BUSINESS

Column: GameStop has spawned 1,001 theories, most of them wrong. Here's what's right

Most takes on the GameStop stock situation are based on commentators' excessive eagerness to weigh in on a phenomenon long before it has played out, on profound ignorance about how the stock market works and its history and on a desire to praise Davids for besting Goliaths. (Dania Maxwell/Los Angeles Times)

BY MICHAEL HILTZIK | BUSINESS COLUMNIST

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Over the last week it's been hard to escape hearing about GameStop, the stock trade through which an army of small investors has made Wall Street big shots weep.

Finally, the little guy has gotten revenge on the suits, we're told. Also, the stock market will never be the same.

And: Congress and regulators will finally have to do something about market manipulation, especially by short sellers.

> *The 'zero commission party' is a one-sided party based on a fraud.*
>
> **— Dennis Kelleher, Better Markets**

These are among the thousand-and-one takes being dispensed by pundits about what GameStop *means*. Most of them, however, are wrong.

They're based on commentators' excessive eagerness to weigh in on a phenomenon long before it has played out, on profound ignorance about how the stock market works and its history and on a desire to praise Davids for besting Goliaths. As George Pearkes, a market strategist writing at Business Insider, observes: "We can't just let a story like this be interesting and mechanically unique. Instead, it's got to become a morality play."

Let's unpack the most prevalent takes to penetrate the miasma of misunderstanding and misrepresentation that already shrouds the GameStop story. *Then* we can figure out what, if anything, it means for finance writ large.

To recap, briefly: Individual investors, many of them taking their lead from a forum on the Reddit online community named WallStreetBets, started piling into shares of GameStop, a money-losing video- and computer-game retailer with 5,000 stores facing a bleak future as game-buying shifts from physical products to digital downloads.

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Column: Explaining the Reddit-fueled run on GameStop

Jan. 26, 2021

During January, GameStop shares soared nearly 2,500%, from $18.83 to $483, before pulling back.

The rise was turbocharged by purchases of call options, which allow the buyer to acquire shares at a set price at a point in the future, but don't require as much capital per share as actual share-buying.

Brokerages such as Robinhood (more on them below) allowed customers to buy and sell without paying a commission, removing a source of friction that might have led some players to think twice before buying.

All this produced billions of dollars in losses for investors who had sold the stock short (by borrowing shares and selling them, in the expectation that they could buy them back later at a lower price, return them to the lenders, and pocket the difference). This is known as a short squeeze.

The buyers have gleefully declared victory over the shorts. Some, having played with GameStop and a few other shares such as AMC Entertainment, have moved on to new crazes, including what looks like an attempt to drive up silver prices.

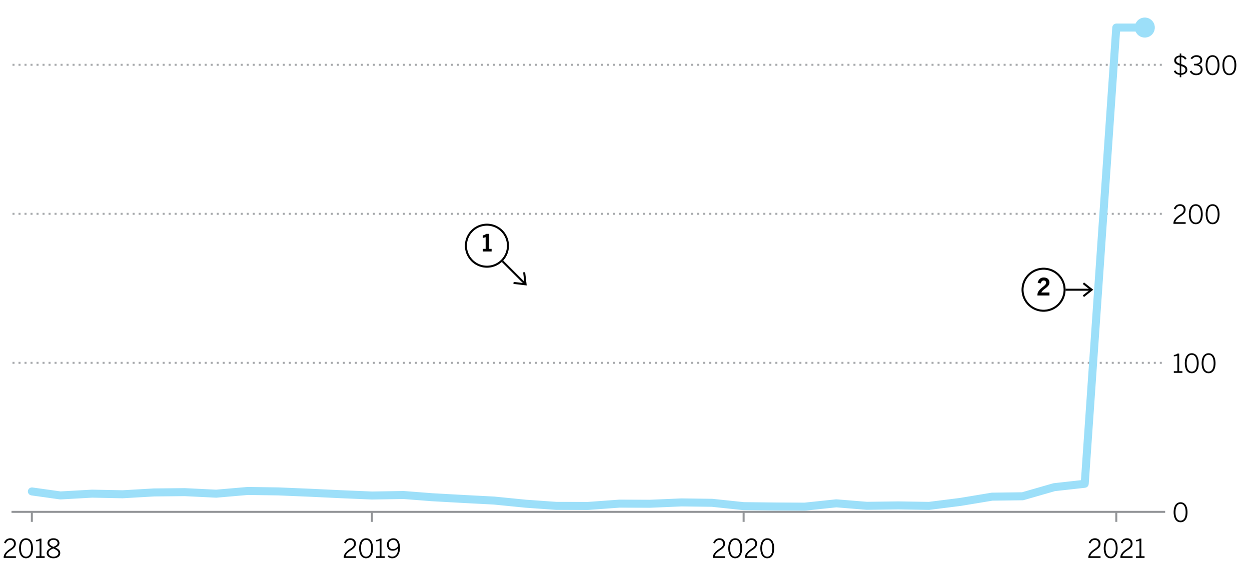
At the time of writing, some air appears to be leaking out of GameStop, which fell $100, or nearly 31%, in Monday trading on the New York Stock Exchange, closing at $225. But it has fallen and recovered before. We'll see.

