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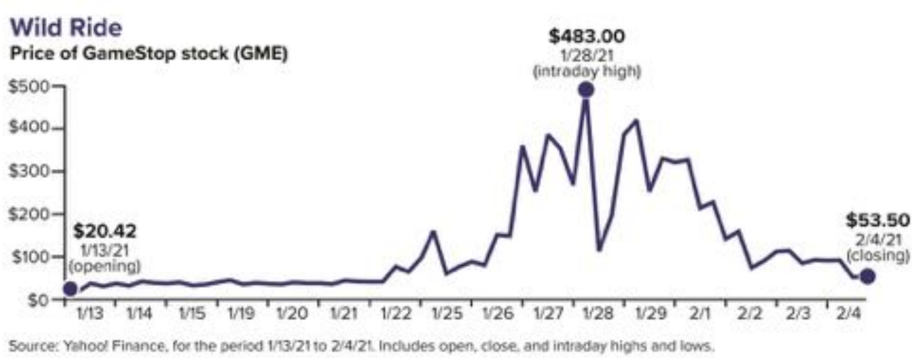
GameStop, Reddit, and Market Mania: What You Need to Know

At the heart of this story are two very different sets of investors: professional managers of multibillion-dollar hedge funds and a small army of individual investors connected through social media.

Over the course of 11 trading days from January 13 to January 28, 2021, the stock of GameStop, a struggling brick-and-mortar video game retailer, skyrocketed by more than 2,200% — creating a mix of excitement and concern throughout the financial world, as well as among many people who pay little attention to the stock market.[1] Other stocks of small, struggling companies made similar though less dramatic moves.

At the heart of this story are two very different sets of investors: (1) professional managers of multibillion-dollar hedge funds, who took large, risky positions betting that GameStop stock would drop in price; and (2) a small army of individual investors, connected through social news aggregator Reddit and other social media sites, who worked together to buy large numbers of shares in order to drive the stock price up.

As the stock price rose, fund managers were forced to buy more and more shares at ever-increasing prices to "cover their bets," while individual investors continued to buy shares in hopes of continuing the momentum. The opposing forces created a feeding frenzy that sent the stock to dizzying heights far beyond the fundamental value of the company.[2] The stock price peaked on January 28 and lost almost 90% of its peak value over the next five trading days.[3]



If you are confused, concerned, intrigued — or a combination of all three — here are answers to some questions you may have about the recent market volatility triggered by "meme" stocks, an Internet term for stocks heavily promoted through social media.

1. What is a hedge fund, and what were the hedge funds doing?

A hedge fund is an investment company that uses pooled funds to take an aggressive approach in an effort to outperform the market. These funds are typically open to a limited number of accredited investors and may require a high minimum investment. Hedge funds use various high-risk strategies, including buying stock with borrowed money or borrowing stock to sell, called buying or borrowing on margin. This enables the fund to increase potential profits but also increases potential losses. (Individual investors can use these high-risk techniques, but the investor must meet certain financial requirements in order to establish a margin account and accept the increased risk.)

In this case, certain hedge funds borrowed shares of GameStop and other struggling companies on margin from a brokerage firm and sold the shares at the market price, with the expectation that the share prices would drop significantly by the time they had to return the shares to the lender. The funds could then buy shares at the lower price, return the shares, and pocket the difference, minus fees and interest. When GameStop share prices began to rise quickly against expectations, the "short sellers" began to buy shares at market prices in order to protect against future losses. These purchases helped drive share prices even higher — supply and demand — which led to more purchases and even higher prices. This created a situation known as a short squeeze.[4]

To understand the level of risk faced by the short sellers, consider this: An investor who actually owns shares of a company can lose no more than 100% of the investment, but there is essentially no limit to the potential losses for a short seller, because there is no limit to how high a stock price might go. This is why short sellers were willing to buy at ever-increasing prices, accepting large losses rather than risking even larger losses. In addition, they were forced to add additional funds and/or other securities to their accounts to meet margin requirements; investors must keep a certain percentage of the borrowed funds as collateral, and the higher the stock prices went, the more collateral was required in the margin accounts.[5]

2. What is Reddit, and what were the Reddit investors doing?

Reddit is an online community with more than a million forums called subreddits in which members share information on a particular topic. Members of a subreddit dedicated to investing coalesced around a strategy to buy GameStop stock in order to push the price up and squeeze the hedge funds. The potential for this strategy was first suggested on the forum in April 2020, but it exploded on Reddit and other social media sites in January 2021, after a change in the GameStop board of directors that encouraged bullish investors coupled with an announcement from a well-known short seller predicting that the stock price would quickly drop.[6]

While some investors genuinely believed that GameStop was undervalued, the movement developed into a crusade to beat the hedge funds in what amateur investors perceived to be a "game" of manipulating stock values, as well as a more pragmatic belief that there was money to be made by buying GameStop low and selling high. The fact that many young investors were gamers who felt an affinity for GameStop added to the sense of purpose.[7]

