

Gamestop: How online ‘degenerates’ took on hedge funds

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Abstract

The spread of COVID-19 has forced many people around the world to adjust the manner in which they relate to and participate in the goings-on of the outside world. This article examines a seemingly novel attempt by a few amateur investors to take on the might of hedge funds’ cutting-edge algorithms. Our analysis includes an examination of short-selling, online investment communities and the problem of collective action they face. This piece examines how Wall Street betters on Reddit, with little or no experience, brought a new series of questions about regulation and speculative investing to the fore. We close by reflecting on the kinds of questions that people who are interested in the stock market (no matter their ability) might ask themselves in the very near future.

Keywords: Gamestop; finance; short squeeze; collective action; wallstreetbets

Introduction

COVID-19's arrival seriously impacted everyone's daily lives globally, creating a seismic shock that pushed everyone further and further away from business as usual. As a result, a significant proportion of the world's population started to work from home, and could no longer enjoy shared social activities. This turn inward facilitated a climate in which people looked for new ways to spend their leisure time, new trends to chase and new ventures in which to participate.

As COVID-19 spread around the world, the various lockdowns and quarantine measures imposed by national governments spurred strong interest in investment and stock markets. Increased market volatility, a wide variety of stocks trading at historical low prices, and the prospect of a quick recovery attracted a large group of novice traders to the stock market, often for the very first time. The existence of commission-free trading applications, such as Robin Hood, allowed easy access to a large number of first-time traders, mostly in their 20s and 30s, to the stock markets.

Compared to traditional stock market investors, these novice traders proved to be much less risk-averse and more active, possibly as a side-effect of being housebound (**Popper, 2020; Eaton et al., 2021**). Some of these novice traders joined internet forums and message boards, allowing them to interact with, and to receive advice from, more seasoned traders. The staggering volume of online venues and advice portals meant that some neophytes focussed more on interaction and fun, rather than acting on the basis of solid financial advice; to that end, this venture had the feeling of a pastime. This casual interest notwithstanding, one forum in particular, the Reddit forum r/Wallstreetbets, had been growing significantly since the start of the pandemic.

High frequency trading was on the rise since 2006, the year when high frequency trading first exploded into the mainstream. However, the daily trading volume had been declining since 2008. The overall trading volume was not substantially affected with the arrival of these new traders. To that end, their presence was not viewed as a kind of threatening presence. This all changed drastically in January 2021, as demonstrated in Figure 1:

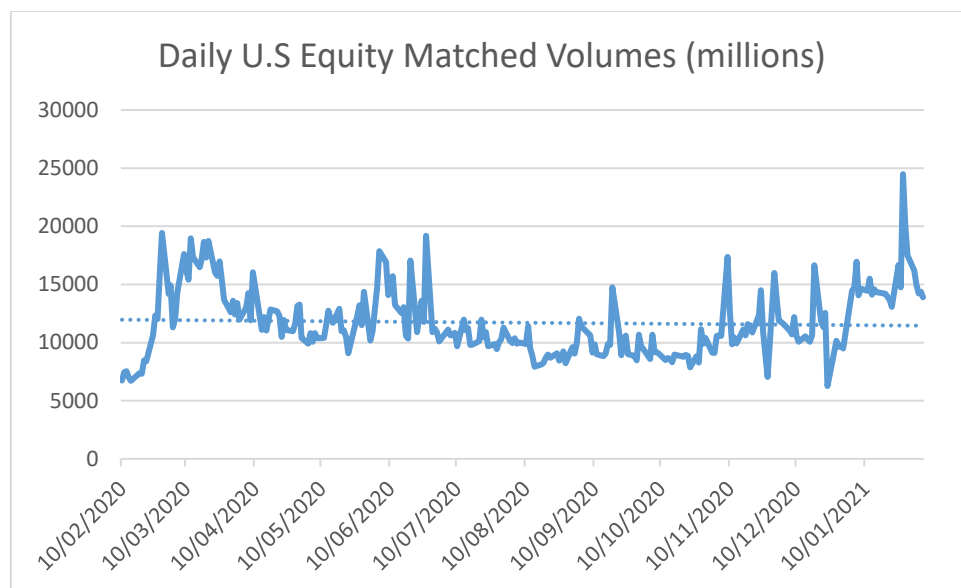


Figure 1: Daily U.S Equity Matched Volumes (in millions)
(source: <https://www.nyse.com/markets/us-equity-volumes>)

