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GameStop

OFFICE 425-883-7990 WEB pim4you.com

"Speculators may do no harm as bubbles on a steady stream of enterprise. But the position is serious when enterprise becomes the bubble on a whirlpool of speculation. When the capital development of a country becomes a byproduct of the activities of a casino, the job is likely to be ill-done."

- John Maynard Keynes

We don't normally weigh in on day-to-day financial news at PIM. Generally, the most popular topics are inconsequential or an idea that we've been working on for months before the general public takes notice. The topic of Reddit/GameStop traders vs the hedge fund industry is one that deserves some attention due to the incomplete or inaccurate information in circulation.

What's Going On?

GameStop is a brick-and-mortar retail store that sells new and used videogames and consoles. The company has been targeted by short sellers (those who sell borrowed shares in the hopes of buying those shares back in the future at a lower price, earning a profit) due to the firm's declining financial position and perceived lack of long-term viability. Recently a group of traders loosely organized on an internet forum called "Wall Street bets" have argued that regular investors should buy as many shares as possible to drive the price higher and force the short sellers into buying their shares back at a much (much) higher price. This has generated billions of dollars in losses for the hedge fund industry. In the past twelve months, GameStop shares have traded between $2.57 - $483.00, with most of that gain coming last week.

Is This Market Manipulation?

Yes, it is. Last week GameStop briefly had a market cap of $40 billion, roughly the same size as eBay, Kraft-Heinz and Public Storage, (respectively, not collectively). It seems very unlikely that a video game retailer (not named Amazon or Microsoft) will ever grow to a level that justifies such a valuation. The interest in GameStop seems to be primarily due to small investors sharing ideas and strategies on an internet forum and not based on the prospects of the business.

Investors using whatever platform they have available to talk-up stocks for their own financial gain is nothing new. This has been going on since people settled trades under the Buttonwood tree in the 1700s. Usually, it is a small group of wealthy investors doing so quietly. This time it is the opposite, with many small investors being as loud as possible and making the issue about social equality. It is still market manipulation, even if their other point is valid.

Is Short Selling Bad?

No, not really. Short selling is a tool with many different uses. At its most extreme it can be used to drive failing firms out of business so that their capital can be more efficiently allocated elsewhere. This is "creative

destruction", an unpleasant but necessary requirement of financial capitalism. This type of short selling is very risky and rarely used as a stand-alone investment strategy. Technically, short selling has infinite risk because the stock must be purchased to repay the stock loan at any price. This is the squeeze in "short squeeze".

Short selling is more commonly used as a hedging tool, to mitigate risk. Hedge funds identify and establish short positions in companies that they think have poor prospects. These short positions, it is hoped, will profit from a general market decline that may lower the share prices of good companies they own outright (have long positions). Further, the sale of borrowed shares generates cash that can be used to buy more shares of companies that the hedge fund believes have a bright future.

James Chanos is an elder statesman of the hedge fund industry who was instrumental in discovering the Enron fraud. In an interview last summer, he said that over his career he has rarely made money off his short positions.

Small Traders vs. the "System"

Brokerage firms and regulators are not working against small traders, though this has been a popular conclusion in the press and with politicians. Last week Robinhood, the most popular broker for the Reddit crowd, limited the number of shares of GameStop that investors could purchase. This was due to regulatory requirements to maintain an orderly market, not an effort to stop trading in GameStop. Modern trading appears relatively instantaneous. But behind the scenes exists a daisy chain of credit agreements and contracts between the parties to the transaction. This process of providing cash or securities to the buyer/seller is called settlement.

The DTCC (Depository Trust and Clearing Corporation) settles most trades in America, somewhere around $2.15 quadrillion (15 zeros) worth. In 2019, some 650 million transactions went through DTCC. Robinhood, Schwab, Fidelity and all other broker-dealers are DTCC members and are subject its rules. These rules ensure that trades can be processed quickly and without risk of failure. Every investor, including you, our valued PIM clients, benefits from the DTCC system. It guarantees that a completed trade results in either cash or shares on settlement date. Without it, all transactions would be at risk, and securities would become less liquid and therefore less valuable.

Member firms post collateral (cash) at the DTCC to pay for any failed trades. The amount that member firms need on deposit depends, in part, on what the firm's clients own. If a firm's clients collectively own a large amount of highly volatile GameStop shares, the possibility of failed trades increases and so, therefore, does the DTCC collateral requirement. An individual account holder may not feel like paying for shares of GameStop he/she bought at $400 when it is trading at $200 the next day. But their broker-dealer is on the hook for the trade through their collateral account at the DTCC.

The problem exacerbates itself with each additional share of GameStop traded, which is the reason that Robinhood limited trading on that security. It is rumored that Robinhood raised $3-4 billion to meet their collateral requirements over the past two weeks. Failure to meet collateral requirements at the DTCC puts a member firm into receivership immediately. Literally the next day the firm is closed, and their clients are forced to move their accounts elsewhere. The trading restriction on GameStop, and a few other securities with similar characteristics, is done by broker-dealers wanting to stay in business not hedge funds conspiring against the public.

Is There Anything Interesting Here?

Yes, thanks for asking. Two things come to mind. The largest hedge fund caught up the GameStop saga is Melvin Capital. The firm needed $2.7 billion to stay in business last week, after losing $18 billion in a short squeeze. Remarkably, two other hedge funds came to their rescue. This is not normal. Generally, hedge

funds enjoy watching their competition fail. They wait for the losing firm to close, then buy their assets at pennies on the dollar and hire away their best talent. They only help when there is a chance of systemic risk that could harm their own businesses. It appears that at least some hedge funds felt that what happened with GameStop was bad for the industry at large. Second, and this is the reason for the quote from Keynes, the Reddit crowd is now looking at manipulating industrial metals markets (platinum, palladium, rhodium and silver). Silver has a long history of market manipulation, making it a natural target. Unlike GameStop, these metals are used in real world applications, and therefore their manipulation could cause the prices of consumer goods to increase.

Conclusion

Short selling is the act of borrowing then selling shares of a publicly traded company, in the hope that the shares can be repurchased at a low price, at a later date, and returned to the lender. The spread between the initial sale proceeds and the later purchase price is profit. Short selling is a legitimate investment strategy, more frequently used as a hedging tool than for wealth-building. There is, theoretically, unlimited risk, as the price of the shorted shares may go to infinity rather than down. As the price of the shorted shares continues to rise, losses mount creating a “short squeeze” that must eventually be covered at potentially considerable cost. This is what some hedge funds recently experienced.

Limiting trading on a stock during a period of extraordinary volume and high volatility is sometimes required to maintain the collateral requirements of the Depository Trust and Clearing Corporation, and ultimately to maintain secure and orderly markets. This should be thought of as a circuit breaker, a risk-management tool that benefits all investors and has nothing to do with punishing retail, social media market manipulators.

The extent to which the GameStop story has impacted PIM clients is very limited and temporary. We do not pursue the types of strategies that would bring a company like GameStop into the portfolio, nor do we short sell. There was increased uncertainty in the market last week as hedge funds were forced to re-assess their portfolios and trading strategies, causing the worst weekly decline since October. Most of that lost ground has since been recovered as strong earnings from corporate America come to the forefront.