The Long And Short Of Gamestop

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The hot topic this past week has been the huge runup in the share price of Gamestop and several other companies that had been considered yesterdays news, if not last decades. Like every story there needs to be bad guys and good guys. In this case there were three roles: played by hedge funds that short stocks, the discount brokerage firm Robin Hood and the 'Reddit crowd wallstreetbets'.
Let's take a look and see if this is a classic good vs evil narrative or a just a bit of excitement for the media since Trump isn't around anymore.

Let me start with the fact that I have never been a fan of hedge funds. I don't like their usual pay structure that I believe incentivizes them to take on too much risk. Also, once they have a position on, they can act like born again converts in the pursuit of convincing others of why they are right and why any dissenter should be defenestrated. I have seen this over zealousness cause good analysts to lose their jobs.

Yet hedge funds, and specifically hedge funds that short securities, do serve a purpose. As I have mentioned before nearly half of the stock market activity is from passive investing, meaning there is no analysis or homework being done by the purchaser. Hedge funds are active investors who presumably do research on the securities they buy and sell which is a needed condition for an efficient market.

Shorting stocks -the act of selling borrowed shares today on the anticipation of buying them back later at a lower price-can be a public good. For example, short sellers can put a ceiling on how high overly promoted stocks can go. I have read about hedge funds whose founders cited this noble goal as the reason for the creation of their fund. Think of them as the shepherds watching the Wolves of Wall Street types.

Shorting also provides liquidity outside of algorithmic trading. Also, it is important to remember that short selling is not for the faint of heart. I don't do it because of the unlimited liability involved. Say you short $10,000 dollars worth of Shopify shares at $20 dollars a share because you think it will drop in value and you can buy it back at 10 dollars and make $5000 dollars. But, if you were wrong and Shopify goes to $1420 dollars a share (which it did Friday). You have lost 700 000 bucks. So, if you decide that shorting is for you, make sure you do lots of homework, have your stop losses in place and don't plan any other activities while the short position is on.

So, though I am not a cheerleader for hedge funds, I respect what some of them do. Lets now take a look at the reddit crowd and what many small investors have been able to accomplish. One thing they have done is bring some humility to an industry that can be self reverential. They have also acted in concert which may raise some regulatory concerns if it is determined that a few of the initial tooters of the idea of the short squeeze on Gamestop benefitted excessively by convincing their peers to go after these hedge funds. This is called “front running" and it is closely monitored by the markets.

The other issue is that if Gamestop really is not worth $300 dollars a share, or whatever it is at now, eventually it is going to drop in price and many of these young and possibly idealistic investors are going to be stuck holding shares that are worth a fraction of what they paid for them.

Every generation of investors has to go through the same tough love experience. That disillusioning moment when you realize that you and all your friends were wrong. The realization that Mr Market may be emotional at times, but he doesn't care about you.

There are no good guys or bad guys in this saga no matter how much we want there to be. At the end of the day there will be more losers than winners and it will be considered an entertaining side show for those of us on the sidelines. Meanwhile, does anyone know anything about silver?