So what's the right way to think about all this?

GameStop stock's long slump, sudden success

GME shares remained in the doldrums after suspension of their dividend in June 2019.

Price per share



(1) **June 2019** Dividend suspended

(2) **January 2021** Retail buying spree

1. Short selling is not the problem. For some reason, the Reddit-inspired buyers focused on short sellers as both master manipulators of stock and proxies for Wall Street generally. Neither is true.

Corporate managements hate short sellers, because who wants ants at your picnic? Managements whose shares look overvalued by conventional metrics and therefore have a big stake in promoting positive sentiment — think Elon Musk and Tesla — detest shorts with a passion.

Firms have attacked short sellers by "accusing them of crimes, suing them, hiring private investigators to probe them, and requesting that the authorities investigate their activities," among other things, investing expert Owen Lamont has observed.

Some GameStop advocates have pointed to reports that short interest in the stock reached 140% of outstanding shares in the marketplace. This is a widely misunderstood metric.

It's an artifact of stock market accounting, derived from the fact that a share can be borrowed more than once, which makes it seem that more shares are short than is possible. Matt Levine of Bloomberg has a good explanation here.

It does *not* signal "naked shorting," in which people short shares they haven't borrowed or for which they can't identify lenders in a process known as a "locate," and so fail to deliver the shares to their buyers. In most cases involving traditional stock investors, naked shorting is illegal and the Securities and Exchange Commission will investigate if it thinks it's happening. Executives of companies on the downswing sometimes complain that they've been attacked by naked short-selling, but often they're just trying to deflect blame.

Short sellers didn't drive down the value of GameStop. The company's management did that, mostly by failing to adjust to new realities in the gaming market.

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Column: GameStop isn't the first stock market mania, and it won't be the last

Jan. 27, 2021

On June 4, 2019, the company reported that its same-store sales had fallen by more than 10% over the previous year and might fall by another 10% in the following year. Management eliminated the company dividend to save $157 million in cash annually.

The stock, which had lost almost 40% that year already, fell an additional 35% the next day and remained roughly in the $4 to $6 range until late last year, when entrepreneur Ryan Cohen bought a big stake and started pushing management to turn the company into an internet leader.

By the way, lots of Wall Street firms are still shorting the stock — as the first group took their losses, others plainly have stepped in, reasoning that the value of a money-losing mall retail has-been is probably closer to $0 than $483, a price that made it look more valuable than Delta Air, Kroger supermarkets and Best Buy.

One last word: Short selling is good for the market. Numerous academic studies have found that constraining short selling in a stock tends to make that stock overvalued, to its investors' ultimate disadvantage.

2. Why did Robinhood shut down buying of GameStop shares?

One of the milestones in the GameStop saga for conspiracy theorists came Thursday, when Robinhood, the zero-commission broker that numbers many GameStop plungers among its millions of customers, announced that it would cease taking new orders for GameStop and a host of other stocks enjoying Reddit-fueled run-ups. Customers could, however, hold their positions or sell.

To some, this looked like a ploy in which Robinhood, which had long claimed to be "democratizing" the stock market by giving the little guy a path to trade for free, was just fronting for the big guys after all, protecting the short sellers by not letting GameStop rise any further. In fact, GameStop started falling after the announcement, Q.E.D.

Among the sub-conspiracies was that Robinhood was actually owned by Citadel, a Wall Street firm that had already bailed out one of the GameStop short sellers.

That doesn't appear to be true, but Citadel is a big customer of Robinhood; Citadel, which manages actual stock trading for Robinhood and other brokers, pays Robinhood to route Robinhood customers' trades its way, a controversial system known as "payment for order flow."

The explanation, as Robinhood and other brokers that also halted buy orders for GameStop tried to communicate, was that the trading restrictions were required by Wall Street plumbing. Essentially, the brokers have to post their own capital to guarantee that a customer's stock trade will actually happen, which takes two days.

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Column: U.S. billionaires are done with Social Security taxes for 2021, but you'll pay all year

Jan. 8, 2021

When GameStop and other Reddit-fueled stocks took off, the brokers were ordered by Wall Street clearing firms, which sit at the top of the order-execution pyramid, to post tens of millions of dollars more in capital to guarantee those trades. Those capital rules, incidentally, were put in place by regulators in an effort to avert a repeat of the 2008 crash, which really hurt the little guy.

