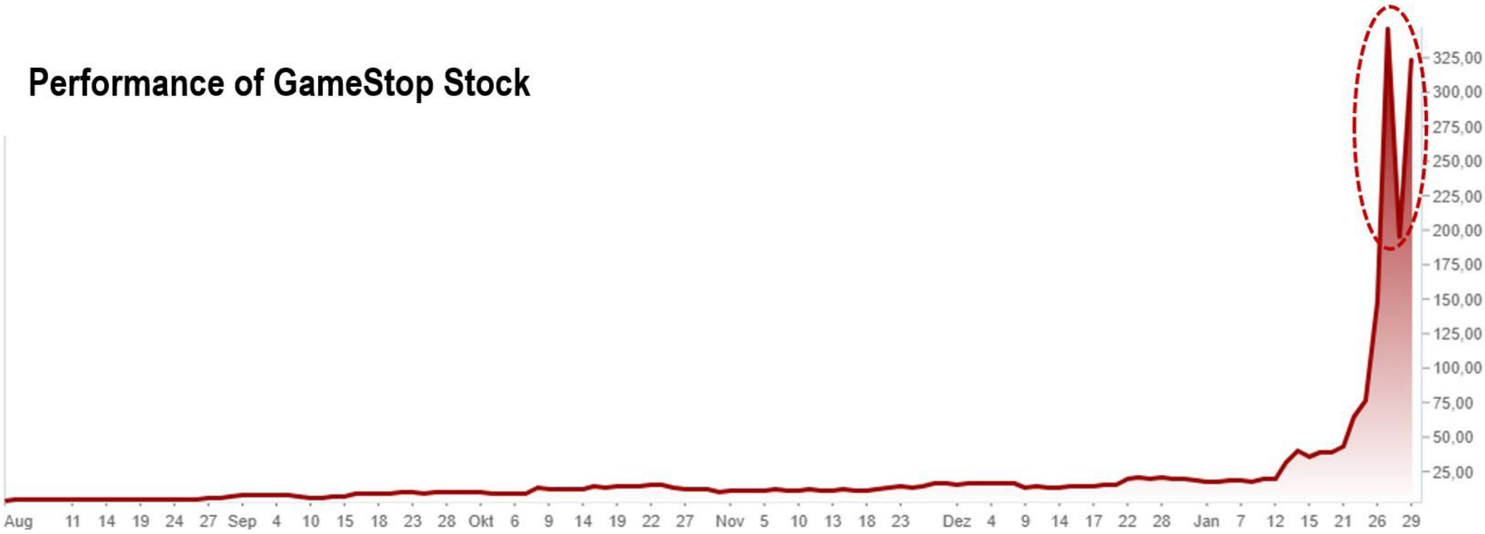
1 February 2021

The GameStop case or „how many Davids could bring Goliath down“

The Gamestop case is making waves and is not only making it into the financial news. The Internet is full of (humorous) articles about how a group of small investors can cause an international hedge fund (or „Wall Street“) to stagger.

As described in our last stock market commentary (18.01.2021), many small investors have independently discovered the stock market in the last year and have already provided for one or the other bizarre capital market anecdote (keyword „Signal“). „The power of the small“ is, as mentioned, not to be underestimated, because at the end of the day Wall Street is also just a market where the price is formed by supply and demand. Last week, a group of small investors decided to challenge large international hedge funds.



The share price of the U.S. company GameStop has, as a result of the support purchases
over a period of 12 months a performance of over 8,000 % !
Source: Teletrader, retrieved on 01.02.2021

What happened?

Hedge funds used short selling to bet on falling GameStop stock prices. However, starting from the Reddit board „WallStreetBets", small investors covered themselves with the stock to drive up the price and force the hedge funds to liquidate their short position (short squeeze). The aim was on the one hand to help the company, and on the other hand to get one over on „Wall Street". The result was a price explosion of the share price and a loss of billions for the hedge funds.

When social media is abused for market manipulation and price fixing, it is of course illegal, even if the „official" goal is not profit but a lesson for the big investment houses. The short squeeze has paid off for some private investors, but for others it will probably be a bitter loss, because the current price developments are not fundamentally justified.

#silversqueeze

Which effects the illegal market practices have and which unrest it brings into the market, shows today again. Silver reaches, thanks to small investors and a Reddit call, its highest value in over eight years. Now they are trying to undo the counter-positions of major U.S. banks. However, rumors were already spreading that it was an organized initiative of hedge funds. These games do not have much to do with sound investment.

How do short sales work?

Step 1: Choose underlying, borrow and sell securities

First, the hedge fund (or other capital market player) borrows a stock, for which falling prices are expected, from banking houses or other large investors. However, this is only possible if a correspondingly large amount of collateral (often a multiple of the targeted securities) is offered as security. The hedge fund (the short seller) sells the stock with the goal of buying it back (and then giving it back) at a later date and hopefully a lower price. The difference between the selling price and the buying price is the hedge fund‘s profit or loss.
Basically, the lower the price of the stock, the cheaper it is to borrow. Along with the likelihood of the underlying stock (in this case, GameStop‘s stock) rising or falling, a number of other relative valuation indicators also play a role.

Step 2: Hope, hope, hope

Probably the most important step of all is that of watching the market. Now that the short seller has sold the underlying asset (i.e., GameStop stock), he hopes that the market will react negatively to it. Hedge funds often sell large sums of individual securities in order to unsettle other investors with the higher volume and the resulting price losses. In the best case a chain reaction follows, the large part of the remaining investors also sells, and the underlying asset falls further.

Step 3: Buy back and return the underlying asset

In the last step, the short seller must buy back the shares in time and then return them to the lender on the previously agreed return date. This shows whether the price has fallen, and a profit has been made, or whether the price has risen, and losses have been incurred.

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