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To Short or Not to Short

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In asset pricing literature, short-sellers are considered as informed traders as their trading behavior often signals adverse news about firm fundamentals (Akbas, 2016). In a frictionless stock market with no binding constraints on short-selling, informed short sellers freely trade based on their information. In most cases, institutional investors take the lead role in this activity and trade based on current conditional expectations of the firm's value. It is obvious that in this process the better-informed investors gain while other retail investors lose money. Regulators across the world deal with this issue differently. While in Europe, hedge funds need to report their short positions to regulators (public) if it crosses 0.2% (0.5%) post-2012, in the US, the daily aggregate short positions of exchanges are maintained by Financial Industry Regulatory Authority (FINRA).[1] Whether such regulatory mechanisms are enough or not is a debatable topic. However, it clearly shows that shorting is somehow under the regulatory rudder, especially after the global financial crisis.

There are enough anecdotal pieces of evidence suggesting that institutional investors are better informed about the investment potential of a stock compared to their retail counterparts (Cai et al., 2010; Yan & Zhang, 2009). Still, recent events show no assurance that such superior information always transforms into economic benefit. One prominent example is the recent surge in the price of GameStop, a US-based video games store operator. This stock experiences a skyrocketed spike in price in the last week of January 2021 that leads to a huge economic loss of certain multi-billionaire hedge funds (short-sellers) and unexpected profit to few amateur retail investors. Astonishingly, it reveals the mighty influence of social media in generating abnormal valuation where fundamental analysis loses its logical significance.

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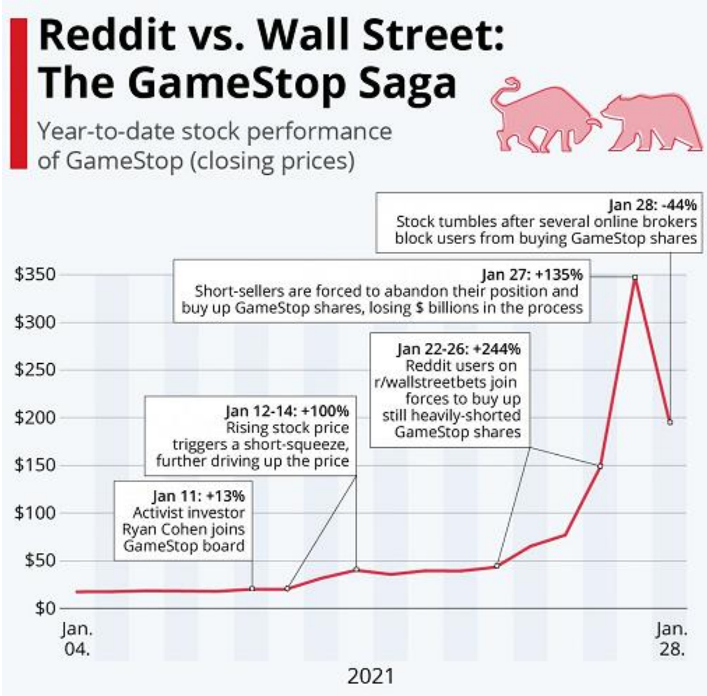
[1] https://www.pionline.com/article/20151021/ONLINE/151029970/nyse-pleads-for-rules-to-make-hedge-funds-reveal-short-positions

