Private Bank

Equity Strategy Bulletin

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Avoiding the Madness of Crowds

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Avoiding the Madness of Crowds

Anyone looking just at index level returns in the past week may be unaware that a small pocket of the market has succumbed to chaos. A horde of internet traders has taken aim at select favored shorts among the hedge fund community, rallying countless retail investors and wealthy celebrity tweeters to their cause. **If this sounds hyperbolic, it is not. But this episode is also unlikely to have long-term consequences for broader equity markets. Fundamentals-based investing has time on its side.**

Last June, shares of bankrupt rental car company Hertz rallied over 500% in a week, as a group of investors bid up the stock despite clear fundamentals pointing to the company's ultimate demise (Figure 1). The euphoria did not last. Hertz' insolvency ultimately prevailed over the speculators. This month's craze was initially concentrated in a select few names, namely GameStop, a video game retailer, Blackberry, a former leading cellphone manufacturer now more focused on software and security, and AMC, the troubled movie theater chain. All three names characterize a broader group of companies with large institutional short bases, but which have for months been favorite long positions among retail traders active on popular investing-focused internet forums (Figure 2).

Figure 1: "YOLO" traders cut their teeth with bankrupt company Hertz last June

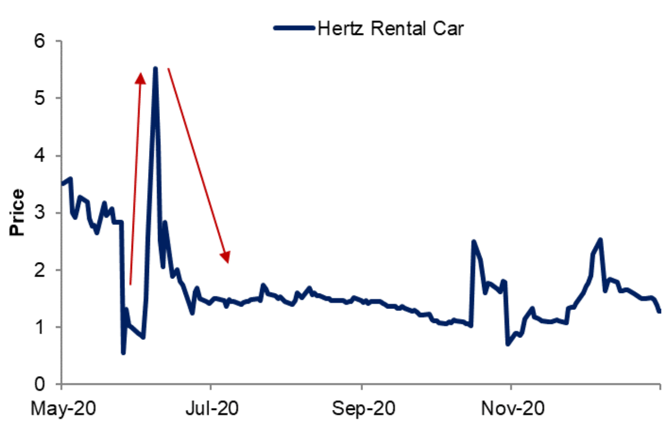


Figure 2: The 15 most shorted stocks in the Russell 3000 have all rallied significantly

Name	Short Interest as % of Float	YTD Return
GameStop Corp	138.40	1648%
Ligand Pharmaceuticals Inc	64.24	80%
Bed Bath & Beyond Inc	64.08	155%
National Beverage Corp	62.52	91%
AMC Networks Inc	60.22	50%
Macerich Co/The	58.44	86%
SunPower Corp	53.57	110%
Tanger Factory Outlet Centers Inc	49.70	73%
Academy Sports & Outdoors Inc	46.26	11%
Accelerate Diagnostics Inc	46.26	97%
Tootsie Roll Industries Inc	45.85	50%
Gogo Inc	44.59	64%
BigCommerce Holdings Inc	44.55	48%
Clovis Oncology Inc	42.80	84%
Ontrak Inc	42.24	59%

Source: Bloomberg and Factset as of January 27, 2021. Note: "YOLO" is short for "you only live once" and is a moniker for many higher-risk trade ideas circulated online.

Past performance is no guarantee of future returns. Real results may vary. For illustrative purposes only. This should not be construed as an offer of, or recommendation of companies discussed.

These opposing forces appear to have collided in the past week with the retail throng currently winning the battle, as many of these names have doubled several times over, while one of the largest GameStop short investors had to be bailed out by competitor hedge funds. Trading in these names over the last few days has been characterized by incredible volatility and frequent exchange-mandated trading halts. Exacerbating this apparent short squeeze is heavy use of call options by retail traders, which can provide levered upside but leads to significant "delta hedging" buying flows from market makers.

Several companies, including GameStop and Blackberry, have released statements indicating a lack of material change to their businesses that would justify such significant share price moves. Others, like AMC, have taken the opportunity to issue new equity in secondary offerings, much to their creditors' delight. AMC's June 2026 bond has rallied from $20 to $65 YTD, and a full $25 rally so far this week.

Why Should I Care, and What Should I Do Now?

If this episode turns out like last June's Hertz saga, the excitement could end as fast as it began. More importantly, some signs of stress among certain hedge funds is unlikely to cause a systemic issue in our view. Furthermore, we would advise against joining the "fun", and stick to our preferred method of fundamentals-based investing, which we believe has proven much more fruitful over the long run.

The 100 most shorted names in the Russell 3000 make up just 0.7% of market cap, and this episode will ultimately turn out to be another side show with little direct broad market impact. We would note however that this episode comes at a time when several sentiment indicators have suggested growing levels of market complacency, including a spike in call option volumes relative to puts, falling intra-market correlations, and a drop in NYSE short interest (Figures 3 and 4). Indeed, after a significant rally in both growth and value equities since November, some consolidation remains possible in the short-run.

