IDIOSYNCRATIC RISK

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The house always wins.

TWITCH PLAYS POKEMON

Six years ago, on February 12th, 2014, an anonymous Australian programmer launched a social experiment on the video game live streaming website "Twitch," known today as, "Twitch Plays Pokemon." During February of that year, his stream consisted of a livestreamed, crowdsourced attempt to play Nintendo's Pokemon Red Gameboy game, by parsing commands sent to the streamers console through the twitch channel's chat room. The stream became enormously popular, and eventually reached an average concurrent viewership of over 80,000 viewers. The community eventually completed the game on March 1st of 2014, after over 16 days of continuous gameplay, 55 million views, a peak simultaneous participation of 121,000 players, and 1,165,140 unique player contributors, which remains the *Guiness World Record* for "most particpants on a single-player online videogame."

It might not be difficult to overstate the cultural impact of Twitch Plays Pokemon, but it was certainly a moment in the modern history of the internet. The community spawned countless memes on Reddit, and was memorialized in articles from *Ars Technica*, *CNET*, *Polygon*, *GameSpot* (not quite), *Kotaku*, where the proceedings were called, "mesmerizing," "beautiful chaos," and "like watching a car crash in slow motion."

The thing about Pokemon is that it's a children's game. It is not difficult, and it does not require long (or even medium length) sequences of precise inputs. There are relatively few places where you can be irreparably punished for making a poor decision, and despite the best efforts of trolls and griefers, the community made relatively swift progress in the game. By the 18th of February, after six days, the community had reached Team Rocket's hideout in Celadon City (For reference, it takes roughly 1 hour and 20 minutes for the world record holding speed runners to reach this point in Pokemon Red). Inside the hideout, though, Twitch encountered a problem. The building is a giant maze made up of floor tiles that turn into conveyor belts which swiftly

take the protagonist off the correct path if you step in the wrong direction. It is not a difficult maze, but crucially, trolls can actually prevent forward progress at this point in the game, where before, they were only able to waste time (interminably, but still).

The difficulties caused an intervention by Twitch Plays Pokemon's developer, which was intended to make the game easier to play. "Democracy mode" was introduced, which tallied inputs over a 30 second period and then selected the one which received the most votes. Twitch anarchists, griefers, and trolls were outraged and launched the infamous (or more accurately, relatively obscure and unknown), "start9" protests, whereby they spammed the chat with the command "start9," resulting in the game repeatedly opening and closing the start menu instead of doing anything productive. They won. Eventually anarchy mode was re-instated, but a special command was added which allowed a super-majority of users to briefly switch the game into democracy mode, after which time, a simple majority of users would be able to vote to turn anarchy back on. Eventually, twitch got through Team Rocket HQ, and 10 days later, they completed the entire game.

Last week, in the final trading days of January, 2021, a popular subreddit known as /r/wallstreetbets/ channeled that same spirit of outrage, together with a similar level of modern online organizational sophistication, into a coordinated assault on short sellers involved in the equity of the largest video game retailer in the United States, GameStop (NYSE:GME). The first thing that needs to be said about the "GameStop Squeeze," therefore, is that, while it does demonstrate the power of coordinated action and participation by retail traders, it also seems illustrative of the difficulty of bringing any semblance of order to the chaos.

The amount of misinformation and deceptive propaganda that has latched onto the forum is staggering. A large cross section of wall street bets users, for example, believe that GameStop shorts are structurally incapable of covering their short positions because more shares are sold short than exist in GameStop's statutory free float. This belief persists even though trading volume in GME shares has exceeded the free float in 4 of the last 7 trading sessions, averaging over 30 MILLION shares a day for the last 15 sessions. As a reminder, as of January 15th, roughly 106M GameStop shares were sold short. It is a lot of shares, to be sure, but it can hardly be said that there are not enough shares on offer for the shorts to cover. The situation reddit believes exists is one where the trading volume in GME should have dried up because so few holders are willing to sell. The data does not back them up. As if on cue, IHS Markit and S3 Partners, who track data on cost to borrow and short interest are out this morning, Monday, February 1st, with their estimates of GME's short interest. As things stand today: IHS Markit estimates the stock maintains 38% short interest, while S3 believes possibly 50% of GME's float is still sold short. This would seem to imply that 75-80% of the short position that existed a mere two weeks ago has been covered.

