

IDIOSYNCRATIC RISK

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Yo, Gamma Gamma!1

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Archegos is a Greek word for "Prince."

YO, GAMMA GAMMA!

OR: LET'S MAKE A MARKET

Two days ago, on March 20th, 2021, Alex Kirschner penned, for Slate.com, an article titled, "[The Dumbest Financial story of 2021](#)," and chose not to bury the lede any deeper than its subtitle: "Everyone involved in the swift fall of Archegos Capital Management should be embarrassed." Mr. Kirschner's moral outrage is justified and understandable, but the great simplicity of the polemic is that it doesn't attempt to confer any legitimacy to Archegos' trading strategies or suggest that there is any great complexity to the operation of the erstwhile family office. Rather, he gets more or less directly to the point.

Archegos was a family office run by Bill Hwang; formerly, portfolio manager for Tiger Asia Management, at least until that fund plead guilty to insider trading and criminal fraud charges related to price manipulation of Chinese Bank stocks, against which Tiger Asia had taken short positions. As recently as 2018, as consequence of that plea agreement, Hwang could still be found on a blacklist at Goldman Sachs, who refused to do business with the disgraced former trader. But this is the crux of the argument in Mr. Kirschner's article: in the wake of Friday's trading debacle, we are informed that Mr. Hwang is no longer on a blacklist at Goldman Sachs, who had lent Archegos substantial sums of money, along with a handful of other large banks (Credit Suisse, Nomura, Morgan Stanley), which enabled him to engage in similar trading strategies at his new firm. This time, his activities were not discovered by regulators. Rather, he was found out by a more egalitarian jurist, Mr. Market, as the unwinding of Archegos's portfolio positions created devastating losses within both the financial sector and the broader market.

For those of us focused on the identification of overpriced securities that might lend themselves to profitable short selling opportunities, the revelations contained in this story do cut through a veritable Gordian knot of suspicions and incredulities related to the price performance of numerous high-flying

issues in recent months. The scale and simplicity of the scheme seem to provide the answer to a number of the rhetorical questions that have been repeatedly presenting themselves to interested and observant market professionals. Questions like, “but who would think that you could...?” and “they wouldn’t be so bold as to simply...?” And it would seem to suggest that, like many of those who involved themselves in the frenzy over highly shorted equities like GME and AMC, Bill Hwang seemed to believe that market manipulation would be tolerated so long as the prices of the securities he manipulated were rising. He was right. It was (and is) tolerated, as long as it was profitable.

To better understand what caused VIAC, DISCA, IQ, and all the rest of Archegos’s positions to collapse on Friday, it’s necessary first to understand how a market is made. Lesson #1: buying a security doesn’t make its price rise, and selling it doesn’t make the price fall, which can be easily understood by anyone who observes the fact that for every purchase consummated, there is a sale on the other side of the ledger. A security’s price rises, then, when the supply available for sale at the current price is overwhelmed by the interest of eager, price insensitive buyers who begin offering higher prices in the market in order to convince the “diamond-hands” shareholders clinging onto their securities to let them loose. In normal times, there are rational limits to the premiums that even the most eager, conscientious buyers would be willing to offer over the quoted market price. The reverse is true, of course, when a security’s price is falling. For a stock to fall, its shareholders must offer lower prices to the market in an attempt to encourage sidelined and cautious value-focused investors and traders to scoop them up. That stocks tend to fall faster than they rise (usually) is just a symptom of the notion that there are a lot more reasons you might be forced to sell an investable security at any price than there are for an individual to be required to buy them, price notwithstanding.

Extreme price movements are caused by extreme mismatches between supply and demand. Or more accurately, they are caused by technical dislocations which create markets that structurally cannot resolve the mismatch between supply and demand by simply adjusting price. That price is the only variable the market is capable of adjusting is already in evidence: GameStop shares are “exhibit A.” In order to manipulate the price of a stock lower, then, you simply have to force somebody to sell it, and ensure that nobody in the world is going to buy it. If that sounds like a tall order to you, well, the devil is always in the details. In order to manipulate the price of a stock higher, all you have to do is force somebody to buy it and ensure that its shareholders will not sell it. Given that most companies are majority owned by passive investment vehicles which do not sell shares in reaction to price movements, no matter how extreme, this is an order of magnitude easier to accomplish. Because higher prices, rather than “efficient” prices, are generally perceived positively, the unofficial, unstated, regulatory stance on such activity seems to be, “no harm, no foul.”

