurch because they couldn't sell at a higher price; they had to wait until the next morning when trading resumed to sell their stock — and at that point the price had dropped from its zenith.

One of those brokerages was Robinhood, a trading app popular among younger investors for its ease of use and ability to purchase fractions of shares — which requires less money. Robinhood halted and/or limited trades for a number of those shorted stocks in order to tap its credit lines and raise an additional $1 billion overnight to meet reserve requirements.[5]

GameStop Lessons

The GameStop gambit demonstrates some of the risks associated with trading on margin — which is basically investing with money you don't have. Short-selling is a key tactic among hedge funds, because they are managed on the premise of "hedging their bets." One of the interesting lessons learned in January is that social media can be used to coordinate the efforts of millions of smaller, individual investors — a volume strategy previously available only to large fund managers.

With that said, it's worth reiterating some of the basic tenets of investing — especially for people nearing retirement. One of the reasons the GME strategy worked is because it was largely facilitated by younger investors — who could afford to take that kind of risk. For investors looking for a less rollercoaster, more long-term growth strategy, keep the following guidelines in mind.

1. Due Diligence — A company's stock price is only one factor when deciding where to invest. With GameStop, investors bought shares even though they knew the increasing price did not reflect the company's true value. In fact, GameStop had recently announced a planned closure of 1,000 stores, which is why hedge funds shorted it.[6] But be aware that, unless you are betting on a price drop, financial problems are usually a red flag.

2. What Goes Up — Most investors are looking for a stock with the potential for rising share prices, which generally reflects sound fundamentals, expanding revenues and positive growth prospects. However, rapid-fire price growth in just a few days? That's generally a sign of high risk.

3. Must Come Down — In most investing scenarios, share prices tend to reflect the financial health of a company. If prices escalate higher than warranted, there's a very good chance they will drop again. In this case, it's all a matter of market timing as to whether an investor will profit or lose money.

One of the biggest positives to take away from that week is that people are starting to invest at a younger age, and today's investment apps make it easier for them to do so with small trades. The media attention has likely spurred even more people to learn how and where to invest.

Final Thoughts

There is a lot more to investing than just pressing a few buttons on your smartphone app. The mechanics may be easier, but it's important to understand how the markets interact, how they respond to different economic cycles, what to look for in a growth stock or, as we learned, a deteriorating stock. Perhaps most important is evaluating our personal circumstances to create an investment strategy designed to meet specific goals.

Day traders and short-term investors frequently take the time necessary to monitor a stock and buy/sell based on momentum and direction. Most of us have other jobs and other priorities that make this time-consuming task rather difficult.

A short-term, speculative growth strategy is generally not appropriate for someone nearing retirement. And for long-term goals, a long-term strategy is generally lower risk and requires less attention. However, for investors with the time and money, it may be worthwhile to apportion some of your assets for more active money management. In this scenario, it is prudent to consult with an experienced investment advisor to help make informed buy and sell decisions.

[1] *Google Finance. Feb. 2, 2021. "GameStop Corp. Performance." https://www.google.com/finance/quote/GME:NYSE?sa=X&ved=2ahUKEwj27-L_-8vuAhWNmVkKHQDzBP0Q3ecFMAB6BAgBEBk. Accessed Feb. 2, 2021.*
[2] *Yun Li. CNBC. Jan. 30, 2021. "GameStop, Reddit and Robinhood: A full recap of the historic retail trading mania on Wall Street." https://www.cnbc.com/2021/01/30/gamestop-reddit-and-robinhood-a-full-recap-of-the-historic-retail-trading-mania-on-wall-street.html. Accessed Feb. 1, 2021.*
[3] *Eddy Elfenbein. Crossing Wall Street. Jan. 29, 2021. "CWS Market Review – January 29, 2021." https://www.crossingwallstreet.com/archives/2021/01/cws-market-review-january-29-2021.html. Accessed Feb. 1, 2021.*
[4] *Yun Li. CNBC. Jan. 30, 2021. "GameStop, Reddit and Robinhood: A full recap of the historic retail trading mania on Wall Street." https://www.cnbc.com/2021/01/30/gamestop-reddit-and-robinhood-a-full-recap-of-the-historic-retail-trading-mania-on-wall-street.html. Accessed Feb. 1, 2021.*
[5] *Ibid.*
[6] *Katie Brockman. Nasdaq. Jan 30, 2021. "3 Lessons Investors Can Learn From GameStop -- And Where to Invest Instead." https://www.nasdaq.com/articles/3-lessons-investors-can-learn-from-gamestop-and-where-to-invest-instead-2021-01-30. Accessed Feb. 1, 2021.*

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