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A Little Perspective on Crowdsourced Market Mania

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COMMENTATORS HAVE WRITTEN EXTENSIVELY ABOUT THE RECENT SURGES IN VARIOUS POCKETS OF THE EQUITY MARKET—MOST RECENTLY, IN HEAVILY SHORTED STOCKS.[1] Given the complexity and opacity of this market segment, the breathtaking moves left many investors understandably unsettled. While there is still more to learn about the volatility unleashed by the so-called "short squeeze," for now I'd like to address some client questions about the episode and attempt to put it in a larger context.

What Happened?

A group of retail investors identified a handful of beaten-down stocks deemed to be "COVID losers" and went long these companies, both outright and on a leveraged basis via options.[2] Positive investor sentiment, in combination with thin market liquidity, drove the stock prices higher. Call-options buying accelerated the upward climb, as banks (which sold the options) had to buy back the shares to hedge their short exposure and buy further exposure as the value of the options increased with the stocks' appreciation. (With a long equity position, you can only lose what you initially invested, as the stock price can't go below 0. But there is no ceiling on how high a stock can go, so with a short position, you are risking a theoretically unlimited amount of money.)

The meteoric rise in prices put some key market players in a precarious spot. Several hedge funds that were short these stocks were "squeezed" into buying them back at much higher prices. Meanwhile, the capital cushion of the brokerage firm processing most of the trades was depleted when the main clearinghouse for US stock trades required the firm to post additional collateral amid the frenetic trading.

How Did it Spill Over?

So how could stocks comprising less than 0.2% of the market cap of the S&P 500 Index[3] (as of January 27) wreak such havoc? The manic activity in this seemingly small slice of the market spilled over into the broader market when the hedge funds that were short these stocks and experiencing large losses were forced to trim back risk in other holdings, which had grown in size relative to their now-depleted capital.

Key Concepts

- A group of investors decided to purchase stocks and call options on a select group of stocks in an effort to drive their prices higher—and they succeeded in the short term.
- It's not that unusual to see a dramatic rise in certain stocks that appears to be divorced from underlying fundamentals.
- The conditions that created this latest "mini-bubble" could potentially occur again. Therefore, we could see some form of government intervention or regulation designed to tamp down market volatility of this sort.

[1] Investors short stocks by borrowing them from a broker and selling the shares at the current price in the hope that they can buy them back later at a lower price and return the borrowed shares in an effort to profit from the price difference.

[2] Investors can profit by buying a stock (going long) or by buying a call option on the stock, which costs a fixed premium. For traders who buy call options instead of the underlying shares, a stock-price collapse would result only in the loss of the premium paid to purchase the options contract, as buyers typically allow their options to expire in the face of a price decline. If the price rises, call-option buyers can exercise their right to buy the underlying stock at a lower, agreed-upon "strike" price.

[3] S&P 500 Index is a market capitalization-weighted price index composed of 500 widely held common stocks.

Forced sales frequently target the biggest, most liquid long-equity holdings, which in this case were large-cap tech stocks. Since large-cap tech makes up around 25% of the S&P 500 Index, sizable sales of these companies affected the performance of the broad index. (Forced sales are a common feature of market swoons that swiftly spread from a relatively small corner of the market.)

How Unique Is This Episode?

Clearly, there are some unique aspects to the recent short squeeze, but a dramatic rise in certain stocks that appears to be divorced from underlying fundamentals is not that unusual. Today's record-low interest rates, search for higher returns, accommodative policy, zero commissions, and plentiful market liquidity are all conditions ripe for performance spikes that may not be supported by fundamentals.

What *is* unique is the ability of social media to rapidly proliferate an idea to the masses and markets. Efficient markets depend on the free flow of capital to the best uses of that capital. If an argument for or against a company is promulgated on social media and sways large numbers of investors into action (i.e., trading), technicals can overwhelm fundamentals. When that behavioral dynamic is accompanied by a mismatch in liquidity (in this case, substantial volumes of smaller companies that need to be funded with bigger, more liquid companies), systemic risk can quickly become an issue (**FIGURE 1**).

FIGURE 1

Anatomy of a Vicious Cycle

Source: Wellington Management. For illustrative purposes only.

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Investment Implications

As of this writing, the recent trading frenzy appears to have subsided, reversing much of the gains and losses. It seems that the social-media-induced volatility was an isolated event without far-reaching consequences, but we shouldn't get complacent: The conditions that created this latest "mini-bubble" could potentially conspire again, triggering yet another speculative frenzy. Going forward, we could see some form of government intervention or regulation designed to tamp down market volatility of this sort.

- **Fundamentals still matter.** Low interest rates and high valuations in many parts of the market have intensified the search for return and could lead to more mini-bubbles, characterized by capital being misallocated to companies with poor business models and earnings prospects. However, most long-only active managers are unlikely to deviate from their strategies.
- **Long-term investors may be rewarded.** While short-term technicals can temporarily overtake the market and cause volatility to spike sharply, the historical linkage between company fundamentals and performance should ultimately realign. For equity investors in long-only active strategies, focus and discipline can be your strongest allies.
- **Technical dislocations of the kind seen recently can provide opportunities** for discerning investors to pick up fundamentally strong companies at favorable entry points.

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