Robinhood didn't have that money in hand, and to keep from failing, it had to clamp down on the trades. The brokers had a hard time explaining this to laypersons such as CNN anchor Chris Cuomo, who conducted a train wreck of an interview with Robinhood CEO Vlad Tenev on Thursday.

Cuomo apparently has nominated himself as protector of the small investor.

"When the big guys, including one of the main investors in your company [he meant Citadel] started to lose, you shut down the game to starve the little guy," he said. "I used to work in finance, so I know this stuff," Cuomo said, then proceeded to demonstrate how little he does know.

He asserted that only the New York Stock Exchange has the authority to "shut down" trading in GameStop or anything else, a power it exercises only in the limited cases when it suspects fraud or material news is pending. "If anyone was going to … shut it down, it should have been them," Cuomo said. "But it wasn't, it was you."

In fact, there's a third reason the NYSE can shut down trading in a stock — when it becomes so volatile that the price goes out of whack. As it happens, the NYSE shut down trading in GameStop *19 times* Thursday, for up to about five minutes at a time. That was after pausing trading 13 times over the previous three days.

The trade has laid bare some inequities in stock trading that might benefit from closer scrutiny by lawmakers and regulators.

Dennis Kelleher of Better Markets, a superbly informed critic of Wall Street, says Congress should hold hearings "focusing on the key issues, not just the apparent or obvious issues, including everything from fragmented markets that are currently designed more for wealth extraction by the biggest financial firms to market manipulation and conflicts of interest."

Kelleher observes that it's still unclear how capital requirements affected Robinhood. If they did, he adds, that might mean that the rules for Robinhood weren't tight enough to begin with — one area that congressional hearings might delve into.

He also says that payment for order flow should be outlawed because it could produce conflicts of interest, including the ability of the firms receiving the flow to trade ahead of customers.

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Feb. 3, 2020

“The ‘zero commission party’ is a one-sided party based on a fraud,” he adds. Customers may not pay commissions, but that doesn’t mean they’re not paying in some other way, as “the de facto commission and additional costs are merely shifted and disguised into after the fact costs and fees.”

3. You say you want a revolution? What’s most amusing about the GameStop story, in a sad way, is the notion among small investors that they’re striking a revolutionary blow against the Wall Street establishment.

“My goal isn’t to get rich on this, my goal is to bankrupt these billionaires,” says John Motter, an unemployed Angeleno who invested more than he received from the government’s coronavirus stimulus check in GameStop, as my colleagues Daniel Miller, Suhauna Hussain and Hugo Martìn reported. “I would buy magic beans on the street from a stranger if he said they had the potential to ruin a billionaire’s life.... A lot of people are really angry, and no one’s forgotten 2008.”

In fact, many on Wall Street are enjoying the ride, even as proxies for small investors. As of last March, the three biggest investors in GameStop were the investment management firms Fidelity, Vanguard and BlackRock, which combined owned more than 50% of the shares.

BlackRock reported that as of Dec. 31 it still owned 9 million shares, which means that over the last month the firm and its clients added about $2.1 billion to the value of their holdings (on paper).

By almost any measure, GameStop and its fellow internet meme stocks are a sideshow. Their run-up is barely even a blip on the nearly $100 trillion in worldwide stock market value. Short sellers may become more circumspect about disclosing their activities to avoid becoming targets of a raging mob, but they have to disclose something, by law.

In any case, most short sellers have tended to avoid broadcasting their positions, because that often brings in investors on the other side. Hedge fund operator Bill Ackman discovered this in 2012, after he announced an audacious short bet against Herbalife, only to find billionaire Carl Icahn betting against him, perhaps just to be contrary. Ackman lost the contest, eventually closing his position at a loss.

4. Don't trade, just invest. Those who complain that Wall Street is a casino rigged against the little guy are doing it wrong. As in real casinos, the most consistent winner is the house, especially when it's got small-time plungers on the floor.

What's seldom understood is that that whole edifice of stock market advice, including CNBC's blanket coverage, is geared toward traders, not investors. It aims to get viewers into the game, where they're vulnerable to getting fleeced.

Trading stocks as a game requires research, timing, capital and luck, all of which are in short supply in the small-investor community. One also needs a tolerance for gains being eaten away by transaction costs and taxes.

Investing for the long term, however, can overcome these disadvantages; the average index fund focused on the Standard & Poor's 500 stocks has returned an average of more than 7% a year over the last couple of decades.

But that's not as much fun. You won't have momentary gains that make your heart race and have you believing you've kicked a billionaire in the behind, but you're less likely to discover that the billionaires are still, when the smoke clears, the winners.

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