The GameStop Affair: Short-Term Popularity Versus Longer-Term Appeal

STATE STREET GLOBAL ADVISORS

- Our process typically avoids the sorts of companies that experienced extreme trading activity in January.
- Speculative episodes like the GameStop Affair are yet another signal that decision making by the marginal investor is not being driven by the underlying fundamentals – a situation that we believe to be unsustainable.

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In the war between Wall Street and Main Street that took shape in January, a few small, heavily shorted companies, including GameStop, grabbed a lot of attention when investors banded together to execute a short squeeze – driving up the companies' stock prices, which in turn forced short covering and drove the prices up further.

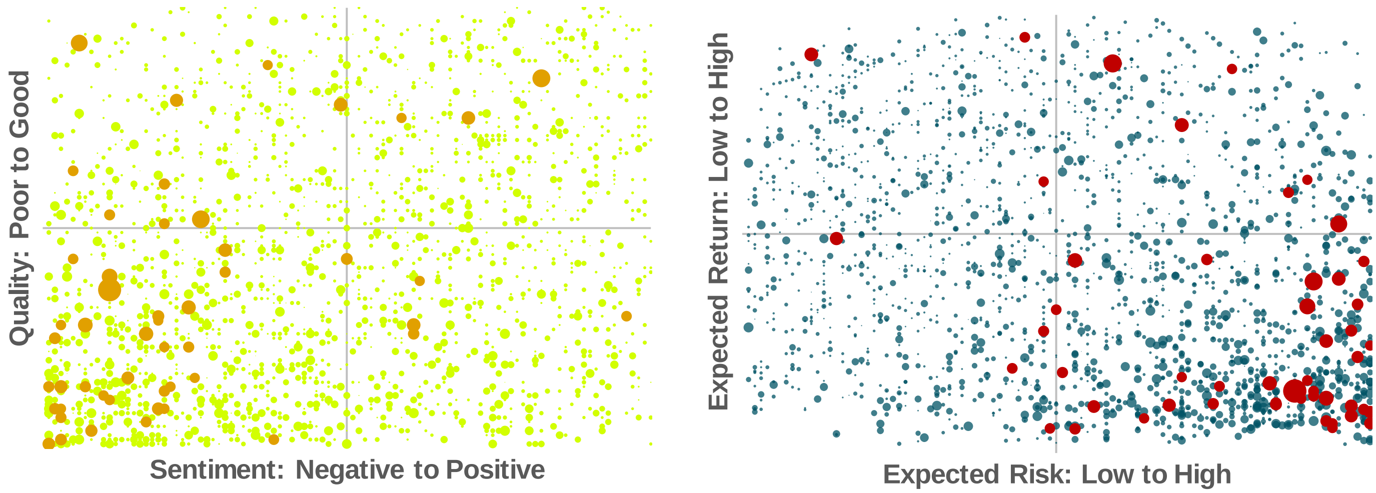
This month's commentary will explore this so-called GameStop Affair. We'll take a look at the underlying characteristics of a group of heavily shorted target stocks to demonstrate how our investment process evaluates them. In general, the stocks that experienced a short squeeze in January are largely inconsequential to our investment strategies in Active Quantitative Equity (AQE). They are fundamentally unappealing over the longer time horizon that we care about most.

Our assessment of recent market actions

Our stock selection process in AQE rests on three key themes – value, quality, and sentiment. Risk is also a critical consideration in our portfolio construction process. Viewed through the lens of these investment dimensions, the cohort of stocks with the highest positive return in the last two weeks of January (including GameStop) were higher risk, lower quality, and even showed poorer investor sentiment compared to the average stock in the Russell 2000 Index. In short, these stocks were unattractive on *all* the dimensions of our investment process (see Figure 1).

Figure 1: The Most Heavily Shorted Stocks in the Last Two Weeks of January 2020 were Unattractive on All Dimensions of Our Investment Process

Russell 2000 Stocks, Arranged According to Relative Attractiveness on Various Dimensions of AQE's Investment Process. Highlighted Stocks are the 50 Stocks Most Heavily Shorted



Source: State Street Global Advisors, Refinitiv, as of 15 January 2021. Bubble size is proportional to the percentage of outstanding shares shorted.

One might have expected that this cohort of stocks would have shown strong investor sentiment during this period. Sentiment is based on how market participants collectively perceive a stock's future earnings, profitability and growth, which we measure along multiple dimensions. One of these dimensions focuses on the hedge fund industry and includes measures of short interest data. The more heavily shorted a stock, the more negative the sentiment.[1]

Massive short-term gains – and massive short-term losses

Based on all of this, it's probably not surprising that we don't have much exposure to the cohort of stocks that recently become subject to short squeezes in our strategies, due to their fundamental lack of appeal over the time horizon that matters most for our investment approach. Some of these stocks did experience a massive surge in returns over a short period of time, only to come down again. But the price moves were so significant – up to 800% returns in some cases – that they weighed disproportionately on market returns.

Expressed in attribution terms, the heavily shorted cohort contributed around +1.3% to the total return of the Russell 2000 in the last two weeks of January, while the rest of the stocks in the index contributed around -3.5%. While it would be nice to have a contribution to returns as large as this for a couple of weeks, the fall from grace can be just as swift. The same heavily shorted cohort of stocks detracted from Russell 2000 returns by -0.6% between the end of January and February 12, while the rest of the index contributed +11% in the same period.

The Bottom Line

Our process typically avoids the sorts of companies that experienced extreme trading activity in January. The action of these companies is largely irrelevant to the returns we are seeking to deliver to our investors, but the speculative phenomena we have observed in financial markets in the past six months or so is yet another signal that decision making by the marginal investor is not being driven by the underlying fundamentals of companies. We believe these conditions are unsustainable.

[1] Except for rarer occasions where extremely shorted stocks can experience a short squeeze. We allow for that potential in our signal by including an adjustment in the metric for stocks that are more likely to experience a squeeze. For example, in the latter half of January, out of the 50 most heavily shorted stocks in the market (as measured by percentage of outstanding shares shorted), five that were viewed at highest risk for experiencing a short squeeze were adjusted to avoid taking the most negative view on their sentiment. Of course, this doesn't mean that these five stocks registered *positive* sentiment – in fact our assessment of sentiment overall for these stocks remained negative despite the adjustment. And, because they were unattractive on virtually every other dimension of our investment process, we largely avoided these five stocks in our portfolios during this period.

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