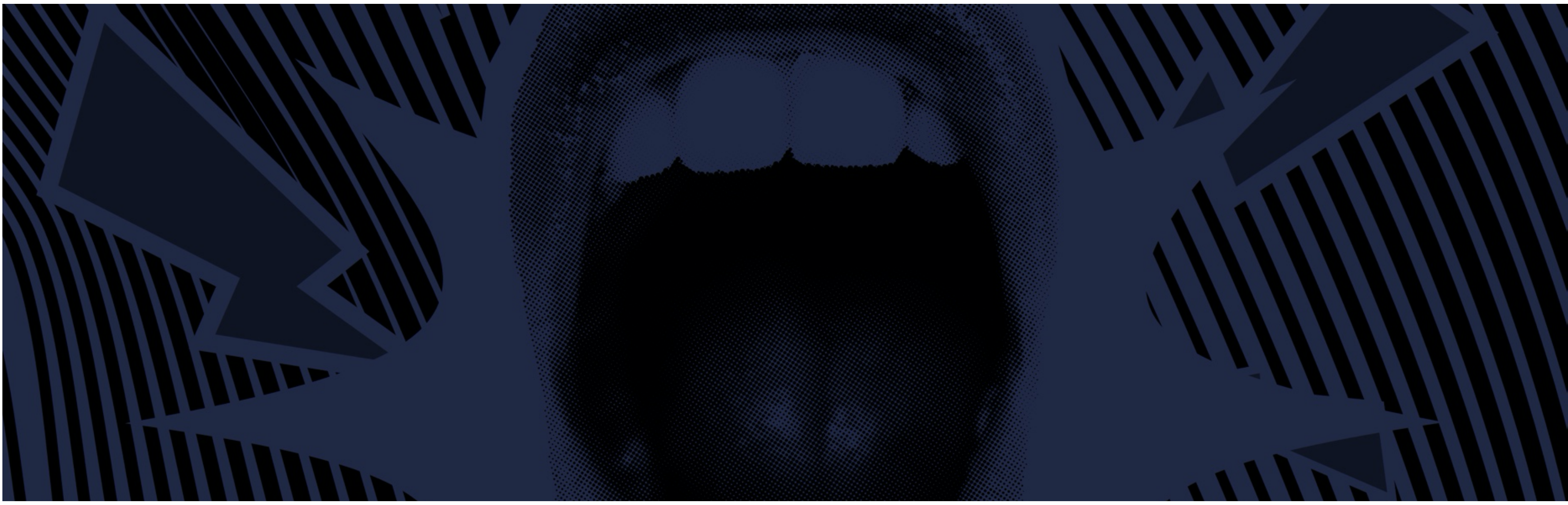
1Q2021 White Paper
Game Over? Unpacking the GameStop Frenzy



GameStop, a video game retailer that has been losing money for years, shuttering stores and witnissing its stock price decline for six consecutive years (prior to 2020) has become the focus of mainstream media and even gained attention from Federal regulators. At the end of January, google searches for GameStop exceeded searches for Coronavirus. It landed the front page or lead story in a variety of well-respected business publications including Barrons, the Financial Times and Bloomberg and prime time news outlets. GameStop watched its stock price rise almost 2000% in 12 trading days. **(Chart 1).** The market cap of the struggling company surged from $1.3 billion at the end of 2020 to a little over $24 billion in late January. To put this in perspective, its market cap surpassed large cap companies such as Occidental Petroleum, Quest Diagnostics and Clorox.

In this white paper we aim to answer several questions on many investors' minds: What fueled interest in a company where fundamental analysis would suggest avoiding it? How did the GameStop rally impact the broad market? What were the implications of the GameStop frenzy? What lessons can we learn? And what are the key differences between trading and investing?

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What fueled the interest in GameStop?

While there are multiple social media sites that give stock tips, the one that seems to be gaining the most attention is the website Reddit. Reddit did not start as a website to share stock ideas. It is a social media website where its members post pictures as well as share ideas and thoughts on a variety of topics such as sports, politics, and news. Most recently, it has been a hub for speculative day traders, many of whom have little experience in true investing, to post stock ideas.

The initial interest in GameStop had some merit. The attention was fueled by hopes that Ryan Cohen who is co-founder of chewy.com, a successful home delivery service for pet food, toys etc., could turn the company around after taking a stake in 2020. Seeing the depressed stock price and bearish view from hedge funds and institutional investors, Reddit members turned contrarian and encouraged investors to buy the stock. Retail investors who followed Reddit used online brokerage sites (e.g., Robinhood) to facilitate their bullish trades on GameStop through not only buying the stock out right but also using bullish strategies in the options market.

Chart 1

GameStop Stock Price Soars

Data is from January 8, 2019 to February 1, 2021. Source: Bloomberg Finance LP, Verdence Capital Advisors.

How the unjustified rally temporarily disrupted the broad market

To maximize returns, some retail investors bought inexpensive options with a high strike price in hopes of getting the inflated stock at a lesser cost. The sharp volatility forced market makers who facilitate trades to hedge themselves and buy the stock at any price. Clearing houses, who settle trades, started to increase the collateral online brokerage sites had to deliver to clear such volatile trades. As can be seen in **Chart 2,** GameStop saw erratic daily price moves, rising nearly $200 one day and then dropping nearly $150 the next. This is a stock that over the past five years has, on average, seen a daily price change of $0.01.

