6 Takeaways from the GameStop Stock Market Drama

Date : January 29, 2021

Lots of investors are watching the war on Wall Street right now involving the stock of GameStop, the retail store in the mall that sells games, consoles and and even drones. As of the end of the last week in January, shares of the once-humble little GameStop were trading in the triple digits around $190, though the price had dropped 40% from the previous day when many platforms put restrictions on the stock. Midweek, GameStop's value was up by more than $10 billion.

With the help of analysis from the Wharton Business Daily radio show on SiriusXM, here are six things that investors can learn from GameStop's crazy ride:

1. **The players**. This battle is between retail investors – everyday investors – and professional investors, or hedge funds, which pool investment money from wealthier investors in hopes of making their money grow. Wall Street Bets, a small group of retail investors on Reddit, is behind some of the GameStop stock spike, reportedly taking on hedge funds and Wall Street for short selling the GameStop stock.

2. **The short sell**? This is a trade that allows investors to bet on the price of a stock going down, rather than up. "With short selling, an investor is selling shares before they buy them," explained Sasha Indarte, an assistant professor of finance at the Wharton School, University of Pennsylvania. "This type of transaction is happening in reverse from a typical transaction. You're selling before you buy, and in order to make that happen you have to borrow shares. When you're doing these steps in a different order, you're still hoping to sell high and buy low. But now, because you're selling before you're doing the buying, you hope that the stock price is going to fall over time."

3. **A tricky move**. Short selling is more common among investment professionals than everyday investors because "the risks are potentially much higher when you short sell a stock compared to when you are just outright buying and later selling a stock," said Indarte. In other words, the chances are higher that you will lose the money you invest. But if you don't, the gains can also be higher.

4. **Squeeze play.** Headlines are referring to this battle as a "short squeeze." Companies can have what's known as "high short interest" when analysts are pessimistic about certain things happening with the business. GameStop fit that profile. "Gamestop's business model might face some challenges in a year like 2020 and 2021 during a pandemic when more people are buying online rather than going to stores in person for their shopping," noted Indarte. "Investment professionals and hedge funds were pessimistic so they took out these short positions. When there's a lot of short interest, what can happen is that when there's a bit of a price increase, you can get more momentum for further prices increases that end up further hurting the short position (remember, you bought the stock betting it would go down). If you're losing a lot of money on a short position, you may have to close out some of it. Now to close [the transaction], since you already sold, you're now going to have to buy. And if there's a lot of buying that's being induced by this price increase, that can further increase the price."

5. **A bad move?** Is there something wrong with the effects that shorting can have on a company? While the battle between small and big investors might suggest it, not everyone agrees. "One view is that it's a trade that allows people to act on their beliefs," said Indarte. "Similarly, if you're buying a stock, you could stop buying the stock and that's going to have an effect on the price, as well. So, it's not clear that the shorting itself — the fact that trades are being executed in that way — is necessarily bad. And the option to short versus buy gives investors more flexibility and thus should mean that the prices are going to be more informative and reflect more of the

beliefs and information of investors."

6. **The end game**. While the portrait of the retail investor taking on Wall Street is dramatic, even compelling, it's likely not going to end well. "The hedge funds that were engaging in the short-selling activity are feeling the most acute pain right now," because the price of GameStop is high — 200% higher than it was at the beginning of the week, said Indarte. "We're going to potentially see more pain felt by the retail investors that are bidding up the price of GameStop right now. It's hard to justify the prices that we've been seeing for the company based on the company's fundamentals (things like cash flow that analysts study to understand the longer-term potential of a stock). I wouldn't expect the stock price to stay this elevated. It's difficult to think of a potential change in fundamentals at the company that would result in such a high increase in its valuation. It looks like it potentially could be bubble-like when it's not linked closely to fundamentals. What that means is that when the buying activity slows down, some of the people that opened up those positions might experience losses later on. So, we might end up seeing losses both on the hedge fund side and also the retail side."