MARATHON INVESTMENTS Newsletter, January 31, 2021

The S&P 500 closed at 3,714.19 on Friday, down 3.3% % for the week and also ended the first month of the new year in the red, down 1.1%.

The big story of the week was GameStop (GME) as the stock saw one of the biggest **short squeezes** of all time. GameStop closed at $325 on Friday, up more than 1,600% from about $18 at the beginning of the year. The speculative buying hit a fever pitch this week and we are experiencing a battle royal between an army of retail investors, communicating on social media, and Wall Street hedge fund professionals, who had made short bets on stocks like GameStop and AMC Entertainment. It is David versus Goliath: the small guys versus the big institutions.

Paraphrasing the father of value investing Benjamin Graham: In the short run the stock market acts like a "voting machine" (reflecting all kinds of irrational behavior), while functioning in the long run more like a "weighing machine" (reflecting a firm's true value).

What is Short Selling?
'Short selling' is a common practice at hedge funds. Investors engage in short sales when they expect a securities price to fall. It means an investor borrows shares and immediately sells them, hoping to buy them back later at a lower price, return them to the lender and pocket the difference.
An example, someone sells a stock short that is priced at $10. Maximum gain is $10 if the stock price goes to zero, but maximum risk is infinite if the stock keeps going up to $100, $1,000, etc. In that case, the short seller can only return the borrowed stock by covering his position through buying it back at a much higher price.
Elon Musk, whose Tesla stock is under continuous attack by short sellers (the attackers lost a lot of money doing that), believes that short selling is a scam. Musk: "You can't sell houses you don't own you can't sell cars you don't own, but you can sell stock you don't own."
In favor of the hedge funds however, shorts play a useful role in countering the market's mechanical bias toward bullishness. You can view them as sanitation engineers. They can be helpful uncovering bad company management and practices; short sales put pressure on managements to adjust their behavior.

A **'short squeeze'** is when many investors, looking to cover short positions when prices rise, start buying at the same time. The buying pushes the share price higher, making short investors accelerate their attempts to cover to limit their losses, which sends the shares spiraling higher in a feeding frenzy (feedback loop). A short squeeze is not a new phenomenon and has existed for over 100 years.

In the old days, investors and companies were protected by the **'uptick rule.'** The uptick rule requires that short sales could only be conducted at a higher price than the previous trade. The uptick rule was originally created by the Securities and Exchange Commission (SEC) in 1938 to prevent short sellers from conducting bear raids on companies whose stock prices were falling lower and lower and lower. Sixty-nine years later, at the end of 2007, the SEC dropped the uptick rule. Yes, you guessed it, one year before the Great Financial crisis and this enabled hedge funds to attack weak financial companies by selling their stocks short and driving them lower. Elimination of the uptick rule was a huge and costly mistake and the rule needs to be reinstated in my view.

What Happened Last Week?
We've seen a revolution of sorts this past week, as millions of retail investors organized themselves on the Reddit online forum WallStreetBets (WSB) to perform stock-and-option buys on heavily shorted stocks, especially GameStop (GME), driving their prices up massively. This put a ton of pressure on hedge funds that were short some of those stocks and had trouble covering at much higher prices.
After major losses, some of them (Melvin Capital and Maplelane Capital) received capital injections from other larger hedge funds. The GME short sellers are down $19.75 billion year-to-date and the hedge funds lost $70 billion in aggregate on their shorts this year.

Although many traders made a quick buck from call options, the narrative force behind this was populist anti-establishment sentiment, seeking to cause pain on random hedge funds for the sport of it, with the view that the stock market has been a casino for ages anyway and a bunch of “little guys” found a way to strike back. One of their mottos: You Only Live Once (YOLO).
You would think someone would have informed the Reddit crowd running up GME etc. that the victims are also US pension funds and college endowments who are by far the largest class of hedge fund investment clients in the U.S.

Why GameStop?
Why did the online day trading platform target GameStop? GameStop is an unprofitable mall-based video game retailer with a few recent signals of improvement. Many video games are now downloaded instead of purchased at stores and the expectation is that GameStop would move online as well.
At the beginning of the year, 136% of the float (shares available for trading) were sold short. Each share that is owned by someone had been borrowed and sold by someone else. This is very unusual, typically, only a fraction of shares that are available for trading are sold short. So, why is GameStop trading at $325 when everyone that understand fundamentals think the intrinsic value is $15 at best? The only fundamental that matters: 62 million shares short with a 50 million share float. It is physically impossible to cover this short.
At the beginning of the month, GameStop had a very small market capitalization of $1.3 billion (now: $23 billion) and when millions of day traders bought the shares, including call options, they were able to move the stock sharply upward. Earlier last week, call-options volumes reached a single-day record of 40 million contracts. Buying a call option is a cheap way to bet that a stock will rise. We’re really living the dream. This would not be possible with blue chip stocks, like Microsoft and Johnson & Johnson

After months of fighting to avoid bankruptcy, cinema giant AMC Entertainment (AMC) got caught up in the trading frenzy as well, rising sharply last week as Reddit day traders settled on AMC as another vehicle for their speculative bets against the hedge funds. The stock price tripled and it allowed AMC to raise equity and bankruptcy is off the table for now.

