

# Short Squeezes and Market Hype: What You Need to Know



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Events that sparked market volatility at the end of January continue to make headlines as everyone loves a David vs Goliath story. The clash between the Hedge Fund professionals and a swarm of retail investors that forced the shares of several companies, most notably GameStop, screaming higher has caught a lot of attention, even beyond the usual financial media outlets.

Much has been written about the now-infamous short squeeze, and stories are popping up detailing the fortunes won and lost. The dust is starting to settle, and we thought it would be beneficial to explain some of the key topics in simpler terms to help unfamiliar investors better understand what happened in markets and what they should be mindful of going forward.

## The Retail Army & GameStop

Investors might argue at length about a reasonable fair valuation for a company such as GameStop. As of year-end 2020, the company was valued at around \$1.3 billion. A few individuals interested in the business began posting about the company as an attractive investment idea on online forums, thinking the company was undervalued and should be priced higher. Others noted the high short interest in the company and chatter began to develop focusing on the short squeeze opportunity. As the momentum of the idea caught on retail investors ganged together to force a short squeeze, enticed by the opportunity to make a quick gain trading the company's stock. As the excitement grew and more and more investors jumped aboard, the idea worked, and the company's value surged to over \$24 billion.

## What is a short squeeze?

While some believed that GameStop was worth more than its market price at the start of the year, some notable professional investors took a different view, thinking the company was overvalued and highly likely to decline in price. To express that view, investors sold the stock short – a trade designed to profit when the price declines. The way a short sale works is an investor borrows shares of a company to sell into the market in hopes to buy back at a lower price and return the borrowed shares. As an example, an investor might borrow shares of XYZ company and sell them for \$10 per share. If all goes according to plan, the shares might decline in value to \$6 per share. Then the short seller would buy back the shares at the lower price of \$6 and return to the original owner, profiting from the \$4 difference. However, short selling can be expensive and risky. It can be expensive to borrow the shares, and if the market moves against your views you can be quickly forced to close the position at a loss.

Over the long-term investors typically value a company based on fundamentals such as earnings and sales growth. Still, technical factors can cause changes in price over the short-term. This is where the short squeeze comes into play. Recognizing the high short interest, meaning that there was a large amount of GameStop shares sold short, the commentators in the online forums acted quickly, accurately predicting that if they could create enough hype, increased demand would cause the share prices to rise. And when that happened, the investors who had sold the company short would become forced buyers. To exit their losing positions, the short-sellers would have to quickly start buying back the shares, creating even more demand, pushing the price even higher.

## Regulatory Impacts and Trading Restrictions

As the crowd of small investors saw their account values swell, trouble began to build behind the scenes for some of the brokerage firms. Many of these smaller investors were using startup brokerage providers, enticed by the prospect of zero trading commissions and an attractive user interface. These startup trading platforms may seem attractive, but at the end of the day, regulations require the new firms to play by the same rules as all the incumbent firms. Frustration grew when several brokerage firms froze trading in a number of these highflying stocks, a move that was viewed as rigging the system against the “little guy.”

Without going into depth on the details of trade settlement, what is important to know is that the financial system has regulations in place to reduce counterparty risk and ensure proper settlement of trades. Clearinghouses are the intermediaries that collect and distribute payments between both parties of a trade and make sure ownership of the security is transferred correctly. In this situation, as the value of their customers' positions grew, regulations forced the brokers to post more and more collateral to help settle the trades. Since the share prices were increasing exponentially, the collateral requirements were also rapidly increasing. To meet rising collateral requirements, several firms were left scrambling to find the cash needed. Rushing to get the situation under control many firms decided to freeze trading in some of these securities to prevent their liabilities from snowballing out of control.

## Closing Considerations

We do not know for certain how or when this saga will end as renewed investment interest by smaller players has been a growing theme over the past year. However, there are several notable lessons for newer participants to keep in mind.

First, after a few days of risk-off sentiment across markets following this event, volatility has settled back down, and markets are functioning business as usual. The excitement of the headlines and magnified returns creates a unique story to follow, but so far, the short squeezes have been reserved to smaller, less liquid pockets of the market and we do not anticipate that retail flows would be significant enough to disrupt deeper, more liquid areas of the market. Short squeezes are not a new phenomenon. Institutional investors regularly look for these types of technical opportunities to take advantage of with short-term trades. What was unique in this instance was the fact that the squeeze was instigated by more retail-oriented investors rather than more established players.

Reading or hearing about all the individuals amassing huge gains in just short periods, it is easy to get sucked in and want to participate in the action. Maybe the prospect of achieving these eye-popping returns has caught your attention, and you have decided to try your hand at some of these trades. Importantly, before you begin trading it is crucial to have a plan and properly set your expectations. Big gains in the headlines can be attractive and make you feel like you are missing out. The GameStop short squeeze is just one of the many tempting opportunities to make news headlines. Cryptocurrency, hot IPOs, SPACs, levered ETFs, there are many fast-moving trends that newer investors may be eager to ride, seen as an easy way to capture outsized returns.

History tells us otherwise. Day-trading is extremely difficult, and luck is as big of a prerequisite for success as skill. Successful trading requires you to time your decisions correctly twice, both when you buy and when you sell. The odds of success are often no different than gambling at a casino – tilted in favor of the house. The emotional thrill can be half the fun, but it is important to know your risk limits. Never bet more than you can afford to lose! As numerous stories have now shown, many who latched onto the excitement but were late to the party bought at high prices only to see the value of their “investment” get crushed. As of this writing, shares of GameStop have fallen from a high of nearly \$500 to around \$60.

Lastly, it is important to understand the tax implications of realizing short-term gains. When you sell a security that you have owned for less than a year for a profit, that profit is taxed as ordinary income. Many of the “winners” from the past few weeks may be surprised to find out that they owe a sizeable portion of the gain in taxes. Current tax law favors long-term buy and hold investors versus short-term traders. Gains that are realized after a one year holding period are taxed at a more favorable long-term capital gains rate.

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