February 2021

A GameStop Market: Wear Two Masks?

A Noble Struggle…

Last month, shares of a marginal retail company briefly rose to $500 from $20. Some thought this was a bad sign, but does it mean anything at all? First some background: GameStop (GME) is a chain of retail stores selling new and used video games and consoles. The business has been shrinking for many years. Forward earnings expectations peaked in 2016 at $4.45 per share. Back then the stock was trading in the market between $25 and $30 per share implying a total value for the company near $2 billion. Earnings have declined every year subsequently for the simple reason that video games (and consoles) can be easily purchased online and at lower prices. At the start of 2020 and prior to Covid19, earnings expectations had shrunk nearly 95% from their 2016 peak to only $0.24 per share. The shares, unsurprisingly, had also lost most of their value, and were trading around $4 to $5 per share. Covid19 didn't help the situation. Analysts further reduced their forecasts for GameStop earnings a loss of $0.90 per share. The prognosis was not good. GameStop appeared destined to join a growing scrap heap of marginal retail chains for which Covid19 was the final death-knell. It seemed a good bet that GME shares would eventually be worthless.

Nevertheless, during the Spring and Summer of 2020 the market was still valuing GameStop between $400 and $500 million. Professional investors (hedge funds) and others seized on this perceived mispricing and *sold short** GME shares with the idea that the stock would eventually go to zero or near zero. As a sign of their conviction but also a lack of prudence (as we will see) the number of shares sold short eventually exceeded all** of GME's outstanding shares.

…of the Little guy…

The stage was now set for the entry of Robinhood and his merry band of unwashed individual investors. Named for brigand who stole from the rich to give to the poor, Robinhood is a stock trading app that charges no fees to open accounts or to trade stocks. It even found a way to permit investors to use tiny amounts of money purchase fractional shares of popular stocks with prohibitively high share prices. This offer, together with some irreverent branding, made the app incredibly popular, especially with younger "Generation Z" investors and traders.

As the Robinhooders linked together on social media platforms, something of a collective consciousness formed. The group, acting in concert, *recognized it had the power* to move the market, especially in smaller company stocks. Certain individuals took note and started fomenting trading themes within the core of the group. The media, always keen to take the side of the little guy, started to champion the new muscle of individual investors

* I'm going to over-simplify this dramatically to give you only what you need to follow this discussion: When you buy a stock, you are said to be "long" the shares. You make money if the price goes up. To become "short" a stock you sell shares that you don't own. Put aside questions about the mechanics behind this, which is a long discussion. What you need to understand is that a short position generates a profit if the price goes down. A "short squeeze", in contrast, is a big upward movement in a stock price caused by short sellers buying a stock *en masse*, usually at a loss.
**Normally it is not possible to have more shares sold short than exist, but it appears to have happened in this case.

in a market normally dominated by big-money institutions. The press attention served to further inflate a sense of righteousness and manifest destiny within the group as it began to identify objectives.

…Against the Establishment…

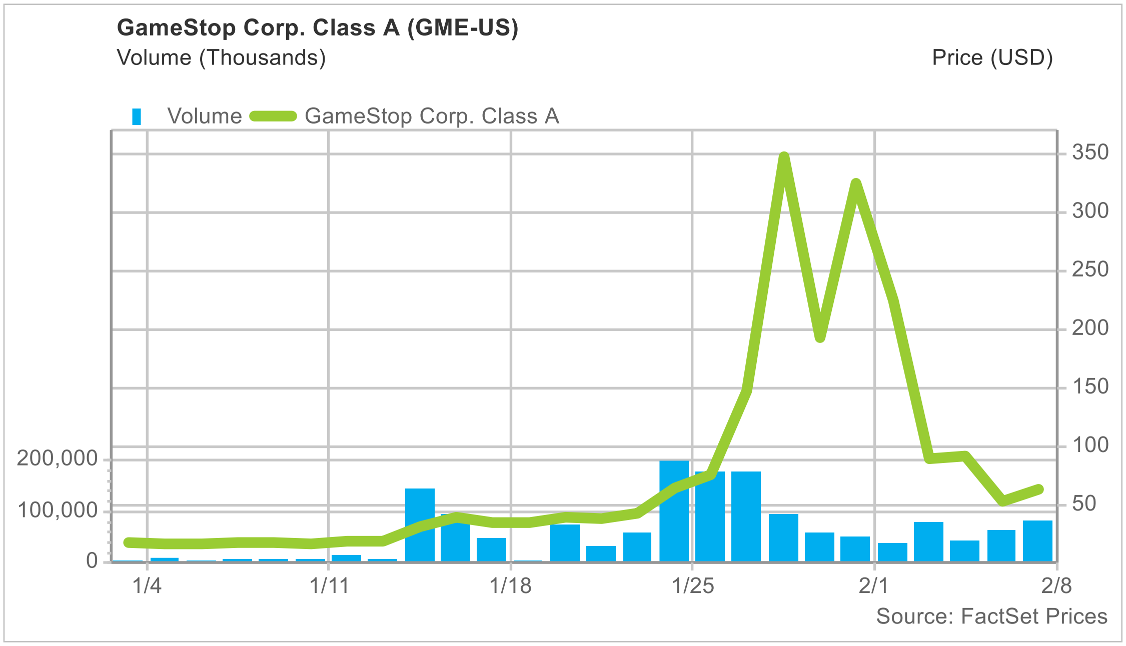
The market had been rising on hopes of reopening the Covid19-closed economy. The government was showering free money on lower income individuals including recent college graduates. Robinhood had democratized buying and selling stocks with free trades. An idealistic new generation, buoyed by attention from the media, was ready to move. It was now that GameStop and its outsized short interest (percentage of shares sold short) came into view.