It might be surprising to learn that it’s not really that hard to force somebody to buy shares in an equity security you’re interested in. The secret, alluded to in this letter’s title, is “Gamma,” the accepted Greek initial for the rate of change in an option’s “Delta,” as the price of the underlying security fluctuates. That is to say, “Gamma” is a third derivative of the rate of change of price movements for an underlying stock, and of acute concern to anybody who makes a market in options or swaps, which are contracts with payouts defined by the first derivative of a stock’s price movement. As with most things, it’s less complicated than it sounds. A derivative is a bet on a stock price, and the bet becomes more valuable as the price of the stock gets closer to the payout. If you make a bet on a stock option, the house owes when the price of the stock exceeds the option strike. Of course, the house charges “investors” for the privilege, but they also buy the stocks they might have to pay out on, to “hedge” their exposure. If the stock price rises, they are forced to buy more as their unhedged exposure grows. The rate at which that unhedged exposure is growing is “delta,” and the rate at which the “delta” is

growing is “gamma,” but the principles of the transaction are simple. If I buy a call option from a bank, the bank buys the stock “just in case” the stock actually goes up and they have to pay out. If I buy enough call options, the bank might be forced to buy more stock than the market has available for sale, and when someone is forced to buy a security nobody is selling, well – we covered that already.

The trading strategy that suggests itself appears to be foolproof. Buy enough shares of a suitably illiquid security majority owned by passive shareholders (which do not sell into strength) and begin purchasing out of the money call options on the price of the underlying. Whether or not your call option contracts expire worthless is irrelevant, as long as the “market makers” who took your bet are forced to buy stock to hedge, you can “lose” money on worthless out-of-the-money options contracts in order to drive the price of your equity position higher. An undergraduate business student armed with Microsoft Excel and Investopedia is capable of doing the math to optimize for the minimal amount of capital required to create the maximum impact on a security’s price.

Professional investors have been conditioned to believe that this is not a viable strategy, by virtue of the fact that it’s “too good to be true.” But a brief glance at the options chains for any volatile, controversial issue will raise questions that can’t be answered by other explanations. Days before expiration, tens of thousands of dollars are routinely punted into call options on shares of TSLA that are out of the money by as much as 100% or more. That these contracts even exist is no small miracle, but that somebody would place real, enormous wagers on them? That’s a crime which requires a motive. The day that GME shares began to rally again, post-January, was February 24th, a day when hundreds of thousands of dollars were punted at out of the money call options set to expire on February 26th, well out of the money. GME shares rallied over 65%.

But who would own enough shares of TSLA, or GME to bother with such a strategy? Presumably only someone who believed that the stocks could be manipulated higher. And how can you accumulate such large positions in illiquid securities? Not responsibly, as they say. And then there’s the question of Archegos. Why would a \$10 billion dollar family office specializing in mid cap equity securities need enough leverage to bring down Credit Suisse? Hm? They must have really had a bead on the fundamentals.

Of course, leverage is cheaper than it used to be. Passive ownership is a greater influence than it used to be on the availability of most equity securities. And increasingly it seems the regulations are not what they used to be. Belatedly, the SEC is reported to be “looking into” trades executed by Archegos Capital Management, as of the time of this writing. That such strategies have become more commonplace as they have become more obviously viable is not difficult to understand.

