HMV WEALTH ADVISORS

Monthly Client Letter
February 2021

In 1984, 33-year-old Gary Kusin started an educational software retailer named Babbage's. Started in Dallas, Texas, Babbage's quickly expanded from educational software to focusing on Atari and Nintendo video games. Little did Gary know at the time, but his company would one day become a symbol of a market movement and capture the attention of households, Congress and regulators across the United States. But before we get into what Gary Kusin's small company became, we need to understand a few key terms and mechanics of a stock market.(1)

Stock markets are exchanges, and in their simplest form are simply open-market auctions. Think Sotheby's or a local estate auction, where potential buyers raise their paddle until only one buyer remains - but at a much larger scale. Thousands of buyers meet thousands of sellers every day through brokers on stock exchanges,(2) and the items of interest are shares of a company's stock. Generally, none of the money in these transactions goes to the company; rather the two parties barter for existing shares of the stock. Most of this activity has moved digitally, but the fundamentals are the same: every transaction has a buyer and a seller, and presumably both sides think they are getting a good deal.

Occasionally an investor may see a stock that they believe is overvalued. In other words, they believe that buyers are willing to pay more for that stock than what it is actually worth. For those brave investors who are so convicted that a stock price is trading higher than its true value, a process exists for them to bet against the company. Through a broker, the investor connects with another investor who owns shares of the stock, borrows the shares and then sells them. This is called shorting the stock.(3) Assuming the price of the stock declines, the investor can buy back the shares at a lower price and return them to the lender, pocketing the difference in price. However, just as a bank may monitor a borrower's credit worthiness, the lender of the shares needs protection to ensure that the borrower will eventually be able to repay the loan. The broker of the deal monitors how much it would cost for the borrower to purchase the shares compared to how much money the investor has available in their account. If the price of the stock rises too much, the broker can demand the investor either put more cash into their account or return the shares. If the investor is forced to return the shares, they must go back out to the market, find a buyer willing to sell and repurchase them. This, known as a margin call in financial jargon, essentially just protects the lender against someone taking on a loan they can't repay.

So, what does all this have to do with a software retailer from the 80s? In 1999, fifteen years after being founded, Barnes & Noble purchased Babbage's for nearly $200 million.(4) Three years later, Babbage's was combined with other similar retailers, and the company went public under a new name, GameStop.(5) Now, nearly 20 years after going public, GameStop has become a stock market phenomenon with the stock price jumping from $18.84 on December 31, 2020 to $325 at the end of January, a 1,625% jump in a single month.(6)

For those watching the financial media (or social media for the matter), the obvious question is how can this happen? Well, a lot of investors were betting against GameStop at the end of last year – a lot. In fact, every share of GameStop had been borrowed and sold, at least once.(7) In January, more investors started to take interest in buying shares of GameStop, partially spurred by speculative investors in an online forum,(8) and that demand pushed the price of GameStop higher. As the price continued to climb, the investors who had borrowed shares were forced to either put more money into their account or buy shares at a higher price to close their loan. As the price of GameStop's stock climbed, more investors bought shares to cover their loans, which created more demand for shares of GameStop's stock, which continued to push the price higher. This phenomenon is called a short squeeze, and the cycle continued throughout January, with the stock hitting a high of $483 on January 28.(9)

What does this all mean for your portfolio? Honestly, not a lot. You own thousands of stocks to mitigate the risk of any short-term dysfunction of any single name in the markets. Investors who bet against GameStop were wrong, at least for now, and they had to buy a lot of GameStop stock to make up for their error. If margin calls didn't exist, January may have looked very different for the price of GameStop's stock. But, margin calls exist to protect lenders and they functioned as expected. Thousands of buyers met thousands of sellers, and they agreed to exchange shares of a stock for an agreed upon price.

We know that on any given day, the stock market can look like a casino with random outcomes. But, when viewed over longer horizons, the outcomes are logical. That is why we continue to encourage our clients to look past the daily noise – no matter how entertaining – and keep a long-term focus. And in case you're wondering, we don't think that it's a good time to buy GameStop's stock.

Sincerely,

HMV Wealth Advisors, LLC

Message to clients: Please contact us if there have been any changes in your financial situation or investment objectives (or investment restrictions that you may wish to impose) that may affect our management of your accounts.

(1) source: https://news.gamestop.com/about-gamestop#ourhistory)
(2) Brokers, or more often market makers, would be similar to auctioneers in our example – they are a neutral party that help to facilitate the trade, generally for a small commission.
(3) This all happens in a very opaque part of the market called the securities lending market. Shorting a stock is extremely risky, and therefore this generally only happens at an institutional level. This is a vital source of information in an open, free market – this communicates negative sentiment towards a stock and creates a way for insightful investors to profit from companies that are setup to fall in value.
(4) source: https://www.wsj.com/articles/SB939241765778349890
(5) source: https://www.cnbc.com/2021/01/31/gamestop-craziness-hits-close-to-home-for-ben-kusin-co-founders-son.html
(6) source: finance.yahoo.com.
(7) source: https://www.forbes.com/sites/petercohan/2021/01/15/with-138-short-interest-board-change-sends-gamestop-stock-soaring/?sh=45812b3b6da8
(8) The online forum is the Subreddit, /r/WallStreetBets: https://www.reddit.com/r/wallstreetbets/
(9) source: finance.yahoo.com