Figure 1 gives us an indication of the recent rise in trades, a rise that picked up a head of steam in the days surrounding the Gamestop short squeeze.

Gamestop Short Squeeze

The spike in trades in January 2021 can be assigned to the aforementioned sub-reddit Wallstreetbets. Individuals often discuss trading strategies in this online forum and they often self-identify as ‘monkeys’, ‘apes’, or ‘degenerates’, given that they are not financial experts. This canny awareness of their lack of expertise is reinforced by the feeling that posters often engage in interactions focused on ‘memes’ and fun, rather than on in-depth financial discussions. This element is further underscored with the idea that there is a significant ‘betting’ element too.

However, and all of a sudden, these amateurs became a force to be reckoned with during January 2021. One user noticed that hedge funds (mostly Melvin Capital) had shorted the stock of brick-and-mortar game shop Gamestop and the idea was launched to push up that same company’s share price. Individuals active in this sub-reddit started to increasingly buy Gamestop’s stock with the idea to hold onto the shares until the short positions of hedge funds expired. As shown in Figure 2, this call to action proved successful.

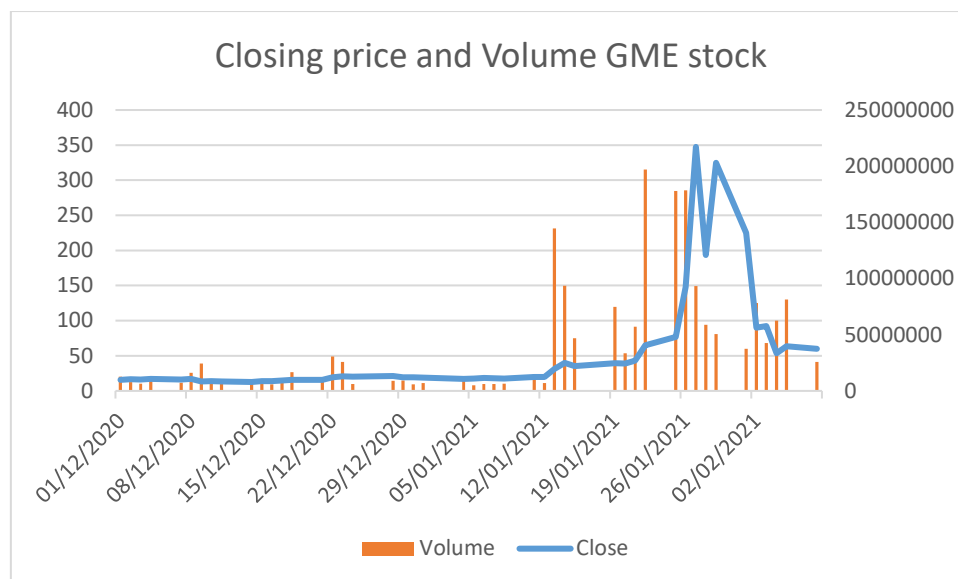


Figure 2: Closing prices and daily volume of Gamestop (GME) stock

This would necessitate hedge funds to buy back their shortened stock at a significant loss.