Nor is the inevitable aftermath. In Archegos’ case, their downfall was caused by Viacom’s own management, who saw their stock price inexplicably soaring and looked to take advantage by selling stock. It turns out that everyone who was bullish on Viacom (your Author knows at least one fundamentally motivated former shareholder) was only interested at reasonable prices, and there was nobody interested in actually purchasing stock issued by the company at near the market price. As the deal runners looked to find a level where investors other than Archegos and their market makers might want to buy some, Bankers’ spreadsheets that monitored the value of Archegos’ equity positions held as collateral against their borrowings started raising internal alarms. By the time Goldman, Morgan Stanley, Nomura, and Credit Suisse realized that they had all lent against the same collateral, the fate of the family office had already been sealed.

It's not difficult to avoid being swept up in the aftermath of a "near-disaster" like this. One simply maintains "price discipline," and sells richly valued equities as their prices start to seem irrational or untethered from fundamental considerations like "Earnings per Share," or "Book Value." What's difficult is "keeping up" with a roaring index full of irrationally priced, illiquid and manipulable issues in the meantime. Thesis creep becomes tempting. A post-mortem analysis of a decade or more of premature stock sales is guaranteed to lead to soul searching: "why do I ever sell these high-quality companies, they must be great, after all, I picked them!" But the simple fact of the matter is that the gamma squeeze will end. The in-flows will become outflows. The momentum variable cannot be a perpetual tailwind for the equity markets, and the fundamentally motivated value investors are extinct, or on sabbatical.

The last thing worth saying about market prices in the gamma-squeeze era is simply this: valuation is not a timing mechanism. That unscrupulous traders have been able to push prices above their historical mean is not an indicator of imminent market collapse. It's rather more the opposite: if it's so easy to game, you can expect people to play. But neither is valuation and historical context irrelevant. It's simply a measure of the gulf between current market prices and real fundamental interest. The wider the gulf, the further the potential fall. The further the fall, the harder the landing.

And you don't need a doctorate from the Chicago School of Economics or a Ph.D. from the school of hard knocks and fat fingered trades in order to fathom the complexities of the issue that brought down a \$10B family office managed by the hugely successful, former portfolio manager of another \$20B+ hedge fund. All you really need to know is the parable of the doctor and his broker. As the apocryphal tale goes, a wealthy doctor receives a stock tip from one of his patients and calls his skeptical broker to place an order. Because he cannot fully trust the tip, and his broker is skeptical, he places a small order, and the stock goes up. The doctor calls his broker back, more assured of himself, and places a larger order to buy shares in the company. The stock goes up. Thrilled by his success and assured of his investing acumen, the doctor calls the broker back a third time, with explicit instructions: he has the broker sell all of his other investments and buy more of the hot stock, while it's hot. Again, the price of the stock rises. Finally, the doctor has had enough. He's not an unreasonable man, and he's made enough money to make a difference for himself and his family. He calls the broker and tells him to sell some shares, but the broker is incredulous. He yells back into the phone, "to WHO? You're the only one buying!"

PAST PERFORMANCE IS NOT A RELIABLE PREDICTOR OF FUTURE RESULTS

Recommendation	Date	Performance Since Recommendation
Short ACEL	October 1 st , 2020	+2.1%
S&P 500	October 1 st , 2020	+18.1%
Long LMND	August 3 rd , 2020	+60.1%
S&P 500	August 3 rd , 2020	+21.5%
Short TSLA	July 1 st , 2020	+209.3%
Short GSX	July 1 st , 2020	-43.5%
Long AKRXQ	July 1 st , 2020	-100.0%
S&P 500	July 1 st , 2020	+28.1%
Long MIK	June 1 st , 2020	+468.4%
Short QSR	June 1 st , 2020	+22.9%
Long MINM (formerly: ZMTP)	June 1 st , 2020	+46.5%
S&P 500	June 1 st , 2020	+30.5%
Long NLY	May 1 st , 2020	+51.7%
Long AGNC	May 1 st , 2020	+45.6%
Short SWKS	May 1 st , 2020	+78.5%
S&P 500	May 1 st , 2020	+36.4%
Long DESP	April 1 st , 2020	+140.4%
Short KNSL	April 1 st , 2020	+58.0%
S&P 500	April 1 st , 2020	+51.3%



The cake is a lie.

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