Avoid the Squeeze

February 2021

- A number of companies with high short interest have been targeted as speculative buying opportunities by retail investors.
- Some of these stocks, most notably Game Stop and AMC Entertainment Holdings, have seen wild price swings.
- While this action in financial markets is disconcerting to investors, our view is that this is likely to be a fairly short-lived phenomenon that highlights the merits of a well-diversified portfolio.

Recently stocks such as Game Stop (GME), AMC Entertainment Holdings (AMC), and others have seen massive spikes in valuation as retail investors poured money into them in hopes of forcing a “short squeeze.” While this has resulted in increased stock market volatility that may continue for some time, we don’t believe it’s a harbinger of doom or a long-term theme.

r/wallstreetbets Short Squeeze

In late January retail investors began piling into to several highly shorted smaller stocks, most notably Game Stop. This appeared to be a coordinated effort from followers of the online message board r/wallstreetbets subreddit on Reddit, a social media news aggregation and discussion website. The investors targeted companies such as Game Stop because they are smaller companies (which means that buying pressure—supply and demand—can drive their prices higher more easily than if they were large companies) with tremendous short interest (over 100% of the available shares of Game Stop had been sold short, for example). The ensuing short squeeze has raised volatility and resulted in significant loses for some prominent hedge funds and other short sellers. A number of discount and online brokers began limiting purchases of stocks involved in the short squeeze drawing the ire of retail investors and politicians.

Many hedge funds have begun to cover some of their short positions, especially in smaller highly shorted names. This has resulted in a broader short squeeze across a range of stocks, although in most cases the valuations of these stocks have not risen anywhere near as dramatically as Game Stop.

Our View: Making Sense of it All

An initial observation is that we expect this will likely have a negative impact on hedge fund performance across the industry in January.

What is a Short Squeeze?

It’s not uncommon for individual companies to become overvalued for one reason or another. When that occurs, investors may seek to profit from a decline in the stock by short selling it, also commonly referred to simply as shorting a stock. The concept is relatively straightforward—an investor borrows the stock and then sells the borrowed shares creating a short position. Eventually the short seller will cover the position, buying back the stock and returning it to the lender. If over the course of this string of transactions the stock’s value declines, the short seller will profit. Of course if the value rises, that would cause a loss for the short seller.

When a highly shorted stock starts to appreciate, it can cause what is known as a short squeeze. Essentially a short squeeze is forced buying that can amplify the positive momentum in a stock’s price. Investors may be forced to buy for a number of reasons including technical (they set a stop-loss at a certain price), they received a margin call (not enough collateral), or to fulfil the terms with which they borrowed. While trading strategies based on short positions can be utilised by retail investors, they are often associated with hedge funds that specialise in such strategies.

Investigations into the legality of the behavior are likely. Regulatory change is always a possibility, although curtailing the behaviour of large groups presents a unique challenge. . In the end though, this seems to be a gray area and with the individuals receiving support from both the far left and far right of the political spectrum it seems unlikely the U.S. Securities and Exchange Commission would prosecute this. There is the possibility of some regulatory change, which we expect would be minor if they were to come about.

The more ominous question is “Does this dynamic have staying power?” We believe the answer to that is probably not. These actions could peter out relatively quickly or stick around for some time, but in the grand scheme of things we do not anticipate a long-term trend. In the short term, there seems to have been a de-risking by short sellers as they seek to limit exposures to small companies with high short interest. There will also be some market volatility to work through.

We understand the current situation is unsettling for investors. The behaviour that we are seeing—a crowd of people buying a stock not because they see fundamental value in the company or its business model but because they are betting against short sellers—is speculative. Speculation is something we have seen throughout history from tulip bulbs to technology stocks. Speculation is not an investment strategy.

SEI maintains our belief that diversification is the cornerstone of well-planned, long-term investment strategy. A well-diversified portfolio tends to dampen market volatility and may also limit exposure to the types of stocks that attract speculation. In general, SEI's portfolios have little or no exposure to headline grabbing stocks.

Financial Definitions

Hedge Fund: Hedge funds are pooled investment funds that implement complex trading, portfolio construction and risk management tactics in an effort to improve performance or manage risks.

Short Interest: Short interest is the number of shares that are currently being held short. Short interest, may also be expressed as a percentage by dividing the short interest by the number of outstanding shares. High short interest indicates investors are generally pessimistic about a stock.

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