The initial surge of Robinhooders into GameStop shares was triggered by modest fundamental news for the company. At the onset, some may have thought they were investing in an undervalued equity. However, the movement's intention quickly took on a different character. By banding together, the Robinhooders' buying power could drive the price of GameStop higher, which would in turn force the short-selling hedge funds to repurchase their shares, sending the stock price into the stratosphere. It was the little guy vs. billionaire hedge fund managers and this time, the little guy was going to have the upper hand.

Cheered on in chatrooms and on stock message boards, and marshalled by the press, the group pushed hard on shares of the mostly forgotten retailer, with the stock doubling to $40 in mid-January. It then nearly doubled again by the third week of January. It had now taken on a life of its own. Message board volume was surging but little conversation was about valuation or fundamentals. There were more rocket emojis than numbers. More expletives than analysis. Certainly, more hyperbole than humility.

…Or was it Something Else…

On January 27, GameStop shares exploded, jumping to as high as $350 per share and giving the company a $24.5 billion market value. Reports were now circulating that big hedge funds, especially Melvin Capital run by Gabe Plotkin, had been severely damaged from their short positions in GameStop and were forced to cover with enormous losses. There were celebrations all around! But the Gamestoppers had overplayed their hands. On the following day, January 28, the Robinhood app, which was itself overly exposed to the volatility in GameStop, was forced by the exchange to restrict trading. Other brokers followed suit. A last valiant attempt by GameStop believers took the shares to nearly $500 outside of market hours. But it was over.



…Because in the Initial Aftermath of the Wreckage it has been Revealed…

GME shares last week lost more than three quarters of their value, finishing the week in the mid $60s. The stock is probably heading back below $30. Stories of Robinhooders getting crushed are only now starting to filter out. However, at least a few reports have emerged that hedge funds *gasp* were among the principal actors and beneficiaries of the saga. Probably, a few brave short sellers also took advantage to sell the stock's big spike, but if they're smart, they'll likely keep their winnings on the down-low.

…That Robinhooders Are No Different than Their Supposed Nemeses

Was this a case of the lowly proletariat engaged in the timeless and noble struggle against unfair advantage of the establishment? Nothing could be further than the truth. The motivation of these investors, if they can be called that, was to profit from a situation. The Robinhooders worked together to collude and distort the value of GameStop shares, with little regard for the actual value of the company. And some cried foul when the rules of the game appeared to change mid-stream, even as their own actions likely crossed the line of legality. In a shocking display of bravado and ignorance, Reddit (a principal host of stock-chat message boards) yesterday ran a pipsqueak five-second add during the Super Bowl claiming that "powerful things can happen" and "underdogs can accomplish just about anything when they come together around a common idea". Wow. What have the GameStoppers accomplished? They proved that a group can massively distort the price of a small company stock temporarily. Yes, a few hedge funds lost a couple of billion bucks. But when this is over, hundreds of thousands or even millions of individual investors will be hurt in the washout. Powerful things, indeed.

Nothing New to See Here

Stock chat rooms and message boards have been around for more than 20 years. Pump-and-dump schemes using the media have been around for in the U.S. stock market for more than a century. Suckers have existed since the beginning of time. Not even the scale of the GameStop situation strikes us as extraordinary. No, the only thing new are the faces of the fresh generation being introduced to being fleeced by stock promoters.

Our Takeaway: Focus on The Long-Term, Own Fundamentals Not Hype

Some have called the speculative mania in GameStop and other names a warning sign. We don't see it that way. We see this a just another normal episode of individual investors trying their hands at gambling in the markets. This is a normal market occurrence and creates a compelling sideshow but it will not change the broader dynamics of the market, in our opinion. Our strategy is unchanged. We continue to manage a concentrated portfolio of deeply researched companies that were selected for their long-term ability to generate cash, grow earnings, and reinvest capital at high rates of return. Double-masking is not necessary or advisable.

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Yours,

John Zolidis
President & Founder
Quo Vadis Capital, Inc.
John.zolidis@quovadiscapital.com
www.quovadiscapital.com

Mr. Zolidis started his career in finance in 1996 following degree studies in Philosophy at Kenyon College and the University of Oxford. He has followed U.S. consumer companies as a senior analyst since 1999, mostly on the sell-side, writing research for institutional investor clients. He also managed money in a buy-side role at a long-short equity fund over 2013-2014. He was named in the Wall Street Journal's Best on the Street list in 2005. Mr. Zolidis founded Quo Vadis Capital, Inc., a Registered Investment Advisor (RIA) and research consultancy, in 2017 and works from New York and Paris, France.

Recent Press. We were cited on February 5 in Barron's in this article on Luckin Coffee. We were quoted on February 2 in Investors' Business Daily in this article on Chipotle Mexican Grill. We were cited on January 26 in Yahoo Finance and Gurufocus.com in this article on Academy Sports + Outdoors. On January 15, in Fortune, we were quoted in an article discussing Marc Lore's retirement from Walmart. Lastly, in January 14, on StreetInsider, we were quoted in another article about Walmart, this time on the company's plans to create a fintech startup.

Braving international travel again later this month. To be perfectly honest, we're getting pretty fed up with being stuck inside under curfew (from 6 pm to 6 am) during a rainy Parisian winter. I haven't seen blue sky in days! Florida sunshine sounds like a much better option. We're heading there next weekend for a week with family. Following that, I will be back in New York state for a week. Hopefully I will get to visit some retail stores and see how things look. I'll be wearing my big mask. Stay safe!

Washington and Lafayette in a Paris park. Would these revolutionaries have been GameStoppers?

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