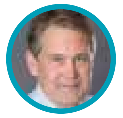

financial fitness

By Erik Ford

GET SHORTY

In the first two months of this year, the financial markets witnessed the phenomenal price increase in the common stock of Gamestop, a stock that had not traded above $20 a share in over three years and had traded below $3 a share in April of 2020. It traded up quickly in January 2021, reaching an intraday high of $483 a share on January 28, 2021. There was no great business plan announced or obvious reason for the value to increase and much of it was attributed to a "short squeeze," exacerbated by commentary on social media. Nothing in this article should be taken as a value judgment or recommendation for or against Gamestop, but simply to use Gamestop as an example.

First, a few definitions are in order. The terms "long" and "short" are used in the financial markets to describe ownership. If you are long something, you own it; if you do not own something, you are short that item. In the financial markets, one can sell something they do not own by borrowing it and then selling it. This is known as a "short sale." You have sold something you do not own (i.e., you were "short"). Of course, since you have borrowed what you have sold, eventually you must repay the loan with identical shares (and interest is charged on the loan as well). Why would someone sell something they do not own? If they expect the cost of replacement to be lower when they repay the loan than when they borrowed the shares and sold them, they make a profit. In other words, you borrow the stock, sell the borrowed shares (the short sale) and then buy the shares back at a lower price to repay the loan in kind. Simple, right? It is unless the share price increases.

As the underlying share price increases, potential losses increase for the short sellers and as each one reaches their point of maximum financial pain, they go out in the market to buy the now higher-priced shares to repay their borrowed shares and stop the financial bleeding. This increases demand for the shares, putting further upward pressure on the stock in question.

Now where this really gets interesting, or painful depending on your position (long or short), is when the short sales are greater than the shares available to cover the shorts. This was the case with Gamestop, for example, as short sales approached two times outstanding shares. The obvious question is how can this happen?

Let us say investor A owns 100 shares of stock X. Their brokerage firm, which is holding the shares for them in their account, uses their shares to loan to investor B (and yes, this is allowed). Investor A is still "long" the shares in their account (i.e., they own them outright). Investor B then sells the borrowed 100 shares of stock X to investor C (a short sale). Investor C having bought shares outright from investor B is now also long the shares. Investor C's shares are then used by their brokerage firm to lend to investor D, resulting in the same 100 shares being borrowed twice. It is important to note that the risk of investors A and C getting their shares back falls to their brokerage firms, not the fate of the short sellers. The brokers are the ones making money on the loan of the shares.

This situation is all well and fine until the price of stock X rises and the short sellers attempt to repurchase the shares they borrowed and sold in order to repay their loans in shares as required. You did not need to get an A in economics to know that if you have more short sellers trying to cover their shorts (repurchase sold shares) than there are available shares, the price will be bid higher and higher, especially if everyone knows it thanks to social media. This is the creation of the "short squeeze." The short sellers cannot find shares to buy while they watch the price rise higher and higher and sellers cannot be found because they have no incentive to sell in a rising market. It can be painful to be on the wrong side of that trade and suffer the pressure of the squeeze. Eventually, the shorts typically get covered and the stock price settles closer to its intrinsic value. How long this takes and who feels the pain is the question.

The Gamestop short squeeze was an extreme case, but short squeezes do occur now and again. Short sellers do play a role in an efficient market by allowing investors to take a position against a stock, but the risk they take is high. The maximum gain for a short seller is the difference between the price at which they sold the borrowed shares and zero if the shares become worthless in the extreme. The potential loss is theoretically unlimited. However, in the past, short sellers have made their mark by exposing some very notable financial frauds or accounting scandals, Enron and Worldcom to name two.

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