GameStop Saga

Let's turn our attention to the beginning of the interesting incident of GameStop. Over the years, the financial performance of GameStop is not up to the mark. Being a brick-and-mortar retailer, it has to face tough competition from digital distribution services. Moreover, governance issues have also distorted the perception of the firm in investors' mind. Further, the COVID-19 pandemic has worsened the situation as in-person shopping has been drastically reduced. This is reflected in falling stock price and various institutional investors, such as hedge funds, expect further value loss for this firm. This expectation somehow triggers a popular short-selling strategy and various hedge fund managers start short-selling this stock. It seems to be easy money on the table, which can be pocketed while covering the positions at a further lower price. One such prominent short seller is Melvin capital who invests almost US Dollars ($) 12.5 billion to take an aggressive short position on the stock.[2] However, there comes a twist when this strategy has miserably failed due to amateur investors' informal grapevine. Wallstreetbets, an online community on the social news website Reddit, is held responsible for triggering an unexpected short-squeeze on shorted positions of GameStop. The users on this platform note these heavily shorted positions taken by hedge funds and decide to buy more of these stocks to raise their price. The stock price starts rallying and a panic covering from hedge funds results in a price explosion. The stock price has moved up to $347.51 on January 27, 2021, whereas the same stock was priced at $19.94 on January 11, 2021.[3] This massive growth of more than 1500 percent within two weeks has shaken the world thoroughly. On January 28, 2021, the market experiences a failure to deliver more than 1 million shares of GameStop. The market value of this stock surpasses $24 billion from $2 billion just in a matter of few days. This forces Melvin Capital to abandon its short positions and incur a loss of 30 percent of its initial investment of $12.5 billion. During this phase, short-sellers altogether incur a loss of $23.6 billion. After hedge funds earn these huge losses, Wall Street starts demanding regulatory help on short-squeeze. Responding to this call for help, numerous online brokers that had let their retailers trade on their platform, banned any purchase of GameStop and allowed only the sale of the same. One of those brokers, Robinhood, however, reversed its decision later on and allowed limited trade from retail investors after hearing a public outcry. Hence, the saga does not come to an end here.

[2] https://leadicdesign.com/qnuvhb50/how-much-did-melvin-capital-lose
[3] https://www.regalunited.com/post/the-legendary-saga-of-gme-gamestop-frenzy



Source: Yahoo Finance

Social Media: An Emergence

The more informed institutional investors often deride the retail investors as "dumb money." They are almost considered potential loss-makers who would lose money against the highly skilled analysts and rational decision-makers. The GameStop tale provides a new turn to this game. Keith Gill, a Reddit user, has invested $53,000 in GameStop in mid-2019.[4] By January 27, 2021, his positions soar up to $48 million. Another user posts a funny video on social media showing how a hedge fund is blown up like a nuclear reactor post this incident of a short squeeze. Another young trader posted, "It's a good opportunity to make money and stick it to the hedge funds." He also said, "By buying GameStop, it's kind of like beating them at their own game." The short-squeeze has resulted in around 73 million page views within one day, as reported by Mashable, a technology news website. Wallstreetbets becomes the fastest growing online community on social media Reddit. On January 29, 2021, overnight the number of users surged by 1.5 million to 6 million members in the Wallstreetbets community.

One alarming impact of this incident is that such banding together is not only restricted to GameStop short squeeze; rather it triggers the same on other stocks as well. On the same day, the short-squeeze was also spotted on the ticker AMC (AMC Theatres). The price of AMC surges around 840 percent. Another popular stock, Blackberry, also experiences approximately 280 percent of upward movement of its share price. Bloomberg reports that the trading volume in the US on January 27, 2021, exceeds the peak volume observed

[4] https://www.straitstimes.com/business/invest/how-a-reddit-user-roiled-gamestop-stock-and-the-markets

during the financial crisis of October 2008. As a result, Robinhood and few other brokers halt purchases of all extremely volatile stocks including GameStop, Nokia, AMC, Koss Corp, Blackberry, Express, etc., on January 28, 2021. Several lawsuits have been filed against these brokers (Robinhood, Charles Schwab, Citadel, etc.) for a forced reduction of stock prices.

The influence of social media on stock price is not very new. Few recent studies have pointed out the role played by social media in promoting "Pump and Dump" (P&D) schemes in a less regulated cryptocurrency market (Li et al., 2019). P&D is one of the favoured methods of price manipulation whereby few investors artificially inflate the price of an asset and then sell those cheaply bought assets at an inflated price (Huang & Cheng, 2015). When the "dumping" of assets is exercised, the price correction takes place and by the time, investors incur a loss. These strategies are common with low priced stocks. In the cryptocurrency market, often P&D is exercised through messaging apps like Telegram. The investors are invited to join the app by posting advertisements on social media platforms. For the stock market, such type of P&Ds may not be discernible as the U.S. Security Exchange Commission (SEC) has deemed P&D as an illegal stock market activity. However, monitoring pranks on online communities is almost an impossible task. Therefore, some mechanisms to ensure social media responsibility is of utmost interest.

