FLASH MARKET COMMENTARY JANUARY 28TH, 2021: GAMESTOP, AMC, AND THE BATTLE BETWEEN WALL STREET & MAIN STREET

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BACKGROUND OF KEY PLAYERS AND EVENTS

• Reddit Forum "WallStreetBets": WallStreetBets is an online community with associated posts/message boards on the social media site Reddit where participants discuss stock and option trading ideas. Over the past 6 months, members of this community have been encouraging each other to purchase shares of struggling companies that are some of the most-shorted stocks by large Wall Street hedge funds and institutional investors (more on shorting stocks in the next section). With growing participation in day trading by individual investors due to the coronavirus pandemic and burgeoning retail trading platforms like Robinhood, the momentum behind this trading strategy has snowballed precipitously across various internet platforms and retail investors as the share price of companies like GameStop have skyrocketed. At times, there has been coordinated buying by members of various groups and new investors continue to jump onboard to participate in what could aptly be described as a "get-rich-quick" scheme.

• Wall Street Hedge Funds: Several large, multi-billion-dollar hedge funds that are widely considered to be the most sophisticated traders on Wall Street have built massive bearish positions (i.e. short positions) on a number of companies whose business models have been crushed by the shift towards online retail shopping at the expense of brick-and-mortar stores. Bearish bets on brick-and-mortar retail – along with other sectors decimated by the coronavirus pandemic (think movie theater companies like AMC) – have increased dramatically since early 2020. Notable names in this case are the hedge fund, Melvin Capital, and short-seller, Citron Research, that had amassed substantial bearish positions in these companies. Their trading strategies are grounded in traditional fundamental analysis and strategic themes.

• The Battle between Wall Street & Main Street: This has been pitched as a war between the everyday individual investor and the financial titans of Wall Street. As retail investors have gained momentum and power to move the market of individual companies, this feeling of "good vs. evil" has grown as a battle cry with several social media investing forums expressing the goal of collapsing targeted Wall Street trading firms. This week it was announced that Melvin Capital received a $2.75 billion investment from Chicago-based hedge fund, Citadel, and Steve Cohen's Point72 Asset Management to shore up the firm's capital position and become less reliant on margin lending from its banking relationships (a.k.a. prime brokers) that could force them to close out positions at inopportune times.

DEFINITIONS OF KEY TERMS AND TRADING STRATEGIES

• Shorting a Stock: Shorting a stock is a trading strategy that bets against the share price of that particular stock. It is the opposite of buying – or going long – a stock that an investor believes will appreciate in value. A short position expresses a bearish view, while a long position expresses a bullish view. To execute a short on a stock, the short seller borrows shares of the company from a lender who owns a long position (and pays the lender some pre-determined interest, or margin, rate for this service). The short seller then sells the borrowed stock at the current market rate and hopes to buy the position back in the future at a lower share price. Those repurchased shares are then delivered back to the lender to close out the short position. For example, assume a short seller wants to short 100,000 shares of GameStop when its share price is $15. He would borrow 100,000 shares from the lender and sell them at the current market price of $15, collecting $1.5 million in proceeds. If the share price subsequently declines to $5, the short seller could repurchase 100,000 shares of GameStop for $500K, deliver the borrowed shares back to the lender to close out the short position, and make a profit of $1 million. However, if the share prices rallies, the short seller begins losing value on the trade. If the share price continues to climb, the lender will require additional capital be posted as collateral to mitigate their risk.

• Put Option Contract: For the buyer of a Put Option, this contract gives the buyer the right – but not the obligation – to sell shares of the underlying company (like GameStop or AMC) at a predetermined price (also known as the strike price). This is often a way for the buyer to express a bearish view on a stock. For example, if one were to purchase 1 Put Option contract at a strike price of $80 with a 3-month maturity, this buyer would have the right – but not the obligation – to sell 100 shares of GameStop at $80 over the 3-month period (1 option contract represents 100 shares of the underlying stock). This strategy would be profitable if the share price of GameStop was lower than $80 over the 3-month period. If the buyer exercises their put option (because it is profitable to do so), the seller of the contract is obligated to buy 100 shares of GameStop at $80 (experiencing a loss because they have now paid more for a security than it is currently worth). For context, many Hedge Funds have been massive buyers of Put Options on GameStop, AMC, and other struggling companies recently.

