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Will the Meme (Game)Stop?

Short Squeezes Are Not New. So What Is Different This Time?

Expect More Regulation to End Market Manipulation and to Stabilize the Markets

For all of you silent "generationals" and baby boomers, a meme (pronounced "meem") is typically an image or short video transmitted over social networks, text, or email that reflects an idea, behavior, or style. The more versions of a meme you see, the likely more popular it is and the more cultural influence it may have. Perhaps you have seen an image of a grumpy looking cat with the text "Good morning? No such thing." There is also the viral Bernie Sanders "inaugural mittens" meme making the rounds. Our favorite is the cozy looking Bernie sitting on the iron throne from the popular TV series, Game of Thrones.

Memes, however, are not always intended to make you laugh. They can also be used to make a statement about society or even to move the financial markets. This year, "meme trading" has been all the rage, causing the share prices of certain near-bankrupt, small capitalization companies to soar as much as 1,760%[1]. The term "meme trading" was coined by Jaime Rogozinski the creator of WallStreetBets, a "sub Reddit" (i.e., chat room or online community) on Reddit.com. WallStreetBets, which has been in existence since 2012 and has over 6 million users[2], was responsible for inciting the moonshot launch of these stock prices. Rogozinski

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originally created WallStreetBets to learn about “high-risk, high-return-type trades”[3] but now calls the online forum a “train wreck happening in real time.”[4].

So how exactly did memes posted on WallStreetBets trigger these massive share price spikes? It started with a “short squeeze” trade idea posted on WallStreetBets that started to gain steam among forum members after a high-profile entrepreneur/investor joined the board of the company whose shares were being heavily shorted. A short squeeze happens when short sellers, or investors betting on the price of a stock to go down, are forced to cover their positions when the price of the underlying stock rises precipitously. (Short sellers pay a fee to borrow shares of a stock from investors, usually brokerage firms, not interested in selling their position. Upon obtaining the shares, the short seller immediately sells the borrowed shares in the open market with the expectation of repurchasing them at a lower price. The short seller locks in a profit by repurchasing the shares at a price lower than they received when selling them. The disparity between the short sellers sell price and repurchase price, less borrowing fees, determines the ultimate profit made or lost on a short trade.) Short squeezes typically occur to stocks with high short interest (i.e., a high percentage of shares sold short as a percentage of total shares outstanding) where the price of the stock rises and the “shorts” need to repurchase shares at higher prices than they received when selling them.

These events are as old as the financial markets (i.e., the “Piggly Wiggly short squeeze” of 1922). Short squeezes are also common investing strategies among institutional (i.e., non-individual, “retail”) investors. Typically, these investors target heavily shorted stocks that have the potential to rise in response to a positive fundamental change in the outlook for the company, and the rise in stock price is usually driven both by new buyers wanting to own the company and short sellers buying shares to “cover” their short positions. Short sellers tend to maintain their positions until their short thesis (i.e., bet) plays out (either positively or negatively), their shares get called by the lender, or if the cost of borrowing becomes too expensive.

The success of the aforementioned WallStreetsBets short squeeze trade inspired a “sticking it to short sellers” meme. This meme proliferated across the forum and other social networks prompting WallStreetBets members to once again collaborate on other “meme stock” or short squeeze opportunities sharing the same “meme” profile. In this case, it was shares of companies with negative long-term business prospects and high short interests.

At the same time, another meme making its way across social networks inspired another “meme stock” herd opportunity. This meme was about the stock price of a Chinese phone equipment manufacturer that serendipitously “zoomed up” in value last year due to sharing the same name as a popular “work from home” software company. As you might expect, this “ticker symbol/company name mix-up” meme converged with the “sticking it to short sellers” meme, setting off yet another genre of “meme stock” opportunities. (The most notable being the share price of a TV network company that shot up because its name shared the same acronym as a near-defunct movie theater operator getting short squeezed). This “meme trading” hysteria hit an apex when Elon Musk, who is no stranger to squeezing short sellers, tweeted his celebratory “Gamestonk!!” meme that included a link to WallStreetBets.

As discussed above, short squeezes are not a new phenomenon. What is new, however, is that individual retail investors have been able to take advantage of this market anomaly whereas in the past it was only in the purview of institutional investors, such as mutual funds and hedge funds, with the means (i.e., capital) to trigger a short squeeze. Today, the perfect mix of factors coalesced to enable retail investors to also taste the fruit of this inefficient market opportunity. These factors include COVID-19, fiscal stimulus payments, social networks, “Robinhood,” algorithmic trading, hedge funds, the pace of vaccine development, and the expectation that the U.S. economy will experience a sharp recovery as more people get vaccinated later this year.