The hedge fund industry both benefitted and suffered because of the GameStop frenzy. Hedge funds particularly market neutral or long/short funds go long and short stocks as their underlying strategy. While some of these funds had direct exposure through either a long or short position in GameStop, volatility in the broad market increased. Hedge funds use leverage to enhance returns. When volatility is low, they can increase leverage. However, when volatility in the broad market rises, they are forced to reduce leverage. Broad market volatility is measured by the VIX Index. This Index rose over 60% in one day. It was the third largest one day swing in the VIX in its history. **(Table 1).** This triggered both indiscriminate buying and selling from hedge funds of names not even related to GameStop to reduce leverage. In this case, more selling than buying, and Indices like the S&P 500 and Dow Jones Industrial Average who on January 27, 2021, posted their worst one-day slide since October, even though GameStop is in neither Index.

Chart 2

GameStop Stock Price Sees Substantial Daily Volatility

Data is from January 11, 2021 to February 5, 2021.
Source: Bloomberg Finance LP, Verdence Capital Advisors.

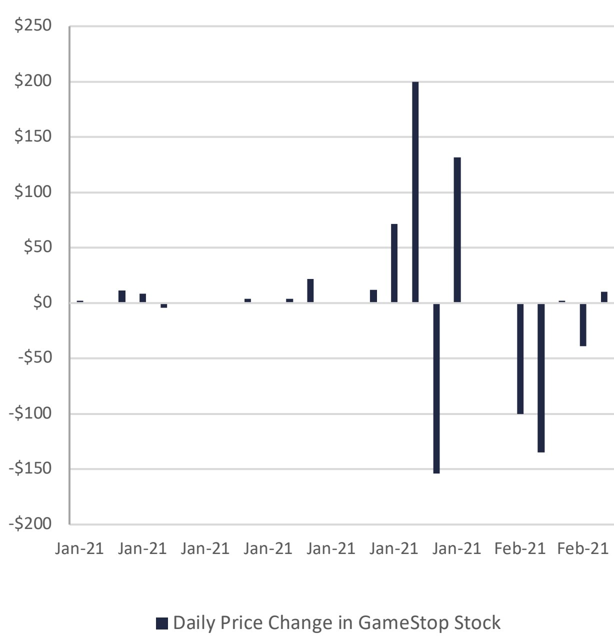

Table 1

Massive Move in Stock Market Volatility (VIX)

Time period reflects January 2, 1990 to February 8, 2021.
Source: Bloomberg Finance LP, Verdence Capital Advisors.

Top 10 Largest One Day Swings in the VIX Index		
1	2/5/2018	115.6%
2	2/27/2007	64.2%
3	1/27/2021	61.6%
4	11/15/1991	51.7%
5	7/23/1990	51.5%
6	8/8/2011	50.0%
7	6/24/2016	49.3%
8	6/11/2020	48.0%
9	2/24/2020	46.5%
10	8/21/2015	46.4%

What are the implications of the GameStop frenzy, and what happens next?

In addition to a brief week of broad market volatility, we saw select retail online brokerage sites forced to place restrictions on specific stocks that were social media speculation targets. This fueled anger and protests from retail traders and quickly gained Washington's attention. The hedge funds that fell victim to the market disruption have now secured liquidity, and market volatility has calmed.

We expect this story will linger in the headlines for some time. Law makers will continue to investigate the trading practices from these online retail trading sites to be able to balance free markets while avoiding a systemic problem in the future. Regulators may move to require retail trading sites to place harsher restrictions on those who can trade in the risky options market. In addition, hedge funds may find less transparent ways of reporting their positions so that they are not the target of social media speculation (e.g., move away from using transparent options market).

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Verdence View and Lessons to be Learned

Get-rich-quick schemes have been around for centuries: Tulip Mania's rise and collapse in the 16th century; Pump and Dump scams in the early 1990s made famous in the movies *Boiler Room* and *Wolf of Wall Street;* The dotcom bubble where investors were convinced that anything with a .com in its name would create massive wealth; or the house flipping phenomenon that led up to the 2007-2009 Great Recession.

Get-rich-quick schemes can be deceiving. While some make hot money early, in reality, the end is always painful and usually takes down the masses. There are losers in this "game" who bought GameStop stock at its peak. They fell victim to the emotional *fear of missing out* only to later see their investment decimated. Unfortunately, those who profited from the frenzy may eventually be among those most negatively impacted. These novice traders become convinced that making money in the stock market is as easy as following a social media site's recommendation, throwing their money at securities without an understanding of fundamentals or why stocks move higher or lower. History shows that this false sense of confidence often leads to long-term disappointment and unsuccessful investing. A successful investor remembers the important difference between trading and investing. Activity on these online trading sites is speculative, high-risk, trading. A true investor uses fundamental analysis, diversification, and risk management to preserve and grow their wealth.

Of course, we will continue to monitor developments, however, we see this as yet another negative consequence of the pandemic, influenced by money being handed out through fiscal stimulus, lax regulations on retail trading sites, and sheer boredom as Americans remain locked indoors. Moving beyond COVID, we expect sound fundamental analysis will ultimately overcome trader speculation.

Trader F.O.M.O.

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