• Call Option Contract: For the buyer of a Call Option, this contract gives the buyer the right – but not the obligation – to buy shares of the underlying company (like GameStop or AMC) at a predetermined price (also known as the strike price). This is often a way for the buyer to express a bullish view on a stock. For example, if one were to purchase 1 Call Option contract at a strike price of $130 with a 3 month maturity, this buyer would have the right – but not the obligation – to purchase 100 shares of GameStop at $130 over the 3 month period (1 option contract represents 100 shares of the underlying stock). This strategy would be profitable if the share price of GameStop was higher than $130 over the 3-month period. If the buyer exercises their call option (because it is profitable to do so), the seller of the contract is obligated to sell 100 shares of GameStop at $130 (experiencing a loss because they have now sold a security for less than it is currently worth). For context, many individual investors, in aggregate, have been massive buyers of Call Options on GameStop, AMC, and other struggling companies recently.

• Put/Call Ratio: This is the ratio of Put Option volume relative to Call Option volume and can be viewed as a gauge of market sentiment on a stock. A high put/call ratio implies bearish sentiment, while a low ratio implies bullish sentiment.

• Short Squeeze: A short squeeze occurs when the share price of a short seller's stock rapidly increases. As a result, the short seller may be forced to close out their short position due to risk- or capital-constraints, even if they still have a bearish view on the stock and believe it will decrease over time. Being forced to close out a short position due to a short squeeze is disadvantageous and destructive to the trading strategy, even if the thesis ends up proven correct. Short squeezes can happen naturally due to market movements, but in other circumstances, they can be executed intentionally to force a negative outcome for the short seller. In the case of GameStop and AMC, Main Street investors are intentionally, some may say maliciously, squeezing hedge funds with large short positions.

HOW THE SITUATION HAS PLAYED OUT: GAMESTOP CASE STUDY

• On July 31st, 2020, shortly before the momentum of social media forums drove the stock to rise, GameStop's price per share was $4.01. As of yesterday (January 27th), the price had ballooned to $347.51, representing a gain of 8,566% in less than 6 months. The overwhelming majority of this rally has come in the past two weeks, as the share price remained below $20 prior to January 13th. This two-week surge is a prime example, albeit an incredibly extreme one, of a short squeeze.

• The buying momentum from retail investors isn't the only reason for the violent and rapid upward trajectory though. While it can be seen as the major catalyst, several other mechanisms are at play here that have caused the momentum to become a self-fulfilling prophecy. The next few bullet points will explain in more detail.

• As the share price of GameStop accelerates upward, short sellers are squeezed. And as we outlined earlier, this can force them to cover their short positions due to risk- or capital-constraints. To cover and close out the positions, the short seller is forced to buy the stock at the current market value of the shares. This adds to the buying demand and drives the price even higher.

• Banks and other market-makers are more often than not the counterparty in option contract positions. Their goal is to be hedged in their net exposure to any security. As such, as option contracts are entered into, the bank will execute offsetting transactions to hedge their risk. To hedge the risk of selling Call Options, the bank would purchase shares of the underlying stock in order to remain neutral. When retail investors, again in aggregate, build massive Call Option positions, the banks and market-makers that are counterparties (i.e. have sold the Call Options on GameStop) must buy shares at the current market price of GameStop to hedge their exposure. This also adds to the buying demand and drives the share price higher still.

• Starting on January 28th, several large custodians and trading platforms – such as TD Ameritrade, Charles Schwab, Robinhood, and others – have enacted trading restrictions on a number of stocks, including GameStop and AMC. According to various announcements, restrictions include some or all of the following: cannot establish new long stock or option positions, increased margin requirements, disallowed naked option positions (i.e. option positions without owning the underlying shares), and liquidation only trades. As a result, at the time of this writing, the share prices of GameStop and AMC were down over 50% in intraday trading.

• It is yet to be determined how this story will end. However, it will likely serve as a cautionary tale for investors considering jumping into bandwagon trades that are fueled purely by momentum and speculation rather than being grounded in reality. On its face, it appears eerily familiar to the “pump-and-dump” schemes made famous by movies like *Boiler Room or The Wolf of Wall Street*. Once the selling starts, the share prices of these companies will plummet back to earth at lightning speeds. And without the artificial buying demand of the aggregate crowd, those left with long positions ultimately will end up holding the bag.

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