GameStop and Reddit: What's happening in the stock market?

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In the past few days, the financial world has been buzzing about GameStop, Reddit, and a short squeeze. Finance Professor, Carlos Slawson, offers some insight into the recent frenzy in the stock market.

Professor Slawson wants the reader to be aware that he is not a financial advisor and has not performed a thorough analysis. But, as a long-time finance professor at LSU, he offers his insight.

Can you explain what's taking place with GameStop (and others such as AMC, Nokia, and other legacy brands) stocks?

The stocks have been extremely volatile. For example, GameStop (GME) has varied between $2 and $500 during the last year. As of late, it appears individuals have conspired to short squeeze several targeted companies. GME's short interest is 90%-140% of its shares available for trade. There are many explanations about what "selling short" means. Essentially, a trader who shorts a stock works with a brokerage firm to borrow shares and sell them now. So, rather than buying stock and hoping to sell it later at a higher price, the short seller sells the stock now and hopes to repurchase it later at a lower price.

If large numbers of people attempt a short squeeze, then there are temporary supply/demand issues. By colluding to buy as much as they can, in many cases, they can temporarily keep prices artificially high, attempting to force short-sellers into a corner. Short sellers may be forced to buy back the shares now or put money in their brokerage accounts to cover the current cost of shares.

How is a group of people online able to rally and influence the market this way?

Various news outlets are reporting that Reddit's r/wallstreetbets took notice of GME's substantial short interest. Large numbers of Redditors agreed to buy and hold GME, regardless of the company's actual intrinsic value, so that short-sellers are forced to buy back at higher prices. There is an indication that the Redditors agreeing to this plan imagine themselves on a noble quest to thwart the schemes of sinister short sellers. With a villain to visualize, others are now being encouraged to join the battle.

However, the short squeeze is not a very nice thing to do as it ignores the intrinsic value and attempts to bully the short-sellers given temporary issues with supply. Consider an analogy of small generators for household use, with which most of us in Louisiana are very familiar. When Laura hit Lake Charles in the Fall, there was a considerable need for generators. Suppose a group of individuals (who realized there was an immediate increase in demand for generators) colluded with a strategy of buying every generator as soon as the supply trucks rolled into the area. Suppose this group gathered large crowds and conspired to buy all the generators and never sell them to anyone in need. Those who truly needed to buy generators would naturally start bidding the price up in a desperate plea to get someone to let go of a generator. The longer the colluding group sticks to their strategy, the greater the rise in generators' price above actual intrinsic value.

The bits of info that I have received indicate that many individuals are attempting a strategy of buying as many shares of GME as they can while also promising not to sell. Such an approach would drive up the price to desperate levels for those needing to buy shares to reverse their short positions in the short run.

What is happening with Robin Hood freezing those stocks on their platform?

Big Tech appears all too willing to take on a guardian role as of late, especially over the last year. A self-appointed protective big brother may have good intentions, but volunteering to rescue free individuals from themselves is not always welcome. We may be tempted to add Robinhood to this list; however, my understanding is that there was no "freeze" on stocks at Robinhood. Investors holding the stocks could continue to keep them or sell them. Robinhood did not allow the purchase of new shares for a while, but there may have been legitimate reasons, including issues with settlement fees with certain high-volatility stocks.

There seems to be a difference of opinion on this from those "inside" Wall Street vs. those on the outside. Why?

What many do not understand is that share price is meaningless without knowing the number of shares. Some understand market cap and those who think share price by itself is meaningful. Business students (or anyone) who understands valuation techniques realize that the equity market value is determined first. This value is divided by the number of shares outstanding to decide on the share price. If the share price is too low in the investor's opinion, then the investors buy. If the share price is too high, investors sell. If investors do not have shares to sell, they can short sell by borrowing the shares and selling them. If a speculator ignores fundamentals and buys or sells based on share price movements alone, that investor is ignoring fundamental value.

Bank of America recently valued GME at a market cap of $750 million ($10 per share). Are large numbers of retail investors colluding to sustain a $21-$35 billion market cap (indicated by a $300-$500 per share price)? Colluding to prop up share price regardless of intrinsic value seems similar to a fictitious case where someone would develop a strategy of buying all available physical dimes, no matter the cost, just so those who need dimes cannot have them. Maybe the dimes' price goes to $1 or $2 or even $5 in the short run. It may last a while, but eventually, some in the colluding group will break ranks and start selling, returning the price paid for a physical dime to 10 cents.

Will this change anything about trading going forward or just a one-time anomaly?

A student in my Financial Derivatives course asked this question yesterday morning. Perhaps traders will be less inclined to short stocks if there is a large amount of short interest? Given that short selling serves a valuable purpose, this would not be a good outcome. Perhaps a politician will draft an excellent new rule to move us closer to utopia? Legislation and regulation with great intentions are not uncommon.

In the end, though, someone will lose. The Wall Street insiders will not go hungry. It will make very little difference in their lifestyles. They know how to hedge their lives. Sadly, the losers will likely be the non-diversified, small investors who don't know anything about market capitalization.

Provided by Louisiana State University

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