Still more Redditors (and more than a few professionals) believe that GameStop's short interest in excess of its float is evidence of market manipulation, or illegal "naked shorting." Of course, it is possible that some GME shorts are "naked," but this does not mean what most people think it means, and the existence of more shares short than there are, in existence, can actually be explained rather simply. The simple fact of the matter is that, once a share is borrowed and sold, the third party who purchased it owns that share of stock, free and clear, and has all the rights associated with share ownership, including the right to lend the share out, again. If they do (and let's be clear, 70% of the time, "they" is an ETF which generates the vast majority of its profit margin from share lending), and the share is shorted again, there now exist 2 shares sold short, and 3 beneficial owners, as compared to 1 share in the company's free float. This is evidence that the lending process actually creates the underlying. Lending dollars creates dollars which can circulate, lending shares creates shares

which can circulate, simple as. “Naked shorting,” in contrast, results from a broker’s failure to “locate” a borrow-able share before executing a short sale on behalf of their client. This is in violation of the brokerage’s client agreements, duties and responsibilities, and has nothing to do with market manipulation orchestrated by a shady cabal of short sellers and hedge funds, who may or may not actually be, “the apex predators of wall street.”

Most Redditors, politicians, and media members have covered last week’s trading seem to have latched on to that last little bit in an effort to frame the narrative into some type of “David vs. Goliath” story, about how individual investors and speculators are “waging war,” on big, bad, sophisticated hedge funds who sell stocks short in order to profit from the destruction of good, honest companies. But there are a couple of widely held misconceptions here, too. First and foremost – the link between a company’s equity price and its liquidity position is tenuous, at best, and it’s certainly impossible for a well-capitalized company to be bankrupted by a falling equity price.

Furthermore, and at the great personal risk of offending some of my clients and readers, I feel compelled to mention that in my decade of buy-side experience, and in the last year of marketing Antrim’s research to hedge funds, I’ve come to the conclusion that most hedge fund strategies just aren’t that sophisticated. Being a great investor requires a tremendous amount of personal discipline. It requires an unbelievable thirst for data and information, a tirelessness in the pursuit of it, and the humility to admit when you are wrong and accept that there are things that you will never know. But the path to investment enlightenment does not lead to a territory inaccessible to the common man, or the average, informed individual. There’s no clubhouse where the secret strategies to building wealth are handed out to the select initiates. And there is no cabal hell bent on destroying the hard work of the proletariat.

The reason that GameStop shares had (at one time) near 230% of their available float sold short was that a lot of really smart investors were holding on, too dogmatically, to a set of simple assumptions and beliefs. (1) Retail is a low quality, low margin business, in secular decline due to the threat of e-Commerce. (2) Video Game retail is even worse, because you can simply download games. (3) Downloading games eats into the one profitable revenue stream GameStop maintains, the extremely lucrative business of “buying” trade-ins (“can I interest you in $3 of in-store credit and 100 points on your Power UP rewards card?”) and selling used-games at “like new” prices. (4) Low ROIC, low margin businesses tend to underperform. (5) GameStop has lost money for each of the last two years. And last, but certainly not least: (6) High short interest names and high cost to borrow names, perhaps unsurprisingly, tend to underperform. If you thought that the short interest in GameStop was the result of the coordinated actions of a secretive cabal of Wall Street’s apex predators, I’m here to tell you that GameStop’s short interest was actually the result of the fact that most video game publishers these days prefer to sell their titles directly to customers through Steam, their own online store, the PlayStation store, or Xbox Live.

For most of us in the business of finding and executing profitable short ideas, what happened last week is a rather mundane, cautionary tale. The simple fact is that most short sellers are wary of equities with an extremely high short interest, and most prefer not to pay a usurious cost to borrow the shares they are looking to short. Throughout most hedge funds’ history, it’s been impossible to profit from simplistic strategies like barreling into the lowest quality decile of companies and taking the short interest as high as humanly possible, and most funds, whether it’s because they’ve experienced a short squeeze like this in the past, or because you don’t need to get burned to learn that fire is hot, simply don’t do it.

