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EVERYDAY EXPLAINED

What's Going On with GameStop?

CU Denver Business School's Yosef Bonaparte on Viral Stocks

Weeks ago, many watched with wonder as GameStop stocks surged to outrageous highs, thanks to retail investors—and an army of Redditors taking cues from billionaire entrepreneur Elon Musk—who bought up shares of the company, keen to squeeze the hedge funds that had shorted GameStop's stock. At its height, the price for a single share of the retailer's stock reached nearly $500, or almost 30 times its $17 valuation at the beginning of January. As the fervor died, prices dropped to $40 per share.

But by March, GameStop's share price had risen again. GameStop (GME) is trading above $240 a share as of this writing. To help explain what's going on, Yosef Bonaparte, PhD, an associate professor of behavioral and protocol finance in CU Denver's Business School, offers his expertise.

What Exactly Is Short Squeeze?

Short squeeze is the inherent risk of short selling, a practice wherein investors borrow shares and immediately sell them, hoping to buy them back later at a lower price, return the borrowed shares, and profit the difference. "Short selling means I sell a stock when I don't own it, but I still owe the stock," Bonaparte explains. In order to make a profit, short sellers count on the price going down between the sale of the borrowed stock and having to purchase shares to return the borrowed, sold shares.

It's no coincidence that the very act of short selling typically has the desired effect of further devaluing a stock. Per Bonaparte, "If you think it's not a good stock, then you short it, and it will go down. It's investing in bad versus investing in good stocks."

If the price goes up, though, that's the squeeze.

The squeeze happens when short sellers start buying stock to fulfill their IOUs, but, by buying those stocks, they unintentionally begin to raise the price of the shorted stock. This can send a signal to other short sellers, who then scramble to buy enough stock, which can initiate even more stock purchases. "Short squeeze happens with every company, even Musk's own company, Tesla, which was under pressure for years from short sellers," says Bonaparte. "The U.S. has one of the most volatile markets in the world due to short sellers."

This was the inherently risky situation for hedge funds that had shorted GameStop, only it was also about to go viral.

Enter Elon Musk and Robinhood

"When Elon Musk tweeted, 'Look at this short squeeze'—and Elon Musk has *believers*, not followers—the news came that there was opportunity there," Bonaparte said. Given Tesla's prior experience with outmaneuvering short sellers, Musk's tweet served as a battle cry. "I call Elon Musk a 'gladiator:' he destroys short sellers."

Musk is the type of influencer that Bonaparte and others in finance also dub a "noisy trader," because Musk's observation, once amplified on Reddit, inspired many more investors eager to make a quick buck (or $48 million, in one case). To Reddit's investor class, the fact that profit came at the expense of overly ambitious hedge fund managers was no small part of the appeal in buying up GameStop shares and only accelerated the viral stock's sharp rise in demand.

"GameStop went up another 64%, so then everybody else jumped on GameStop."

Because everybody else jumped on GameStop, brokerages like Robinhood temporarily halted purchases of volatile stocks like GameStop. It's the Securities and Exchange Commision's role to decide what to trade, and Bonaparte likened the situation to tech companies deciding which apps to block from their marketplaces. The social and political condemnation was swift. Why is it acceptable for hedge funds to systematically undervalue a stock through short selling, yet when individual investors buy that stock because its price is rising it's deemed market manipulation?

Though Bonaparte affirms that Robinhood had done the right thing morally to protect their customers, Robinhood ultimately reversed their decision and reallowed trading of GameStop shares.

As a result, the price went up. And then the price went down. In some ways, it's back to business as usual.

Except GameStop is back above $200.

What's Happening Now?

Bonaparte noted that GameStop's late February price increase reflects a victory on the part of the short sellers: their tactics led to the resignation of Chief Financial Officer Jim Bell, which coincided with the stock's second rise. "This shakeup is a bad example of how outsiders manage to fire a CFO who is only a few years into the position. Sometimes short sellers win."

But the simplest explanation for GameStop's ongoing share price volatility might be that, all things considered, the U.S. does not invest as much in increasing financial literacy as it should. That is why many people are more likely to take the advice of Redditors and social media figures than they are to take an economics class. In his research, Bonaparte pays particular attention to the disproportionate effect inadequate financial literacy has on marginalized populations such as Black Americans, as well as the conditions that lead to these inequities.

He also offers a blunt answer to the question of how to lower the volatility in the stock market:

"More reading. Less trading."

Written by Oliver Ward, University Communications

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