Several investors participating in this forum were already discussing that Gamestop might be undervalued and that the negative sentiment in the market was unreasonable. With 140% of Gamestop stock being shorted, the idea of pushing a short squeeze gathered more traction as reddit investors felt that this would push the price up. If their efforts succeeded hedge funds and short sellers would incur significant losses. The resentment towards Wall Street that brought these small investors together was best explained in the highly discussed and rather post: ‘GME Squeeze and the demise of Melvin Capital,’ whereby the short squeeze plan was introduced in detail, as was the aim of bringing down Melvin capital, a hedge fund. Some users even spoke about class warfare.

What was fascinating too was that these Redditors did this on the basis not of saving a company from a vulture hedge fund looking to capitalise on its closure. After all, Gamestop had made headlines on the basis of a series of anti-consumer practices that engendered a great deal of antipathy in the last two quarters of 2020. This negative press might have gone some way to compounding the depressed share price. Gamestop’s scandals included but were not limited to: arranging contests in which successful applicants got to work longer hours without remuneration (**Gach, 2020**) and mishandling the release of the coveted PlayStation 5, selling machines to bots instead of customers meaning that eager consumers had to wait up to 6 months (**Fischer, 2020**). Footage of a disgruntled customer also went viral in November 2018 when a Gamestop employee refused to return a copy of a game purchased there, leading to the enraged man destroying shelves and promotional displays (**Vincent,**

2018). However, GameStop does create some nostalgia in these online communities, many of whose participants might have enjoyed videogames in the past.

In a House Committee on Financial Services meeting, entitled: 'Game Stopped? Who wins and loses when short sellers, social media and retail investors collides?' Keith Gill, aka roaringkitty and DeepFuckingValue, spoke eloquently about the events leading up to the squeeze. This footage has gone viral, with a video published by Forbes, somewhat confusingly entitled: 'Gamestop investor Keith Gill's opening statement goes VIRAL', garnering over 1.3 million views at time of writing, only six days after being uploaded.

Gill spoke eloquently about the serendipitous difficulty of looking for a job in 2009, the year he graduated, and the exact time around which a financial crisis was taking place, a crisis caused in large part by short-selling. Indeed, the financial crisis already indicated before how shortsellers can create havoc on financial and global markets, and that the current architecture to address their potential detrimental impact is limited (**Wouters & Van Kerckhoven, 2011**). Moreover, he emphasised that he believed the stock was undervalued and had a concomitant belief that Gamestop would recover. He also drew a distinction between the informal quality of reddit exchanges, as akin to pub-talk, as opposed to the slick teams of experts that hedge funds can draw upon. In closing, Gill mentioned that he supported the view that individuals should be free to send a message through how they invest, and so the question of whether or not this kind of collective action would be witnessed again and when looms large.

Collective Action Problem

This move was the first time that so many individual traders joined ranks. Normally, a collective action problem would arise on the basis of this lack of precedent (**Olson, 1965**). Indeed, in order for the short squeeze to be successful, traders would need to secure the ability to buy into the stock, and to hold onto it as its price rises. However, a rising stock price provides individual traders with an incentive to reassess their position and to capitalize on the gain. Forfeiting short term gains in order to force hedge funds to acquire their shorted stock at a higher price is particularly difficult when the underlying stock has increased twentyfold in selling price. This was also possible with the Gamestop stock due to its relatively low number of outstanding shares (46.89 million of shares in free float). Several other stocks mentioned on the reddit forum also shortly went up around the end of January, but their gains were significantly smaller and even more short-lived. For example, AMC has a free float of 136.29 million shares, Blackberry 508.11 million shares, and Nokia has more than 5 billion. These

other shares were also not shorted to the same extent, hence rendering the initial ambition of forcing hedge funds to reacquire their shorts void in these cases. This has also led to a genuine move to anticipate what commodity redditors might 'Gamestop' next. In February 2021, Bloomberg and Forbes attributed the 8-year high value of silver to Reddit investors (**Farchy et al., 2021; Hart, 2021**), a claim unfounded as per most Redditors comments. It is also interesting to note how the collective action is characterised in these works in which Redditors are referred to as an 'army'.

