The rise of the retail investor

By Jean-Jacques Duyvené de Wit

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Governments and central banks across the globe have implemented measures to counter the expected negative effects of Covid-19 and lockdowns on economies since the start of the pandemic. Many central banks drastically reduced the cost of borrowing through monetary easing and with fixed income yields dropping to very low levels, investors (often with borrowed cash) have turned elsewhere in search of yield.

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The MSCI World Index, a broad measure of global equities, ended the 2020 calendar year 14% higher than where it started. Many companies globally are trading at lofty valuations, fuelled in part by cheap money.

However, there's another interesting trend that's emerging.

Short squeeze

The website Reddit has many communities where users can discuss and share information on matters of interest. One of these subreddits, called wallstreetbets, is an online forum where participants discuss stock and option trading.

Characterised by profane and juvenile behaviour, their aggressive trading strategies often entail speculative, leveraged options trading. Their activities are often viewed as gambling since they ignore fundamental investment practices and risk-management techniques.

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All around the world, conditions have forced people to stay home, and with access to cheap money (free money in the case of US stimulus cheques), one can understand the increased uptake of retail online trading and investing.

One of the strategies recently employed on wallstreetbets was to identify a company that had large short positions on it – and then to buy up the stock to trigger a short squeeze.

Desperate short holders receiving large margin calls – and most likely breaching risk limits – would then have to buy stock to cover their short positions. Their buying would drive prices up further – the point at which the community members would sell out of their positions at a profit.

Regulators

This was their strategy with the US stock GameStop. In the last few weeks, we’ve read about the community’s involvement in international shares like GameStop, Steinhoff, Koss, TRX and commodities like silver. Our colleagues monitoring institutional trading are as a result reporting record-breaking volatility numbers, the likes of which they’ve never seen before in single stock names.

There has been wide media coverage on large multinational institutions involved in manipulating the Libor rate – these are rates mostly traded in the institutional space. As those institutions found out, there are regulatory repercussions for colluding to influence the price of financial instruments.

It will be interesting to see whether similar action is taken by regulators against retail traders who collude to influence stock prices. Interestingly enough, a lot of the evidence against the institutional traders manipulating the Libor rate was gathered from online messenger services/chatrooms.

Bubble

Unfortunately, a lot of the activity by traders in the wallstreetbets community seems to be speculative – they are taking leveraged short-term positions hoping that there will be a buyer at a higher price when they want to sell their stock.

They disregard investment practices of fairly assessing companies, valuing them individually and against competitors. In the words of Ed Seykota: “There are old traders and there are bold traders, but there are very few old, bold traders.”

Long-term stock market investors know that most financial bubbles are characterised by speculative bubbles, often fuelled by cheap money. These periods of speculative investor behaviour manifest themselves time and time again. The question remains: when will this bull market end? There’s no easy answer – as we all know, bull markets can run far harder and far longer than most people expect.

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