WINTHROP WEALTH

FEBRUARY 2021 CLIENT QUESTION OF THE MONTH: GAMESTOP

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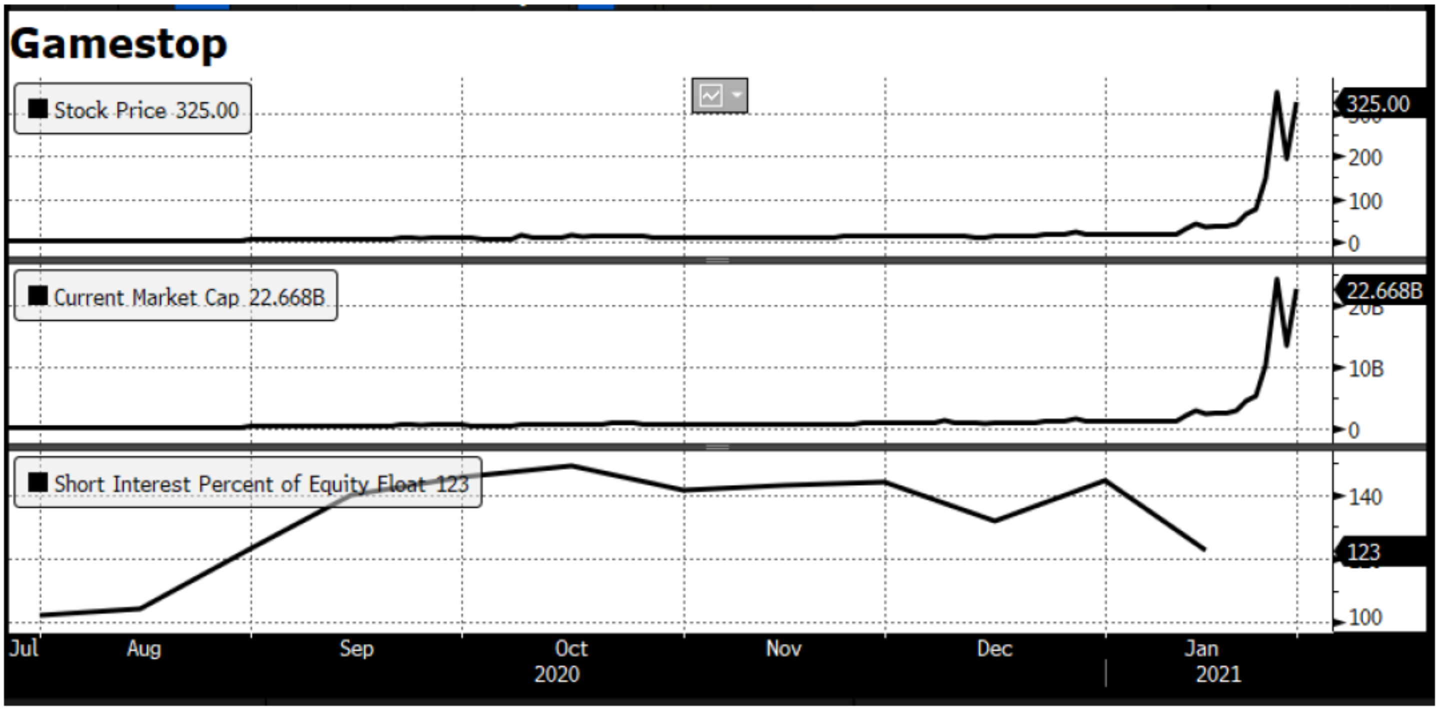
In our ***2020 Market Review and Outlook*** we pointed out several signs of froth in the stock market, including, the average first day-return for IPOs averaged 40% in 2020 (Bloomberg), a record number of special-purpose acquisition vehicles (SPACs) coming to market, a boom in cryptocurrency returns, individual stocks rapidly increasing after announcing stock-splits or index inclusion, and sentiment indicators reaching their highest levels in years. Well, the month of January provided the most glaring example of speculation and froth in years- Gamestop (GME). The surge in Gamestop shares has become one of the more fascinating and compelling market stories in recent memory. GME started the year at $18.84 before increasing to $483 on 1/28 and finishing the month at $325. Gamestop was up +928% in January.

Right now, this extreme speculative activity is contained to Gamestop and handful of other smaller cap companies. According to Barclays, the market cap of heavily shorted stocks (stocks with a short interest to float ratio > 20%) is only $40 billion. To put this number in context, the market cap of Apple is close to $2.2 trillion. If we see this behavior spill-over into larger companies or broader parts of the market it would be cause for concern.



How did we get here?

The story of Gamestop's stock surge starts with the company and the speculators who bet against it (mostly hedge funds). Gamestop is a retailer of new and pre-owned video gaming consoles, accessories, and titles with over 5,000 stores across 10 countries. The company has been in secular decline for years, with peak revenues occurring in 2012, and had become a favorite for hedge funds to bet against or short.