Essentially what has occurred is that there are many unemployed or employed but not working individuals with extra time and extra cash to invest in the market. Commission-free stock trading applications have made it much easier and cheaper for individuals to invest, and social networking platforms like WallStreetBets have enabled individual investors to share trading ideas and work together (collude?) on “meme stock” opportunities. The “moonshot” rise (and fall) in the price of these “meme stocks” was the result of the social network herd of retail investors buying shares and options on shares, institutional investors covering their short positions, momentum-based trading algorithms piling into stocks exhibiting a strong trend, and other institutional investors that participated in “meme trading.”

It would be naïve to think hedge fund investors and other institutional managers were not making money on these “meme stocks.” In fact, there were “huge (institutional) players” investing on both sides of the “meme stock” trade (i.e., making money both on the short squeeze and the sell-off that typically occurred after the squeeze).[5] For this reason, one has to wonder was it really the retail investor that started the “meme stock” frenzy or was there a (big) element of institutional investor influence on WallStreetBets that fomented these memes? This is also why we do not consider “meme stocks” to be reflective of a social revolt that will continue to pit the retail investor against Wall Street. Instead, it is a reflection of some temporarily unemployed, mostly millennial, investors who have a little cash and a lot of time to play the “game” of investing before the economy opens up more broadly, the stimulus checks stop, and the need to go back to work rises.

Regardless, we will not be surprised to see more government regulation come down the pike to inhibit these abrupt market spikes. In fact, a U.S. House of Representatives Financial Services Panel is already set to occur on February 18 to discuss the market volatility caused by “meme trading.” We also expect the U.S. Federal Reserve and the Securities and Exchange Commission (“SEC”) to support increased oversight and regulation, especially since they spent the past 12 months trying to stabilize the financial markets.

At the end of the day, what the “meme stock” revolution exposed is that collusion and manipulation can result in big profits (or losses if you are the last investor buying at the peak of a “meme stock” spike). This phenomenon also caused increased market volatility and uncertainty among market participants, which could have implications on their willingness to re-invest historically high cash reserves back into the market.[6] With that said, company fundamentals will ultimately determine the value of a stock price, and a company’s intrinsic value will continue to be dictated by its ability to generate and grow revenue, earnings, and cash flow over the mid-to-long term. While we do not see a continuation of “meme stock” share price "pops" destabilizing the U.S. stock market, we do agree with Rogozinski's conjecture that this phenomenon will ultimately end up being a train wreck for some retail investors, especially if they increased the ante of their investments beyond the free handout of a stimulus check they were able to exploit.

How Do We Assist our Clients Avoid Market Volatility?

While we cannot completely eliminate market volatility as it impacts client investment portfolios, we think that professional management can lower the effect of volatility. Allocating much of our client financial assets to professionally managed mutual funds enables us to benefit from these experts who focus on narrow sections within the financial markets. The portfolio managers we choose to manage client investment capital must have a demonstrated history of delivering good results compared to an appropriate benchmark. Knowing how portfolio managers have navigated market volatility is one small item within the context of our more comprehensive due diligence process. What we know from experience is that utilizing experts to manage client assets tends to minimize downside portfolio risk during periods of market turbulence. Reducing the size of losses when they do occur means that recovering from these losses requires less growth as the markets move upward. The result is a smoother ride, hopefully reducing client anxiety.

Footnotes:
[1] Year-to-date (01/01/21 to 01/31/21) total return for GME; Morningstar Advisor Workstation
[2] Canales, K. (01/31/21). "Here's how GameStop went from dying retrial relic to a 'meme stock' that has rattled the American stock market". businessinsider.com
[3] Hough, J. (01/28/21). "Reversion to the Meme: GameStop, WallStreetBets, and the New Rules for Stock Trading". barrons.com
[4] Otani, A. (01/28/21). "WallStreetBets Founder Reckons With Legacy Amid Stock-Market Frenzy". wsj.com
[5] Chung, J. (02/03/21). "This Hedge Fund Made $700 Million on GameStop". wsj.com
[6] Personal savings rate was 13.7% as of 12/31/20 as compared to the historical average savings rate of 8.9% since 1959; Federal Reserve Bank of St. Louis FRED database; personal savings rate 13.7% as of 12/31/20

This information was compiled by Ginsburg Financial Advisors.

Unless otherwise noted, financial data are as of February 03, 2021.