Taking Down the House

By Michael McKeown, CFA, CPA – Chief Investment Officer

Well, this was one of the wildest trading weeks in stocks I can remember. When my friends outside of the industry start to text me non-stop about the market, there is definitely something up.

For those who missed it, an online message board on Reddit brought to attention a number of stocks with high shorts interest. High short interest means many investors are betting on the price of the stock to go down. Usually these are hedge funds.

The message board gained momentum with other investors hopping on the train to push these stocks higher. For investors who short these stocks, that means they are losing money. It is known as a "short squeeze" as it is clearly painful to the investment accounts of the hedge funds.

A short squeeze is nothing new. As an example, in 2008, Volkswagen temporarily became the largest company in the world (bigger than Exxon, Amazon, or Apple), due to a short squeeze pushing its stock price higher.

The way the short squeeze happened this time was new, the catalyst being online message boards. But more investors piled on as it gained attention, including average people, institutions, and hedge funds.

On Thursday, the trading app Robinhood, which is used by many on the message board and younger investors to trade, disallowed buying in certain stocks that had gone up substantially. Investors restricted from trading felt this was unfair, looking at a change in the rules during the middle of the game.

This is also is not new. Many people purchased the stock on margin, which means they used debt inside their accounts to gain more exposure. This creates more risk for the brokerage institution. In volatile situations, the margin requirements can change quickly and substantially, not only for the average investor but also institutional investors or hedge funds.

Robinhood reportedly needed to access a credit line because of the risk in underlying client accounts. It did not restrict accounts on a whim. It had to. And it had to take the resulting heat. The brand equity of Robinhood was clearly hurt as nearly everyone with a platform railed against the firm.

What's this mean for the big picture?

For one, it could be a period where hedge funds become weary of putting on short positions. Since they use these shorts to offset their longs (in both stocks and credit investments), they may need to sell to maintain the proper market exposure. In this scenario, there could be pressure on broader markets.

Many of the hedge funds that were hurt in this short squeeze did not have proper risk management in place. The retail investors took advantage of this positioning. It caused an implosion among the large hedge funds. In a way, this is a true Robinhood tale. It was a "taking down the house" of the powerful. Yet there are many houses.

When my buddies texted me about what was going on, my short answer was: the house always wins. The brokerage firms want to be the toll booth for investors. They do not want to take risks that will bring a crisis to their doors.

The upside of all this is more interest in investing. The interest in learning and thinking about markets for many of the novice investors involved should not be shunned. Reading some of the posts on the online forums, there are thoughtful understandings of market structure (not all of them, of course). While many are disparaging them, I see it as a long-term positive.

As in generations before, speculating is the road to investment. But there is a key difference. Speculating is the hope of high, quick profits, without regard for risk. Investing considers risk first. Per Warren Buffett's mentor Ben Graham, investment an "operation is one which, on thorough analysis, promises safety of principal and a satisfactory return."

New investors' wherewithal to take more risk for potentially greater gains by speculating is the same as it ever was. And for younger newbies, there is much more time to recover from losses.

Yet the key to long-term investment success is finding a process that you can stick to, through up and down markets.

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