Comments and Criticism

Pumping up the price of GameStop by amateur investors as well as limiting the trades by Robinhood and other brokers have attracted several comments and criticisms across wide political and intellectual spectrum. Senator Elizabeth Warren states that institutional investors and analysts who criticize the price rally: "have treated the stock market like their own personal casino while everyone else pays the price".[5] She demands strong regulatory action against such incidents and invites SEC "to ensure that markets reflect real value, rather than the highly leveraged bets of wealthy traders or those who seek to inflict financial damage on those traders." William F. Galvin, the Massachusetts Secretary of the Commonwealth, criticizes the amateur investors' behaviour commenting to CNBC: "I think we've all recognized the current pandemic has created a unique situation where many have gotten into day-trading and really have no idea exactly what they're doing ... I think small-time investors like that, unsophisticated investors, are going to be hurt by this." Responding to this comment, Kevin O'Leary, a Canadian businessman, has argued that it's a positive learning opportunity from real life. He hopes that the threat of social media may compel hedge fund managers to think twice before short

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[5] https://www.cnbc.com/2021/01/28/first-on-cnbc-cnbc-transcript-senator-elizabeth-warren-d-mass-speaks-with-cnbcs-closing-bell-today.html

selling aggressively. It has been reported that the state pension fund of New York state has gained immensely from such short squeeze. Experts also believe that these short squeezes would motivate more retailers to invest in stock market and the zero commission brokerage apps like Robinhood will be receiving more business from potential retail investors.

Regulatory Steps

Nevertheless, over the months, regulators have shown enough concerns over this incident. On February 8, 2021, the SEC has released guidelines for companies that plan to raise capital during the period of extreme volatility. The companies are advised to disclose the related risks in their financial statements and inform SEC well before offering such schemes. There has been a growing demand from Wall Street to deem short selling an illegal activity.

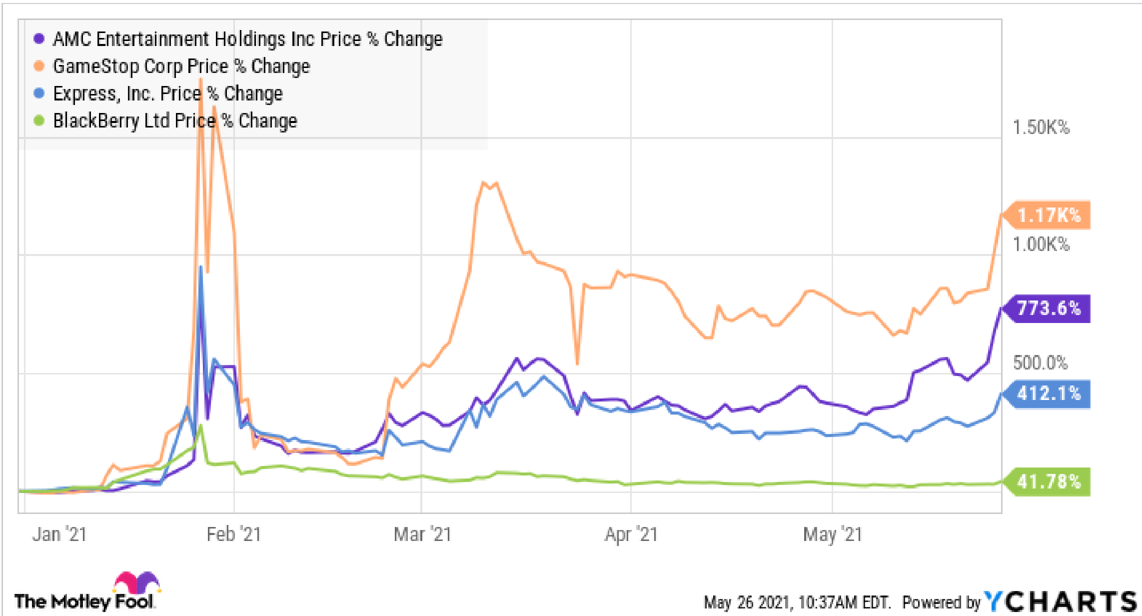
The US regulators are in the mode of devising suitable measures that would motivate institutional investors to disclose more information about short positions, call options and equity swaps held by them. It is also considering increasing transparency in security lending, as this is the root of short selling. Further, it aims to protect common investors' interest by alerting them about those trading apps that carry similar video game-like features but boost risky trading behaviour. Gary Gensler, the SEC chairman, is asking for public input on different trading apps and their features.[6] "We need to ensure investors using apps with these types of features continue to be appropriately protected," he clarifies.