Of late, however, it’s become a more popular strategy, for even large, “sophisticated” funds. Simply pick up the easy money shorting the most challenged companies and most crowded, consensus shorts. One need not be wise to benefit from the

wisdom of crowds, after all. The reason for this shift in behavior, quite simply, is ETFs. The simple fact is that ETFs generate the majority of their profits by lending shares. They don't have any interest in voting their proxy, they merely seek to own an economic interest in the underlying shares that the fund is meant to passively track. It is because passive vehicles have grown so large in the marketplace that it has become "normal" to see low quality companies with an absolutely enormous short interest. The endless supply of shares owned by these vehicles which are available to borrow simply ensures that it never becomes cost-prohibitive to pursue such simplistic strategies, while it would have in a by-gone era.

At the end of the day, the GameStop short squeeze does not pose an existential risk to the equity long/short ecosystem. Of course, it posed an existential threat to a number of funds that had allocated an irresponsible amount of capital to a particular trading strategy without perceiving fully the risks inherent to it, but this has always been the way of Wall Street. For the rest of the funds out there, by next Monday, it will be back to business as usual: finding undervalued and underappreciated longs with fundamental catalysts for appreciation, and finding overvalued and mispriced shorts with deteriorating fundamentals, misunderstood accounting metrics, and promotional management teams.

And in the meantime? The word of the week last week (and perhaps, this week, too) is "de-grossing." Most hedge funds out there that I've talked to are simply yanking gross exposure down until the volatility settles. This isn't really new, either. The same thing happened in 2008, in extreme fashion, when the SEC halted short selling in a select list of financial stocks for a month. Without shorts to de-risk portfolios, managers are forced to sell their long positions. Quality companies beloved by Wall Street see elevated, abnormal volatility and price declines. Without shorts to cover profitable positions as stocks fall, low quality stocks are left with an utter absence of bids. They witness widening spreads, reduced liquidity, and crashing prices. Paradoxically, high short interest names actually tend to underperform, historically, even after short selling is banned (or discouraged) in their equities. And in the end? Life goes on. Gradually, volatility subsides, and trading returns to normal.

I expect that, this time, the volatility will last maybe 10 more trading sessions. That would give the crowd at /r/wallstreetbets/ the same amount of time to take down Wall Street that Twitch needed to take down Pokemon Red. I don't believe that they will be successful.

PAST PERFORMANCE IS NOT A RELIABLE PREDICTOR OF FUTURE RESULTS

Recommendation	Date	Performance Since Recommendation
Short ACEL	October 1st, 2020	-10.1%
S&P 500	October 1st, 2020	+10.4%
Long LMND	August 3rd, 2020	+149.7%
S&P 500	*August 3rd, 2020*	+13.5%
Short TSLA Short GSX Long AKRXQ	July 1st, 2020 July 1st, 2020 July 1st, 2020	+267.4% +75.0% -100.0%
S&P 500	*July 1st, 2020*	+19.8%
Long MIK Short QSR Long MINM (formerly: ZMTP)	June 1st, 2020 June 1st, 2020 June 1st, 2020	+301.6% +10.2% +51.2%
S&P 500	*June 1st, 2020*	+21.6%
Long NLY Long AGNC Short SWKS	May 1st, 2020 May 1st, 2020 May 1st, 2020	+40.5% +35.1% +64.3%
S&P 500	*May 1st, 2020*	+27.5%
Long DESP Short KNSL	April 1st, 2020 April 1st, 2020	+78.8% +79.7%
S&P 500	*April 1st, 2020*	+43.7%

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I sincerely appreciate the friendship, support, mentorship, and camraderie I've experienced during my career in Investment Management and I would like to thank my friends and readers for supporting me, whether by forwarding this email and my contact information along in your network, or merely reading these pages and considering what I have to say.

Feel free to reach out with questions, criticisms, suggestions, and investment ideas if you've got any good ones.