A Dangerous Game(Stop)

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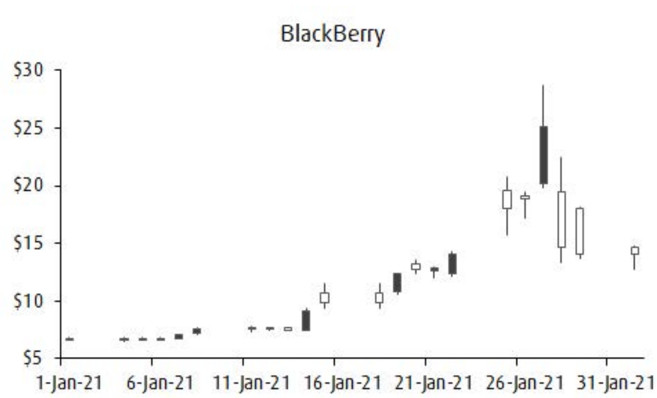
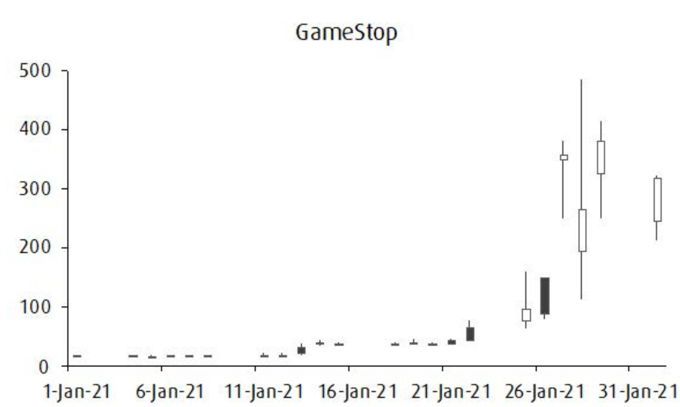
We do not recommend buying GameStop's (GME) stock. Now don't get us wrong, we are fans of videogames as a growing business, but prefer companies with stronger fundamentals such as some of the major game publishers. We wanted to get this out of the way immediately as everyone seems to be talking about the so-called "short squeeze" that led to extreme upward moves in GME's stock and a few others with relatively weak fundamental prospects (among them AMC -a movie theatre chain- and American Airlines: not exactly COVID-proof business models). BlackBerry has also been in the mix. While newsflow and performance has improved significantly for this formerly high-flying Canadian tech company, share volatility has been so great that investors who bought at the peak on Jan. 27th would have lost 40% of their investment the very next day. These moves led to crushing losses for a few hedge funds and massive gains for some nimble day traders who rode the wave. However, we have seen such extreme price moves before, and they seldom end well. Fundamentals are the key determinant of equity value and prices converge toward fair value over time (although it can sometimes take considerably longer than some expect).

BlackBerry - Recent Price Action



Taking a step back, a "short squeeze" occurs when a stock or other asset jumps sharply higher, forcing traders who had bet that its price would fall, to buy it in order to forestall even greater losses. They scramble to buy, which adds to the upward pressure on the stock's price (source: Investopedia). Without getting into the mechanics, it is important to remember that unlike in a long equity position, where the potential loss is limited to the stock going to zero, a short position's potential loss is unlimited. To illustrate with an example, bearish investors who shorted GameStop shares at US$50 (by borrowing shares they did not own from brokerages) with the hope of buying it back lower to "cover their position" instead saw it rally to US$350, netting a loss per share of US$300 on the position.

GameStop - Recent Price Action



What is novel in this case is that a social media movement led to concentrated buying by retail investors who forced sophisticated institutions to scramble to avoid even greater losses - David vs. Goliath if you will. The most important takeaway here is to never underestimate the power of social media combined with very low cost trading platforms, particularly when many people have considerable funds saved and spare time on their hands.

BMO Chief Economist Doug Porter also makes the case that "this is but one glaring example of unintended consequences from ultra-easy monetary and fiscal policies... However, a case can be made that such speculative outbursts could hasten the end of extraordinary policies as the economy eventually returns to something close to normal."

So who are the main actors in this quickly developing saga? Reddit figures prominently. This fast growing social news aggregation and community/discussion website has seen millions of users congregate to its various forums and "WallStreetBets" in particular, which appears to have instigated the GameStop trading frenzy.

Robinhood and other trading platforms also made it easy for legions of day traders to participate. However, the extreme volatility forced it and others to suspend trading in some of the more popular stocks last week prompting conspiracy theories and accusations that they were in league with Wall Street (along with an upcoming Congressional hearing). The truth is probably more complex and less sinister in our view. The main issue for Robinhood and the reason it had to tap emergency funds lies in arcane regulatory rules that force brokerages to put up cash until a trade settles (stock trades settle two days after the purchase date in the U.S. and Canada). Given the massive spike in trading volumes and prices for some stocks, combined with higher collateral requirements mandated by regulators in the U.S., these trading firms had to find billions of dollars on very short notice.

Historical Squeezes

While the circumstances that have led to recent bouts of stock volatility are rooted in new technology and social platforms, there is nothing new about stock short squeezes.

One of the most famous historical examples involved Volkswagen in 2008 when the automaker very briefly became the most valuable company in the world. Hedge funds had shorted the stock heavily based on deteriorating financial performance but Porsche surprised them in March by disclosing that it controlled 75% of the shares of Volkswagen. With so few shares available to "cover" short positions, hedge funds scrambled to buy, pushing up the stock fivefold in four days. The shares quickly retreated after the initial bout of panic buying.

The one common thread in short squeeze episodes is that they tend to be very temporary. Economic history has proven that price overreactions in one direction or another tend to lead to an equally violent opposite move.

In our opinion, the key to long term investment success is to watch short term bubbles and manias from afar and to maintain a well diversified portfolio including cash, bonds, and high quality stocks.

Please contact your BMO financial professional if you have any questions or would like to discuss your investments.

General Disclosure