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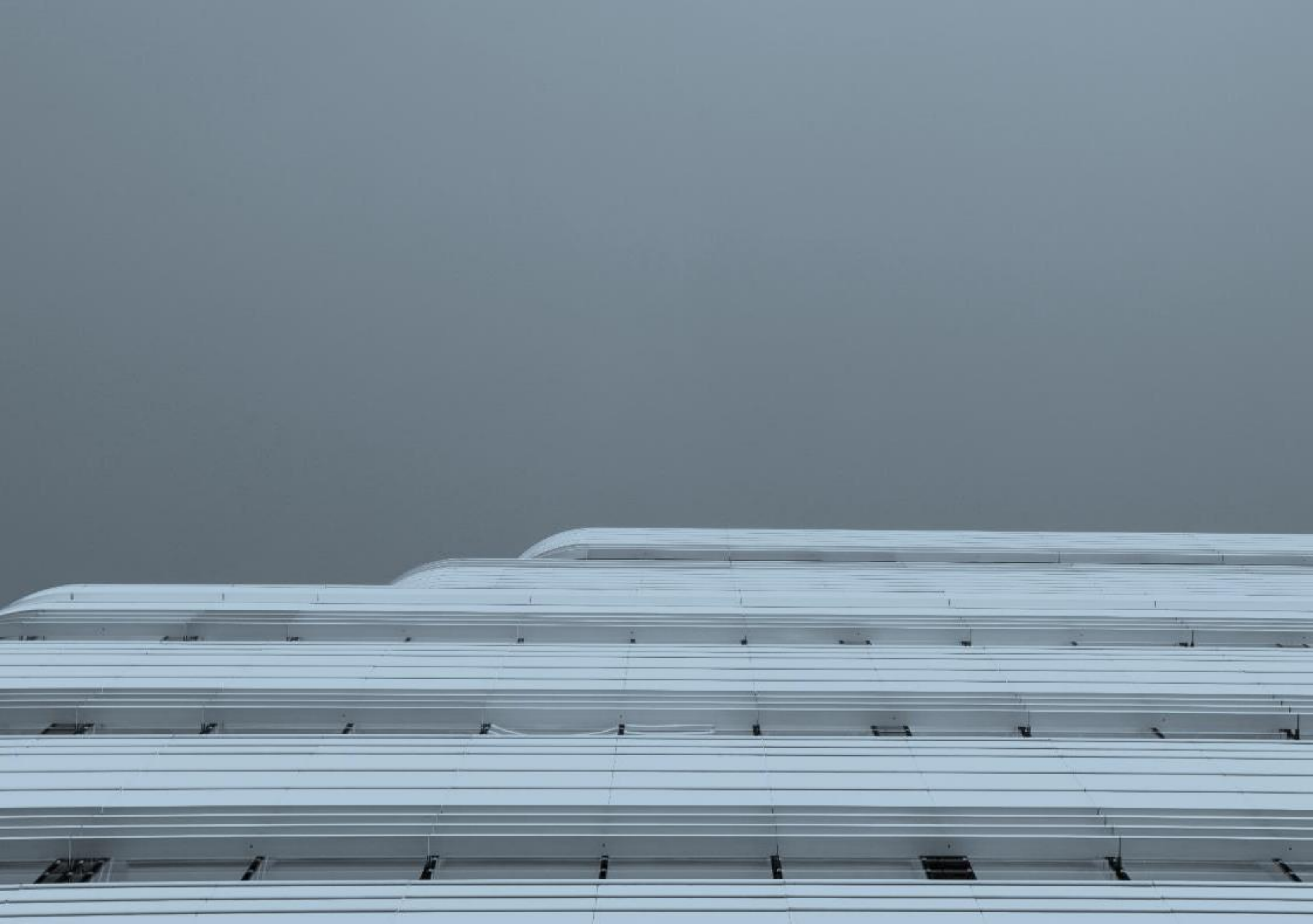
GameStop: A butterfly flaps its wings?



For some months it has been apparent that Lockdown is having a strange effect on all of us, and not in the direction of greater rationality. A legitimate question is how this will manifest itself amongst groups of individuals who are increasingly connected, virtually, by means of internet-enabled networks? With GameStop shares having appreciated by as much as 1,900% in January 2021, it is logical to suggest an answer. These proclivities toward odd behaviours, which individually might be only moderate, appear to escalate geometrically when linked together to produce extreme crowd-based madness. It is tempting to conclude that, when the Covid era ends, the short-term share price moves of the type we are seeing now will calm down. Alternatively, such is the shock that market participants are currently experiencing, this period may challenge the orthodox investment paradigm, which revolves paradoxically around indexation on the one hand and in active management, complete trust in the clairvoyance of the (over) confident stock-picker.

