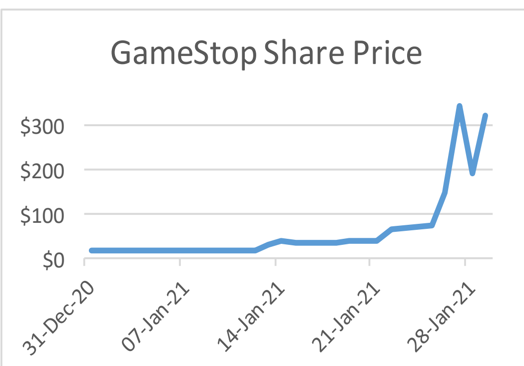
When Will the Game Stop?

In the beginning of January, we watched a mob storm the U.S. Capitol, a shocking event that no one expected could ever happen. At the end of January, markets watched as ‘retail investors’ stormed into some stock that hedge funds had targeted, a surprising event that few expected to happen. So what is going on and what does it mean?

What some hedge funds do to generate returns for their shareholders is to ‘short a stock.’ What this entails is that a hedge fund borrows shares of a given company and immediately sells those shares into the open market at the current price, with the expectation that the hedge fund will buy back the shares in the future at a lower price. In essence, the hedge fund bets that the company’s stock price will fall and the hedge fund will make money. That investment process is the exact opposite of what we do at Argent. As a reminder, we buy stock and hold it for the long term, expecting that the company’s stock price will rise over time. This is called ‘going long’ on a stock.

Whether shorting a stock is bad for the market or un-American is a frequent topic of debate. Hedge funds make the point that they are highlighting a market inefficiency – a stock that is overvalued relative to its prospects. By shorting a company’s overvalued stock, hedge funds argue that they drive the company’s share down to a correct price, thus creating market efficiency.

The amount of stock shorted for a company is updated regularly and made available to the public. This is where the ‘retail investors’ come into play. With platforms for information transfer, like the internet and platforms for trading, like Robinhood, retail investors, who are supposed to be ill-informed, targeted some of the most shorted stocks, GameStop amongst them.



What retail investors did to make headlines in January was collectively buy GameStop and other heavily shorted stocks in substantial amounts. From there, the simple laws of supply and demand took over. If the demand for a company’s stock rises, assuming supply stays constant, the stock price rises to meet that higher demand. That is exactly what happened to GameStop’s stock price. In fact, the stock rose from $19 on January 1^{st}, to $325 on January 29^{th}, or up over 1,700% in one month. This is what is referred to as a ‘short squeeze.’ In a short squeeze, hedge funds that are shorting a stock, in this instance GameStop, are forced to buy the stock back at higher prices to ‘cover their short.’ As GameStop’s stock rose, hedge fund losses rose in tandem.

To put this risk into perspective, when an investor goes long on a stock the potential loss is 100%, in other words, the stock falls to $0 per share. When one shorts a stock, however, the potential loss is infinite, because there is no ceiling to how high a stock can rise. This is what occurred in January as some high profile hedge funds lost billions of dollars in the month.

Whether what we saw with GameStop and other heavily shorted stocks is a one-off event or it represents a new risk in investing remains to be seen. Rest assured, we at Argent closely watch the markets every day and will adjust our strategies accordingly to new risks and new opportunities.

We are open for business and welcome your interest in Argent Capital. We have four successful equity strategies–Large Cap, Dividend Select, Mid Cap and Small Cap. If you have questions on any of these options, please call us.

Sincerely,

Ken Crawford, Senior Portfolio Manager