

A Quick Primer on GamesStop, r/wallstreetbets and Short Squeezes

The press is painting this as some kind of epic collision between the Average Joes and Globo Gym, but it is much more nuanced than that.

First, we have to understand what short selling is. Short selling is when you bet that the price of a stock is going to go DOWN. This is accomplished by borrowing the shares from someone else, selling them, waiting for the price to decline, and buying them back later, and returning the shares that you borrowed. Sounds complicated, but the plumbing is handled by the securities lending systems at your broker.

Several hedge funds were short GameStop stock in pretty big size. That's entirely rational. It's a brick-and-mortar video game retailer that is increasingly irrelevant since most people download their games. People have been betting against this stock since 2015, and GameStop has responded by going to great lengths of financial engineering to frustrate the short sellers, including numerous buybacks. Basically, the entire float (and then some) was sold short, which shouldn't happen.

Enter r/wallstreetbets, who had saved a bit of money during the pandemic and had a surplus of free time. Over the past six months, they've been doing things like piling into stocks like Hertz (which was then bankrupt) and creating all kinds of chaos in the markets. Someone figured out that GME had a large short interest, and the Redditors launched a coordinated attack to squeeze the shorts. Remember, when you are short a stock, and it goes up, you face potentially unlimited losses.

This is where things get a little complicated; this isn't entirely legal. If a group of hedge funds had acted together to force a short squeeze, they would face legal consequences. But it's hard to go after the wsb crowd, because there are millions of them and you can't prosecute everyone.

A contributing factor here is that Robinhood and most of the industry went to commission-free trading last year, which facilitated the raid on GME stock. If trading commissions had been their usual \$8, this wouldn't have happened. The hedge fund with the biggest short position in GME, Melvin Capital, got a capital infusion to avoid bankruptcy. There are about two dozen hedge funds with substantial losses (down 20%-60%) that will have to liquidate, including some household names.

From an ethical standpoint, why should we care about Richie Rich and his hedge funds? Frequently investors in hedge funds are pensions for people like teachers and firemen. Why are state retirement funds investing in risky hedge funds? Because they fall into a class of investments known as alternative assets which provide less correlated returns. This has been going on for years.

Is it evil or wrong to sell short a stock? No. Short sellers did the shoe-leather detective work on massive frauds like Enron, Worldcom, Tyco, and others in the past. They ensure that securities are accurately priced. Were they trying to drive GameStop out of business? Not deliberately--these are all market neutral hedge funds, which means that they are both long and short stocks and only hope that the longs outperform the shorts. They don't need GME stock to go to zero--they only need it to go up less than the longs, and that had been a good bet up until recently.

As for Robinhood suspending trading in GME and other securities, there is no conspiracy here. GME was costing Robinhood money in clearing costs, and had the potential to bring down the whole firm if too many people had bought the stock on margin and experienced losses. Robinhood is in trouble, and recently drew down a credit line and got a capital infusion. Note: if you have money at Robinhood, I would get it out immediately.

Robinhood was the one brokerage that encouraged the gamification of investing and now they are reaping the consequences. There are no easy answers here, apart from the SEC subpoenaing Reddit and getting the IPs of the Reddit posters and knocking on their door. If Robinhood fails, SIPC will cover most of the small accounts but the large account balances will be in trouble.

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