The Perspective

Rational, independent thinking™

(Game)Stop the Insanity

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We utilize a rational and rigorous process to find, analyze, and select investments for our clients.

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(Game)Stop the Insanity

Many people were looking forward to 2021 with the hopes that it would be a return to normalcy. 2020 was indeed a crazy year. Thankfully, it appears that there is a sliver of light at the end of the pandemic tunnel as several COVID vaccines are being administered around the world. However, even with that tidbit of good news, other incredible events have stepped in to keep us saying to ourselves, “Are you serious?!”

Perhaps no other market story has kept us glued to our screens in recent days more than GameStop. It’s a retailer of video games and other electronics accessories. This business used to be hugely profitable, generating returns on net invested capital of over 60% and nearly half a billion dollars of free cash flow per annum just a decade ago. But, like many retailers that were built around physical locations, the online world eroded this franchise. Revenues are down one-third from their peak and free cash flow has evaporated.

Without getting into too much detail, "shorting" a stock is making a bet that the stock price will decline. Let's say LeakyBoat Corp. is $50 per share and you think its price will fall. You, with the help of your broker, borrow a share of LeakyBoat Corp. and then proceed to sell it at $50. You now have $50 cash in your account, but you owe one *share* of LeakyBoat Corp. to the broker. If LeakyBoat Corp.'s price sinks to $30, you can buy back a share at this new lower price, repay the loan of the one share to your broker, and pocket the profit of $20.

What makes shorting stocks riskier than buying stocks (called going "long") is that in theory, your loss is unlimited. When you go long and buy a stock, if it goes to $0, you've lost 100% of your money. No one would call this anything but terrible. Nonetheless, this is much better than what can happen with a short. In the example above, if instead of dropping to $30 per share, LeakyBoat Corp. rose to $150 per share - and you decided or were forced to close out (or "cover") your position, you'd now be paying $150 to buy back the share that you need to return to your broker. Your loss would be $100, double the original proceeds you received from shorting the share. When we joke about losing "only" 100% of your money with a long position as not being the worst outcome, this is why. Shorting stocks is not for the faint of heart and it should indeed come with the warning label "Don't try this at home".

GameStop closed 2020 at just under $20 per share. Because many people had a less-than-rosy outlook for GameStop, it was a heavily-shorted stock, with *many* investors betting on its continued decline. Importantly, several of the short sellers were sophisticated hedge funds. The funds often publicized their short positions, hoping to use the media in an attempt to drive down the price of the stock they've shorted so they could cover their short with a handsome profit.

In such situations, if the share price starts to rise instead of fall, a "short squeeze" may occur. This is when the price rises so much that the short sellers can't withstand the emotional and financial pressure, and they buy the stock to cover their position rather than face the prospect of losing multiples of their initial capital. Up until this point, none of this is unusual. Short sellers have long faced the prospects of others trying to create short squeezes, which result in even higher prices and more buying by short sellers to cover their positions.

Where this story deviates from the norm is how a few people in an online forum thought they could facilitate and exacerbate a short squeeze in GameStop by using the force of tens, if not hundreds, of thousands of retail investors to drive the price higher. What started as an attempt to force a short squeeze evolved into a "Let's teach those Wall Street bastards a lesson" crusade. Hordes of retail investors, many of them using a retail trading platform called Robinhood, stampeded into GameStop stock, driving its price to nearly $500 per share in just a few weeks, a nearly 30-fold increase from where it was at the beginning of 2021. Along the way, they did inflict some pain on several hedge funds which suffered billions of dollars in losses.

However, what was unfortunate about the entire situation is that it seemed to us that the hedge funds were not going to be the biggest casualties in the end. We watched with fascination as the stock went vertical and then subsequently retreated nearly 90% from its highs.

It is still the early stages of the aftermath of the GameStop saga and there are several key takeaways we feel are worth noting.

With Great Power Comes Great Responsibility

As this stock market soap opera was unfolding, a few high-profile business people used their online influence to encourage retail investors to continue their buying campaign. This select group of business icons may hate Wall Street, and in particular, short sellers, but we think that as one's influence grows, you should be more cautious with your words. As they say, "With great power comes great responsibility". They may have inflicted damage to a few Wall Street enemies, but along the way, these business celebrities – indirectly – likely wiped out most of the life savings of thousands of retail investors. To us, these giants of business and venture capital seemed intoxicated by the outsized influence they had, and they promoted a stampede into a handful of stocks without thinking much about who would get hurt the most in the end. If you're rich enough to own an NBA team, or have built one of the ten most-valuable companies in the S&P 500, maybe you should not be using small investors as your pawns to prove a point, or to entertain yourself by seeing how much you can move stock prices with your tweets.

If It's Free, *You* are the Product Being Sold

Many of the retail investors who were involved in trading GameStop did so using a popular platform called Robinhood. Robinhood experienced exponential growth in its user base in recent years. From its inception in 2013, they grew to over 13 million users. Prior to this GameStop fiasco, the company was slated for an initial public offering at a valuation north of $10 billion.

Robinhood appealed to small investors, many of them young and new to investing, because it offered commission-free trading (outside of mandatory regulatory fees), and presented trading as a fun and entertaining activity.

