Another Short Story

February 8, 2021

One week ago, equity markets experienced a hiccup because of an unusual event involving a market trade known as a short sale. A short sale can be described as follows: an investor borrows stock from his broker and then sells it hoping to profit when the stock falls in price and can be repurchased at that lower price to replace the borrowed stock. As described, this transaction is speculative in nature because the seller is responsible for replacing that borrowed stock at some future time. If the stock rises in price rather than falling, the investor may have to buy the stock at a higher price and take a loss instead of a gain. Normally, investing in a stock can result in infinite upside and the loss of everything. In the case of a short sale gone bad, the loss can be unlimited depending on how high the shorted stock price goes.

Professional investors and hedge funds use this practice for a variety of reasons, one being to reduce portfolio risk. Under normal circumstances, this practice can reduce portfolio volatility because whatever way the market moves, the long versus short positions offset the magnitude of the change.

The current story primarily revolves around GameStop which is the world's largest video game retailer that is not making money but is extremely popular. Many institutional investors and hedge funds shorted the stock driving up the price to parabolic levels. A group of novice investors banded together and began buying the stock and the price soared. From a low of $112 it rocketed to over $483, a massive gain over a few days. The surge caused billions of dollars of losses for those speculators who shorted the stock. Trying to cover their short positions by buying the stock back caused the price to continue higher. It was not until brokerage firms like Robinhood placed margin limits on these transactions did this stock fall back to Earth. Today, the stock is trading at $59. Data from the short-selling analytics firm S3 Partners signals the stock's sky-high short interest has also come back to Earth.

Ihor Dusaniwsky, managing director at S3 Partners, told Barron's that only 26 million GameStop shares were recently sold short, or about 51% of shares available for trading. That is down by more than 35 million shares over the past week alone, implying last week's surge was driven by large-scale short covering. Major investors feared that these losses would also force the sale of other stocks. Fears of fund bankruptcies triggered overall market weakness and sent stocks plummeting. Once there was some clarity that further surges in selected stocks would be limited by brokerage firms, the market stabilized and then resumed the uptrend that began in early November.

This experience is likely to reduce the reliance on shorting stocks as a speculation against companies. These bounty hunters, as we call them, are continually searching for opportunities among stocks that are heavily shorted - betting that they can run those stocks up and garner a substantial profit. These speculative actions have attracted the interest of regulators who are likely to take some action to limit the chances of such events happening in the future.