Other than the incentive to deflect for a quick profit, individual investors also faced an uncertain and short time horizon. When hedge funds clear their short positions, and decide to not engage in shorting the stock again, then there comes a natural point at which the higher stock price will be just that: a higher stock price. Free riding does not provide any benefits as such, given that only traders of the stock benefit from higher stock prices, unless one views hedge funds making losses as a 'public good'. However, all Gamestop buyers face more of a game of chicken situation, given that there exists a natural point at which the short squeeze's original aim is fulfilled (**Rapaport and Chammah, 1966**), except that yielding in this instance is not met with the perception of being a 'chicken', since most traders do not publicly disclose their holdings.

Moreover, participants faced a David vs Goliath situation. In general, individual small investors find it difficult to move stock prices significantly. The efficient market hypothesis means that when stocks do move beyond their expected value, then other stockholders would sell their positions. However, in this specific case, these adjustments did not kick in immediately, most probably because stockholders, those active on the aforementioned forum in particular, decided to hold onto their stocks. In that case, additional demand with locked-in supply would mean that stock prices could move far past what the efficient market hypothesis would suggest.

Building on these concepts, it is clear to see that divergence is very likely. How can an online forum in which users employ aliases 'enforce' adherence?

The collective action problem that typically arises in these cases was mitigated through the usage of 'memes'. These pictures or short snapshots of videos with funny captions encouraged holders of the stock to hold, and spurred community members to either increase or hold the stock. This seemed to work rather well, until trades in the 'meme' stocks were halted or limited by major online brokers, such as Robin Hood. This action clearly killed the momentum of these stocks and was one of the reasons for the stock price's sharp decline in the days following the substantial upwards

movement of these stocks. Longevity for these online communities seems to be a challenge, as interest may quickly cool down, but they do hold potential for unanticipated shocks.

The whole upwards and downwards movement of these stocks, and of Gamestop in particular, has led to instigations related to market manipulation against both the reddit traders, as well as against the brokers who limited trades. Most importantly, it has also spurred interest from policy- and law- makers, leading to the aforementioned Congressional hearing in the US. Several experts and high-level politicians also have commented on the short squeeze with proposals to refine the workings of the stock market, as well as the governance of online brokers. For once, even people working on Wall Street have joined them in requesting greater legislation, a very interesting position to take after years of fervently fending off any attempt at regulating trades (Graffeo, 2021).

Conclusion

Online communities have enabled people to engage in social interactions during lockdowns and quarantines. Their significant growth was one of the most substantial impacts of COVID-19. However, their role as change-makers has yet to be investigated in many respects. In the specific example employed in this paper, an online forum proved capable to shake up the stock market, and the actions taken by its members initiated a debate on the reform of financial markets and the governance of online brokers. The investors gathering in a sub-reddit, called r/wallstreetbets, have been able to overcome the collective action problem with regards to Gamestop, and in so doing, have created havoc for traders shorting the stock, notably hedge funds.

A market that have traditionally been known for being dominated by investors and funds with deep pockets and a swathe of experience and sophisticated algorithms and technology, now witnessed the rise of a new type of market power: small investors who were able to build up momentum and holdings without any formal structures or communication lines, apart from Reddit. It is uncertain whether the Gamestop short squeeze could democratize the stockmarket,ⁱ but it has at least pushed discussions about the governance of stock market and of brokers into the public imagination. When shorting a stock in the future, hedge funds will have to conduct more research, at the very least. These questions might include: is there a feeling of nostalgia that might generate support from a fragmented group of investors? Would small investors risk taking a bet on getting rich, or at least would they think it might be a fun way to pass the time during a global pandemic?

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Endnotes

ⁱ Anthony Scaramucci (former White House Director of Communications) posted on his twitter on 27 January 2021: 'We are witnessing the French revolution of Finance'. These claims seem to be unfounded at the moment, but do point to the importance of the events unfolding from the actions taken by an online forum. <https://twitter.com/Scaramucci/status/1354445427836416003>