Average Account Size

Robinhood	$1,000 to $5,000
E-Trade	$100,000
TD Ameritrade	$110,000
Charles Schwab	$240,000

Source: tinyurl.com/1qc17zsv

Robinhood, through its platform, is responsible for the "gamification" of investing. When we say "game", we mean that literally. Imagine confetti falling across your screen when you executed certain trades. Turning investing into a game obscures the risks involved in buying stocks.

With this business model, Robinhood was incredibly successful at getting users addicted to trading and doing so more frequently than investors on other platforms. In addition to trading more often, Robinhood users also tended to trade more options – one of the most potentially-risky financial products – compared to users of other online brokerage services.

While Robinhood was undoubtedly successful in growing its business, it is unfortunate that their average user did not realize the risks they were taking. "Free" is great, but as the adage goes, if it sounds too good to be true… In this case, while the trading was commission free, there *was* a significant cost. Robinhood made its money selling the order flow of its user base to other institutional firms. These professional traders, often high-frequency traders, or market makers – people who would try to profit from being both a buyer and seller of a stock at various price levels – paid Robinhood for this information so they could use it to successfully enhance the profitability of their own trades. (We would call this front-running, but we're old fashioned!) The selling of order flow on Wall Street is not new, but it is eyebrow-raising how Robinhood was able to generate so much revenue from this practice. To put this in perspective, Charles Schwab has approximately $4 trillion in assets under management. That's not a typo, that's trillion, with a "t". Robinhood is private but is estimated to have $20 billion in assets under management. Even though Charles Schwab is a diversified financial services firm with other revenue sources besides the sale of order flow, keep in mind it is nonetheless *200 times bigger* than Robinhood and has over 14 million active brokerage accounts (this is *before* their acquisition of TD Ameritrade). Despite this enormous size disadvantage, Robinhood was able to generate 2.7x more order flow revenue than Charles Schwab.

		Q2 2020	
Broker	**Trade**	**Payment for Orders**	**Rate/100 Shares**
Robinhood	Equity	$69,116,307	$0.17
	Option	$111,148,089	$0.58
	Total	$180,264,395	$0.30
Charles Schwab	Equity	$32,396,842	$0.11
	Option	$33,745,172	$0.37
	Total	$66,142,014	$0.18

Source: CNBC, Piper Sandler, SEC filings

While it is possible that Robinhood's executive team may be the world's greatest negotiators, we would speculate that institutional traders were willing to pay more for Robinhood's order flow because it was easier to make money trading against these relatively inexperienced market participants. And, even after taking into account the higher rate

Robinhood was able to charge for its order flow, an average of 30 cents versus 18 cents for Charles Schwab, it's clear that Robinhood traders transacted orders of magnitude more frequently than clients of other brokerage firms.

Just as Facebook makes its money by offering a "free" service, but still is able to profit from your cost-free use by selling your personal information to others, Robinhood charges you nothing to execute trades, but there is indeed a significant, but hidden, cost. In fact, this cost was too hidden. Robinhood was recently fined $65 million by the SEC for failing to properly disclose its practice of selling order flow to market makers. We suspect that this practice of selling order flow will come under even more government scrutiny and less-sophisticated investors will hopefully be offered better protection in the future. At the very least, we would hope that Robinhood and other trading platforms will be much more transparent about payments for order flow and improve their disclosure about the risks of trading certain types of financial products like options.

Chasing High Returns in Short Time Frames is High Risk

This is the message we all wish was untrue. Of course it would be fantastic to be able to – repeatedly and with acceptable risk – make high returns in short periods of time. Who wouldn't want to see their portfolio triple in a few weeks? Unfortunately, we are unaware of any investment approach that accomplishes this in a reasonable *risk-adjusted* manner. With GameStop losing 90% of its value in just a few days after hitting its peak, we hope that people realize that investing is not a game and there can indeed be a significant downside. Although the final chapter of this tale has not yet been written, we are already reading stories about people who have lost their life savings and have also had their personal lives destroyed as a result of the financial catastrophe they have suffered.

Risk is an ever-present part of investing. At certain points during the market cycle, the recognition of risk recedes more than it should, particularly during periods of stock market exuberance. The words "margin of safety" may seem trite, but we'll bet that tens of thousands of investors had wished they had not forgotten these words of wisdom in recent days.

Financial catastrophes can occur in a heartbeat. We've experienced a few tumultuous periods during our investing careers and this is why our approach to investing is focused so much on protecting the downside. We're not likely to own the highest-flying stock in any given year, but we're okay with that because it also makes us less likely to get run over by the proverbial financial bus.

We are not saying that investing cannot be fun. There are few pursuits that are as intellectually and financially rewarding. However, just because something can be fun doesn't mean it should be undertaken in a cavalier manner. Skydiving is exhilarating, but you'd better be sure you take every safety precaution before you jump out of the plane.

The longer this bull market continues, and the more you see stories about "easy" ways to make money quickly, the more you need to be cognizant of the growing risks posed by rapidly rising stock prices.

> *"Be fearful when others are greedy, and greedy when others are fearful."*
>
> Warren Buffett

Sincerely,

Lung-Ming Lam
(416) 342-5626

Kevin Kuebler
(416) 342-5625

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333 Bay Street – Suite 1140, Toronto, Ontario M5H 2R2 | www.SilverHeights.com