Figure 3: Call volumes have spiked ahead of puts

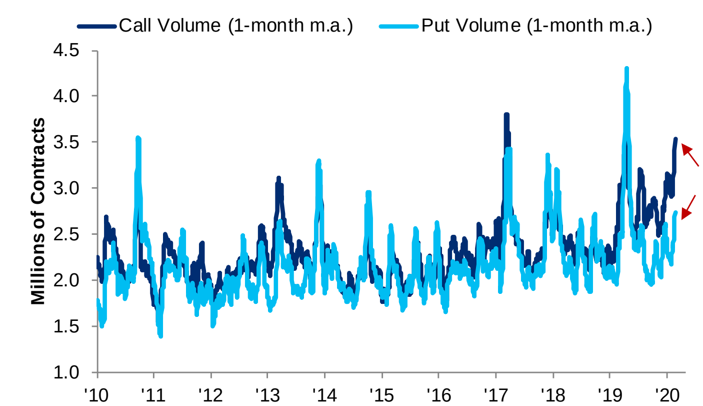
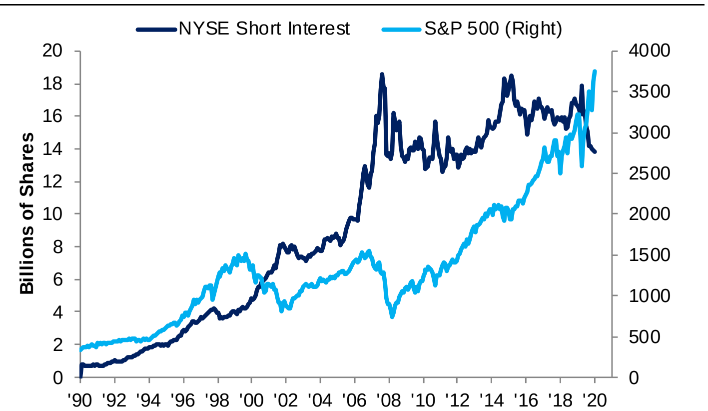


Figure 4: Short interest has fallen to its lowest level since 2014 despite growing markets



Source: Bloomberg and Haver Analytics as of January 27, 2021

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While market volatility may occupy day traders in the ensuing trading sessions, we continue to expect the emergence from COVID restrictions to dominate the economic and market dynamics in the coming year. Interestingly enough, it appears the most widely circulated retail ideas have shifted from expensive growth stocks, which were in favor for much of last year, to extreme value, with a loose thesis that reopening will boost returns in many of these names. We don't disagree with that broad hypothesis, but certainly would avoid any deep value names that have far exceeded any reasonable level of mean reversion. We instead would point to other more fundamentally sound candidates for such a rebound trade.

Indeed, while our Leave your Home Basket has rallied 25% since the wave of positive vaccine news in November, the group has still underperformed those companies who benefitted from COVID-related disruptions by 93% since the beginning of 2020 (Figure 5). In addition, we also see an opportunity in perhaps more "traditional" but also fundamentally attractive areas of the market like health care. Relative valuations in US and global Health Care are at 10-year lows, with long-term demographic tailwinds likely to drive strong share price growth, as we outlined more deeply through our Outlook 2021 Investing in Longevity theme.

Figure 5: Stay at Home vs Leave your Home Basket

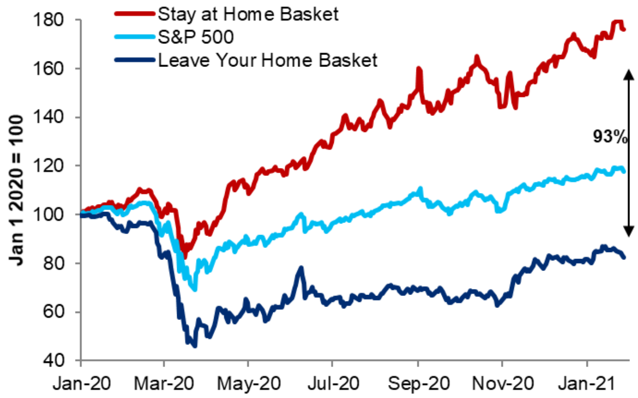
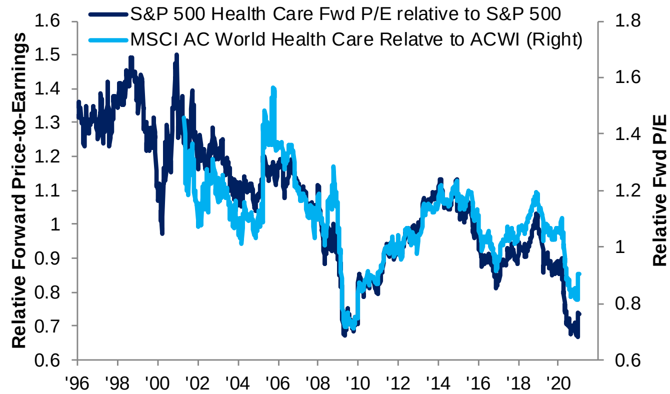


Figure 6: US and Global Health Care Relative Forward P/E



Source: Bloomberg and Haver Analytics as of January 27, 2021.

Note: Note: "Stay at Home" basket includes names identified to benefit from COVID-related disruptions and a shift to working from home

"Leave Your Home" basket includes Buy and Neutral Rated US names in the following sub-industries: Banks, Industrial Conglomerate, Machinery, Oil Gas & Consumable Fuel, Textiles Apparel & Luxury Goods, Energy Equipment & Services, Hotels Restaurants & Leisure, Building Products, Retail REITs, Construction & Engineering, Leisure Products, Airlines, Multiline Retail

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