Never mind for now that these two dominant traits of the era are obviously oxymoronic! In actively managed portfolios the number of shares selected by the manager continues to reduce, driven by the apparently sensible inference that a limited share portfolio represents one of greater conviction. The question as to whether such concentration represents prescience on the part of the promoter, or merely over confidence, is for the main part overlooked. While a belief in analytical certainty and diverse passive indexation are contradictory, in circumstances in which a narrow bull market is dominant, both strategies can be seen to be rewarding their adherents. This paradigm has been strongly reinforced rather than challenged in the Covid-era.

The genesis of the current era lies not in the stock-picking success of the Warren Buffett-led fundamentalists, but in the active investment industry's fallibility in the face of the flow of greater information, available to all at the same time (Yikes!), and the consequent demise of the "information gathering" approach to stock selection. In the post-Enron world no one had an information advantage and if they did so it became one of questionable legality. The concept of "analytical advantage" was born and the myth was re-set that the fund managers and analysts who assisted them were infallible. No one appeared to question this proposition along the inevitable line that 50% must surely be below average, Lake Wobegon-style? The consequence was inevitable: clients, now secure in the belief that the fund manager was invincible, demanded, often via asset consultants, that portfolios should consist of ever fewer stocks. Once the technological revolution had produced a group of highly successful, generously capitalised firms the equity market became an infernal Doomsday Machine with the active leadership group reinforced, at least in the USA, by the "passive" leadership group.

Although contradictory ideas, the symbiosis between the two groups of largely identical shares became irresistible and the price-action mutually reinforcing.

What could break this hegemony became increasingly difficult to discern. The first casualty were professionals in our industry who believed that valuation-elastic might exert some check and balance on the concentration process. A second group (ourselves included) argued that with an equity market bifurcated into “Haves” and “Have Nots”, or disruptors versus disruptees, that there should be convergence. If there was a bimodal distribution of corporate ROA’s, even then at a point in time Haves would increase their asset intensity (if only through acquisition) while Have Nots reduced capital employed (by whatever means necessary). As a last resort all firms would have to embrace the magic of the internet, the profitability gaps would start to reduce and along with that inter-industry equity spreads would start to narrow. Covid appears to have dealt a blow to that theory, as it brought forward a decade’s worth of growth for internet firms and triggered crushing blows to certain analogue ones.

With the “rifle shot” precision of winner-identification now taken for granted, it was perhaps inevitable that highly incentivised Hedge Funds should want to have their cake and to eat it too. Dissatisfied with bringing skills to bear simply on the asset side of the portfolio, what if these titans applied the same logic to the liability side of their book? What if a positive return on assets could be combined with a significant negative cost of liabilities (i.e. funded by the declining share prices of the “Losers”). Certain Hedge Funds became the third component of the Doomsday Machine reinforcing upside valuation pressure on the digital winners and bringing forward undervaluation in the traditional areas.

The short seller squeeze occupies an honourable place in financial history. Just as the Trojans realised that the only way to kill Achilles was by an accurately fired arrow, so the new market arrivals have correctly identified massive design flaws in the current Hedge Fund model. These are revealed to be vulnerability around duration, a funding model that revolves around (lightly regulated) short selling and therefore enhanced leverage, and reliance on mark-to-market accounting as an accurate record keeper. All these beliefs are so divorced from what we know about the world’s reality as to be comical. However, these latent deficiencies lay unapparent for decades, and no doubt produced a complacency that now exacerbates the vulnerability of many Hedge Funds. It has taken the new disruptor class of investors to expose them, and this poses not just an existential threat to some of Wall Street’s most brilliant men (for they are almost always men), but also to the sustainability of the investment industry’s dominant paradigm.

With active concentrated portfolios, indexation preference and Hedge Fund self-interest wrapped around each other in a doomed ménage à trois, it has become impossible for those of us of a contrarian nature to know what would upset the apple cart. The answer, as Pavlov discovered in his dog experiments during the great Leningrad flood, is the mother of all shocks. Only that has the power to shift irrevocably behaviour that is deeply conditioned. It is early to speculate whether equity markets will change in the years ahead, but if they do it may be the GameStop saga that was the butterfly that flapped its wings.

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