FACETOLOGY

FACET

1st February 2020

A kick in the shorts

If ever you're feeling a bit upbeat and bullish about the stock market, you can always shake yourself out of your complacency by turning to one of the many bearish websites and newsletters that have been around since year dot. Their well-rehearsed predictions about the next financial Armageddon can be quite compelling and thought provoking. Of course, the reason they are so well rehearsed is that they pitch the same story day in, day out, 365 days a year. Occasionally, they are right – albeit without the predictability of a broken clock that tells the right time twice a day.

There are, we admit, some long-term structural issues that merit greater discussion. The problem is that whether it be quantitative easing, defined benefit pensions or zero-interest rate policy – these issues, whilst hot topics for the Facetology team, are one-step too mundane or complicated to make it on to radio phone-in shows or daytime telly.

However, the story of how small investors ganged together to buy up shares in GameStop and crush big hedge funds in the process has got a lot of attention over the weekend. It's a story that naturally appeals to perma-bears who naturally align themselves to the little guy standing up to the big guy. But there is, in our view, a catch.

The story started in an online chat community on Reddit called WallStreetBets. A group (a very large group) of small investors started buying up shares in GameStop whose share price was languishing around the mid-teens of $16 where it had been for some years having fallen from a high of $65 in 2007. The reason for this was straightforward enough, the company sells video games via stores and had somehow missed the move to online sales.

In fact, the outlook for the company was so poor that some hedge funds had bet that the company would go bust. And to profit from that, they sold shares in the stock they didn't have by borrowing them from existing shareholders – otherwise known as shorting. To make money, all they had to do was buy the shares back lower down – preferably for a few cents, or zero, if their predictions for the fate of GameStock came good.

But the collective action of a large number of small buyers has now driven the shares up to $325 and, in the process, has caused eye-watering losses for the hedge funds betting for GameStock's demise. This is an example of how shorting is not exactly the mirror-image of buying because the risk vs reward is not symmetrical.

For example, if you buy some shares for £100, the worst that can happen is that you lose 100% of it, or £100. When you short a stock, the losses from the share price carrying on up are, in theory, unlimited. That is why, generally speaking, the really serious business of shorting is done by professionals with advanced risk management tools. Tools which have failed them in this instance.

This is not the end of the story. The incredible rise of GameStock's share price has also attracted many more buyers who are pulled in by the ideological prospect of wrecking Wall Street firms. But a share is only worth what someone else is willing to pay for it. Would you buy it for £325 a share? Or £500? Prices that value the company multiples of what the stock market believed it was worth in the heady days of 2007 at $65. It's pretty clear that someone, at some point, is going to be left holding the baby – and a pretty ugly one at that.

In that sense, as speculative bubbles go, this looks more of a Ponzi scheme whereby the earliest buyers in the revolution have plenty of time to get out again, with huge profits, while latecomers who buy now could lose almost everything.

Happily, we at FACET do not have a dog in this race because we are not activist investors seeking a quick buck. Nor do we engage in short selling. Our client portfolios are, therefore, as far away from the billions of dollars of losses being inflicted on the hedge funds as it is possible to be.

Members of the FACET investment team have been dealing in stock and bond markets for many years and one thing we are conscious of is that however much you think you know, you never know what's going to happen next. This new twist is a game. A very interesting and unusual game, but a game nevertheless.