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Social Media to Social Markets

Viral Trading and Short Squeezes

Introduction

The events of the past week have again served to remind us of the power and influence of social media. The power of influencers and crowd behavior have transitioned from delivering 5 seconds of TikTok fame to moving capital markets. Over recent days, a stock's "virality" has become as important as its volatility, as social media forums have targeted a set of heavily-shorted equities in one of the most publicized "short squeezes" in history. The most eye-popping example of this viral effect has been GameStop, the mostly brick and mortar specialty retailer of video games and gaming equipment. GameStop's stock price began the year at $19/share, peaked at a price of approximately $483 intraday on January 28th (a rise of circa 2,400%), closing later that day at $194, and as of this writing resumed its trajectory skyward. The direct impact has been (principally realized) losses to long/short equity hedge funds that were short the targeted stocks, and (largely unrealized, we presume) gains to a determined cohort of investors that have recently piled in. Additionally, those investors and insiders that owned the stock and/or options prior to these events, are as of now, sitting on sizeable gains.

Performance impact:

In isolation, a short squeeze is often relatively contained, with direct impacts to those on either side of the trade. The events of the past week included a collection of securities that initially had high short interest levels. This broader squeeze had ripple effects across the hedge fund industry. Those funds that were directly short the targets of the squeeze had to raise cash—selling longs and covering shorts, likely to meet margin calls. A ripple effect often follows, as the heavily-levered long/short equity funds de-leverage, creating a cascade of volume that tends to drive down longs (selling) and drive up shorts (covering). This deleveraging (both selling longs and covering shorts) over the past week were some of the most significant on record since the GFC, resulting in a moderate drawdown to start 2021 for equity related hedge fund strategies on average. The situation remains fluid and dynamic, but we expect a drawdown of mid to high single digits for fundamental, long/short equity strategies, on average for the month. A diversified mix of equity managers should fare better, and a further diversified mix of hedge fund strategies better yet as the pain so far seems limited to equities. We do expect the majority of deleveraging has occurred and the impact overall will be short-lived. As always, we advocate for broad risk diversification and portfolio construction that seeks resiliency, allowing investors to stay the course through these events.

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Importance of prudent risk management:

Hedge funds make active use of shorting in an effort to hedge long exposures, introduce an additional lever for alpha, and improve the risk/return profile. As short positions move against the investor they become a bigger position within the portfolio and the uncapped upside to the stock price becomes increasingly problematic, forcing risk management decisions. Long

"problems," on the other hand, become smaller as they move against target, risk managing themselves. This highlights the importance of timing short positions (for example identifying a catalyst for the price to move down rather than just identifying a stock as having generally poor prospects) and the need for strong risk management, diversification, and portfolio construction. This is predominantly managed through prudent position size limits and active monitoring and limitations related to short interest levels and crowdedness. Within a directional long/short equity construct, conviction and concentration is primarily expressed through long positions; shorts enable the ability to express conviction in the longs, removing a degree of systemic risk from the equation. Shorts are typically smaller in size and concentration, in part due to the risk of a short squeeze and disproportionate risk to a portfolio. In this case, it appears a small number of managers may have had outsized exposure to the equities in question, similar to the Volkswagen[1] short squeeze. The difference this time being, the contagion effects fueled by social media networks.

A comment on environment and rhetoric:

We normally avoid commenting on specific positions or trades, along with the speculation as to the driving forces for individual security moves. These events have also caught the eye and attention of politicians and regulators which might have further ramifications, but time will tell. As with most things in life, there are two sides to every story and much can be misunderstood. We applaud the democratization of investing—believing low cost access to markets and the ability to compound wealth should be available to all. Short-selling at its most effective serves an important role in markets, and can improve price discovery, liquidity, and corporate accountability. There is value in different views and this can have healthy benefits to competition and markets. There is a risk to shorting and even more so when trades are crowded; moreover, there is risk to seeking short-term, technical gains enhanced by the embedded leverage of options. Sometimes risk is rewarded and sometimes it is punished. Recently risk resembles roulette more than investing, nonetheless the benefits of building sound asset allocations and diversified portfolios remain.

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[1] In 2008, Porsche used cash-settled options to acquire the majority of public Volkswagen AG float, resulting in a short squeeze and VW temporarily becoming the most valuable public firm through the unwind of outstanding shorts.

Short squeeze:

To short a stock is to take a fundamental view that the prospects for a business are weak with a declining outlook that will have significant impacts on revenue and earnings, resulting in a stock price decline. This view might also incorporate frauds and fads (think Enron, Wirecard, gadgets, and fashion). In summary, to execute a short sale, one borrows the stock and sells the borrowed stock at the prevailing market price. The short sale proceeds are held as collateral until the position is covered (i.e., bought back and returned to the lender of shares). The objective is to buy the shares back once the stock price has declined. Profits accrue if the stock declines in price less the cost of borrowing.

A short squeeze is simply a supply/demand imbalance where demand significantly outpaces supply for a period of time, resulting in a rapid rise in a firm's share price. As excess buyer demand drives the price higher, the short seller may be forced to cover positions, as a risk management measure. Closing positions requires buying the stock, further fuelling stock price appreciation. The short squeeze has always been a risk to hedged investing, requiring conservative positon sizing and thoughtful risk management; the social media frenzy of the last several days has added a viral element to this risk as investors sought to buy stock. The huge surge in purchases of call options provided another source of demand for stock, as market makers in options were anxious to hedge their positions (known as "gamma hedging" in trading jargon). The technicalities of gamma hedging are for another discussion, but the take away is a number of factors came together to further extend speculation.

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