Trading Restrictions
On Thursday, several brokerage platforms including Robinhood and Interactive Brokers began shutting down the trading of those heavily shorted stocks, letting retail users ‘sell but not buy,’ while hedge funds still had access to the markets. This caused a massive backlash against these platforms from retail users and members of Congress. AOC and Ted Cruz agreed with each other for the first – and probably the last - time. In other words, as some saw it, “all traders are equal, but some are more equal than others.” Robinhood was changing the rules during the game, like a referee allowing pass interference right after the other team was denied a touchdown because of it.
After the backlash, Robinhood changed the narrative by saying they needed more cash as clearing houses, that help process and settle trades, asked them for more cash to cover the transactions during these extreme market conditions. After investors threw in $1 billion to shore up Robinwood’s finances, retail traders could buy again, but still with very strong restrictions, like only one share of GameStop.

Broader Market Impact
when a hedge fund loses a ton of money on their short positions, they need to raise cash to pay for short covering and re-balance their short and long positions. As a result, they sold part of their highly liquid long positions like Apple, Alphabet, Amazon, etc. last week. While the behavior of some stocks is reminiscent of historical stock market bubbles, I don’t believe the whole market is in a bubble.

So, is GameStop stock worth 400% more than it was a week ago? Frankly, no, and this behavior is a sign of market froth. When short covering dries up then GME stock will fall back to what it is worth fundamentally and this is a big risk for retail investors who own the stock. If GameStop’s future earnings don’t warrant a valuation of $23 billion it will eventually fall back to earth. In summary, a stock is worth the net present value of all future cash flows.

Remember the axiom: *The market will cause the most pain for the most people most of the time*.
That goes for the GameStop bears. It goes for the bulls, too.

Potential Regulation

Congress has begun to take particular interest in the recent happenings involving Robinhood, GameStop and the retail traders of Reddit. The Senate's committee on banking, housing and urban affairs announced that it will hold a hearing on the situation. Sen. Elizabeth Warren (D-MA) asked the Securities and Exchange Commission (SEC) to "ensure that securities markets better reflect prices that are in line with the intrinsic and fundamental value of underlying companies." The SEC issued a press release declaring that the regulator will safeguard mom and pop from themselves: "We will act to protect retail investors when the facts demonstrate abusive or manipulative trading activity." Proving any type of fraud, such as market manipulation, would require showing that traders conveyed false or misleading information to pump up the stock price. Most likely, it is just people whipping each other into a frenzy on the internet.

Hedge Fund Citadel paid newly minted Treasury Secretary Janet Yellen some $810,000 in speaking fees for a trio of talks in 2019 and 2020. That fact is relevant now, as Citadel not only accounts for a huge chunk of Robinhood's order flow business (about 35%), but also helped provide $2.75 billion in equity capital to wounded GameStop short-seller Melvin Capital.

The hedge funds are getting a taste of their own medicine these days. They need to re-think their business models to avoid getting taken to the woodshed again in the future. How come nobody covered their shorts less than a year ago when GameStop's short interest was also above 100% and the stock was under $3 a share?

What to Expect?

The combination of social media and zero commission trades has created a movement that will be difficult to stop, unless regulators step in. The WallStreetBets traders knew what they were doing and took advantage of a structural inefficiency in the markets. It is impressive that they were able to pull this off, especially when they were up against multi-billion-dollar hedge funds that should have known better. A massive group of people have organized to get a seat at the big guys' poker table. You can't ignore them anymore.

The market has become a casino where the Fed has you believing that Jay Powell is the blackjack dealer and you get your chips on the house. If I were a casino operator, I would be gravely offended next time someone compared me to the stock market.

Building wealth in the stock market requires patience and discipline. Marathon Investments selects quality companies with strong balance sheets which generate above average cash flows and dividends. The company is expanding and interested in new clients and referrals. Portfolios are personalized, there are no investment minimums and costs are low to ensure that you benefit the most in the ***long run.***

This newsletter is intended to be educational and for general interest only. It should not be seen as individual investment advice or as a recommendation to buy, sell or hold any security. All investments involve risks, including potential loss of principal.

Thank you for your interest, Hans

Hans Dijs – President
Marathon Investments, LLC
hans@marathon-investments.com
hansdijs@aol.com
(203) 984-4534
www.marathon-investments.com
Reaching financial success is a marathon, not a sprint. Slow and steady wins the race.
Marathon Investments, LLC is a registered investment advisor