Shorting a stock, or short-selling, occurs when an individual bets that a stock price will decline. The transaction occurs when an individual borrows shares of a company, immediately sells them, and hopes to buy them back later at a lower price, thereby making a profit on the difference. In a simple example, assume someone borrows 1 share of XYZ company, immediately sells the share for $10, and then later buys the share back for $5 and returns it to the original owner. In our example, the person made a $5 profit on the transaction by correctly betting that shares of XYZ would decline.

About a year and a half ago, the number bets against Gamestop started to increase dramatically as several prominent hedge funds started to build massive short positions. By the end of 2020, the short interest as a percent of equity float nearly reached 150%. In other words, if Gamestop had about 50 million shares outstanding, then 75 million shares were short. Why regulators let the short interest increase to nearly 150% is a story for another day, but it is likely something that will be addressed in the future. Note that the theoretical gain on a short sale is capped at 100%, while the losses are unlimited. A stock price can only go as low as $0 but it can rise an infinite amount. The short interest in Gamestop was the equivalent of leaving a tinderbox too close to the fireplace.

What happened?

The proliferation of low-cost brokerage platforms has brought trading to the masses. By offering no transaction costs or account minimums, online brokerage firms have eliminated the barriers of entry to the stock market and have reported a flood of new accounts and trading activity. Overall, the democratization of the stock market is a good thing. Anyone who wants to trade stocks should be able. However, an increased "gamification" of the market will have negative consequences.

Retail traders, mainly congregating on an online chat forum named WallStreetBets, pointed out there was an opportunity to create a massive "short squeeze" in Gamestop if enough capital started buying the stock. A short squeeze occurs when the price of a heavily shorted stock starts to increase (remember that the theoretical loss on a short position is unlimited). As the stock price increases, short sellers are losing money and they have a decision to make – do they close out the short position by purchasing the stock or do they hold and risk losing more money if the price keeps going up? Once short sellers throw in the towel and start buying, the stock price increases further, and this creates a feedback loop. Additionally, the price action can be exacerbated further through options positions.

The short squeeze started to occur and gain incredible momentum in late January as GME increased from about $40 on 1/20 to $483 on 1/28. Trading volume in both the shares and options surged to among the highest in the overall market, which is unusual for a company of that size. As the stock price increased, losses increased for the hedge funds that were short. According to S3 partners, short positions lost $23.6 billion on the stock as of 1/27.

Several trading platforms, including, TD Ameritrade, Charles Schwab, Interactive Brokers, and Robinhood all announced they have limited trading in Gamestop and other speculative stocks. The backlash against these brokerage firms for limiting retail traders' ability to buy the stock became another interesting thread to the story. The brokerage firms responded that the trading halt was mainly due to increased collateral

What now?

> *"In the short run, the market is a voting machine but in the long run, it is a weighing machine."*
> - Benjamin Graham, known as the father of value investing.

This story is only half over. There is no point trying to forecast how high the price of GME can reach as the stock has completely detached from its underlying fundamentals. This would be a completely futile exercise. However, at some point the stock price will return to its fundamental level and reasonable people can agree that the ultimate price will be lower than its current level. Therefore, a major problem will occur when the people who bought near the top are left holding the bag. In other words, if the stock returns to previous levels then billions of dollars will be lost, and most of those losses occur for smaller retail traders rather than institutional hedge funds.

The activity in Gamestop has also started to draw the attention of regulators. William Galvin, the Massachusetts Secretary of the Commonwealth, called for a 30 day pause in GME trading. The SEC said it is "actively monitoring" the situation. We suspect that there will be fallout and new regulations on both short sellers and retail speculators.

Investing vs. Gambling

In our ***July 2020 Client Question of the Month***, we drew the distinction between investing and gambling. What has occurred in Gamestop, both from hedge funds and retail traders, is pure gambling. The success of individuals who gamble in the stock market mostly depends on luck. Successful investing increases your chances of making money through skill and patience.

At Winthrop Wealth, we apply a total net worth approach to wealth management that combines both comprehensive financial planning and investment management. Our investment philosophy is based on providing actively managed, well-diversified portfolios, with a long-term focus. We continue to believe this is the optimal approach for helping our clients ultimately reach their goals and objectives. We do not gamble or look for ways to make a quick buck – this type of short-term thinking can lead to disastrous results and can derail an otherwise solid financial plan.

Please see our ***Winthrop Wealth Principles for Investing in the Stock Market*** for several tips on successful investing.

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The economic forecasts set forth in this material may not develop as predicted and there can be no guarantee that strategies promoted will be successful.

Rebalancing a portfolio may cause you to incur tax liabilities and/or transaction costs and does not assure a profit or protect against a loss.

Likewise, it is important to remember that no investment strategy assures success or protects against loss. Asset allocation does not ensure a profit or protect against loss. There is no guarantee that a diversified portfolio will enhance overall returns or outperform a non-diversified portfolio. Diversification does not protect against market risk. All investing involves risk which you should be prepared to bear.