What's Next?

Although short-selling is still a popular investment strategy, the short sellers of GameStop have incurred mark-to-market loss of nearly $6 billion year-to-date as of March 8, 2021. Despite having the lowest level of short interest in the year, the GameStop stock experiences another rally on this day (March 8, 2021). However, this rally pertains to the announcement by GameStop regarding the formation of a committee for a smooth transition of brick-and-mortar business to e-commerce mode. Ihor Dusaniwsky, the managing director of Predictive Analytics, quotes: "Shorts will continue to be squeezed out of their positions as GameStop's stock price continues to trend upwards."

[6] https://www.reuters.com/business/us-sec-chief-plans-scrutinize-short-sellers-rein-gamification-following-gamestop-2021-05-05/

Very recently, in the last week of May, the stocks of GameStop, AMC, Blackberry, and Express again experience an upward movement between 10-50 %.[7] It seems that these meme stocks are moving to ride another wave. The chart below depicts the same:



Source: AMC data by YCHARTS

This time, the fueled price of the stocks are not much of a concern for GameStop and Express. The short positions of these two companies have drastically reduced up to 80% and 50%, respectively, from the start of the year. However, GameStop still holds 12 million shares (18% of shares outstanding) in the short position at the end of April. For Blackberry, there is an increase in short positions though its short interest stays below 10% of outstanding shares. AMC, on the other hand, is still riding the huge risk of a squeeze as its short interest gets doubled. On a positive note, AMC could have managed to raise $428 million recently through a new offering. Thus, it provides a boost to its balance sheet by taking this timely advantage of the stock rally.

It's now unclear how these possible short squeezes determine the future of short-selling in the long run, and the market reacts to this question differently. For example, Citron Research, a short-seller that earned a loss from the GameStop price rally, is not in favor of publishing its short research anymore.[8] Rather, it focuses on long-term opportunities from the market. In contrast, Joachim Clement, an analyst, suggests that no 'bubble' sustains for long, and so will be the social group's P&D strategy. He opines that short-sellers would regroup and

[7] https://www.fool.com/investing/2021/05/26/why-amc-entertainment-stock-keeps-jumping/
[8] https://finance.yahoo.com/news/citron-stop-publishing-short-selling-160123895.html

continue exploiting opportunities with short-selling mechanisms again.[9] Whatever be the reality in future, this current incident uncovers two major issues hidden from market participants. First of all, it shows that small amateur investors can challenge the traditional dominance of big institutional investors. Second, a parallel information revealing system in social media has quickly emerged in the changing global scenario. Further, it may also endanger other innocent retail investors who are not a part of this social media. Hence, the major challenge for the regulators is to bring this entire system under regulatory purview. Otherwise, the loophole in the financial system, which has been exposed by the GameStop saga, would continue to drain wealth from those who invest based on accurate fundamental analysis. More importantly, the so-called better-informed investors would keep looking for a clue of the puzzle: "*To Short or Not to Short*".

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[9] https://blogs.cfainstitute.org/investor/2021/01/31/gamestop-or-why-the-short-sellers-win/