The strategy worked more powerfully than the amateur investors expected, and some who bought the stock in the early stages of the rally and sold when it was flying high earned large profits. However, those who joined the excitement later faced large losses as the stock plummeted. Once some hedge funds had accepted losses and begun to close their short positions, there was no longer demand for shares at inflated prices.[8]

3. Why did brokerage firms limit trading activity for certain stocks?

At various points during the peak trading activity, some brokerage firms stopped the trading of GameStop and other heavily shorted and heavily traded stocks. They also placed restrictions on certain stocks, limiting trading to very small lots and/or raising margin requirements. In a typical situation, an investor must maintain a 50% margin, meaning the investor can borrow shares or funds equal to the shares or funds in his or her account. Restrictions varied in response to the recent trading, but at least one brokerage firm raised margin requirements on certain stocks to 100% for long positions (purchasing stocks to hold) and 300% for short positions.[9]

The stoppages and restrictions elicited accusations of unfairness from investors and some members of Congress, who believed the brokerage firms were protecting the hedge funds. In fact, the moves were dictated in large part by clearinghouses that process trades from the brokers. These clearinghouses require that brokers keep a certain level of funding (collateral) on deposit in order to cover both sides of any given trade. As trading and values increased, clearinghouses asked for larger deposits. By halting and/or restricting trading of highly volatile stocks, brokers were able to reduce the required collateral, which enabled them to meet the new deposit requirements in a timely manner.[10]

The restrictions also helped protect investors from being overextended and suffering outsized losses amid extreme volatility. And to an extent, they protected the broader stock market. The New York Stock Exchange (NYSE) regularly suspends trading of individual stocks when price swings exceed certain limits. On February 2, when the price of GameStop was plunging, the NYSE suspended trading five times throughout the day, with each suspension lasting less than 12 minutes. Although GameStop remained in the spotlight, more than 20 other stocks also had trading suspended throughout that day.[11]

4. What happens next?

It may take months or years before the full effects of the recent activity play out in the financial markets, but one clear takeaway is that social media, combined with accessible low-cost trading platforms, allows like-minded groups of retail investors to exert power that matches large-scale institutional investors. More than 10 million new brokerage accounts were opened in 2020, and many new investors are trading securities online and through smartphone apps.[12]

Some hedge fund managers have already stated that they will rethink their focus on short selling.[13] And new services aimed at providing tools for professional investors to track investing discussions on social media platforms have quickly risen and may become a staple of investment research.[14]

Although the larger stock market remained resilient throughout the episode, extreme volatility is always a concern, and the Securities and Exchange Commission issued a statement saying, "The Commission is closely monitoring and evaluating the extreme price volatility...[which] has the potential to expose investors to rapid and severe losses and undermine market confidence. As always, the Commission will work to protect investors, to maintain fair, orderly, and efficient markets, and to facilitate capital formation."[15]

What about GameStop and other companies involved in the volatility? The huge price swings had little or nothing to do with the actual value of the companies, and they will need to make fundamental business changes to address the underlying weakness that caused them to be targeted for short sales in the first place. The changes on the GameStop board that helped spark the rally, adding leaders with online expertise, may help the company compete in the marketplace, but that remains to be seen.[16]

As an investor, the lesson for you might be to tune out market mania over "hot stocks," especially when there is little to back up the sudden interest other than speculation. The wisest course is often to build a portfolio that is appropriate for your risk tolerance, time frame, and personal situation and let your portfolio pursue growth over the long term. This strategy may not be as exciting as the wild ups and downs of stocks in the spotlight, but it's more likely to help you reach your long-term goals.

The return and principal value of stocks fluctuate with changes in market conditions. Shares, when sold, may be worth more or less than their original cost. Investments offering the potential for higher rates of return also involve higher risk.

Margin accounts can be very risky and are not appropriate for everyone. Before opening a margin account, you should fully understand that: you can lose more money than you have invested; you may have to deposit additional cash or securities in your account on short notice to cover market losses; you may be forced to sell some or all of your securities when falling stock prices reduce the value of your securities; and your brokerage firm may sell some or all of your securities without consulting you to pay off the loan it made to you.

1, 3) Yahoo! Finance, for the period January 13, 2021, to February 4, 2021

2, 4–5) Kiplinger, January 30, 2021

6–7) Bloomberg, January 25, 2021

8) *The New York Times,* February 3, 2021

9) CNBC, January 28, 2021

10) *The Wall Street Journal,* January 29, 2021

11) New York Stock Exchange, 2021

12) *The Wall Street Journal,* December 30, 2020

13) *Barron's,* January 29, 2021

14) MarketWatch, February 1, 2021

15) Securities and Exchange Commission, January 29, 2021

16) *The New York Times,* February 1, 2021

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