NAPATREE CAPITAL

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THE GAMESTOP (GME) FRENZY

The trading hysteria in shares of video game retailer, Gamestop (GME), is the result of a number of intersecting, overlapping trends. Is it the story of a powerful hedge fund being taken down by an army of retail traders? Partly. Market manipulation? Probably. Without question the dramatic price swings of the stock is incredibly unpredictable and irregular.

Briefly, GME is the largest video game retailer in the country, operating mostly out of stores located in shopping or strip malls. Earnings have been failing for years despite explosive growth in gaming (Fortnite, Minecraft et al). An investment firm, Citron Research, published a note saying the price of the stock was overvalued after an approximate 700% rally from August of last year to early January.

Meanwhile, a coordinated effort by retail traders via Reddit, a Twitter-like social media platform, was underway to continue to buy shares, pushing the price higher. A thread on Reddit, called "Wall Street Bets", with a couple hundred thousand members who post anonymously, continued to pump the stock, encouraging buying. One of the members had tracked the sizeable short activity in the stock, setting off a call to the community to buy and squeeze the shorts out. One of those short sellers, a large hedge fund called Melvin Capital, had shorted a significant number of shares of GME (betting the price goes down). As the price of the stock continued to rise, short sellers, competing with the army of Reddit buyers, continued to sell shares betting on a decline.

Short selling is highly risky. A "crowded" short, meaning many short sellers, generally increases the risk and heightens the volatility in shares. As shares continued to rally, and those short sellers start losing money, they have to cover their shorts by buying the stock back at a loss. This is called a short squeeze, pushing the stock price higher. A "David vs Goliath" theme emerged in GME whereby the small investors relished the game of taking down institutional investors who were short. The stock price rallied 900% from January 15 to earlier this week, fueled by a combination of short covering and continued buying by the coordinated efforts of those armchair traders. Simply put, it was as if there were only buyers in the market.

Enter Robinhood. Robinhood is a digital trading platform which disrupted the brokerage industry in the past few years by offering the ability for anyone to open a trading account with no minimum investment and zero commissions. The app attracted a large number of small investors, exemplifying the “do-it-yourself” trend underway in most industries today. Robinhood also caused the largest brokerages, Schwab, Fidelity, TD Ameritrade, and others, to also slash commissions on trades to $0.

Much of the trading in shares of GME (and other stocks as well, such as AMC, BBBY) was happening via Robinhood. The Robinhood traders, united in solidarity to take down the “big guys” were in the midst of a digital revolution to “occupy” Wall Street. And it worked. Until it didn’t.

This past week shares of GME had wild swings, opening Monday morning around $88 per share and trading as high as $513 in the pre-market on Thursday, before closing around $194 that same day. Trading has been so volatile that Robinhood, the platform whose objective was to democratize investing, restricted trading in GME shares, which actually exacerbated the volatility. The CEO of Robinhood claims the restricted access was to protect their clients from excess losses. I believe that we are not hearing the full story. Restricting access seems a lot more like “Big Brother” and contradicts the principles upon which the company was established.

My opinions in summary…

The small investor: access to investing has never been easier. Anyone with an internet connection can gain valuable insight and information on most publicly traded securities. The tools to learn are the best they have ever been. Kudos to any small investor who can do enough analysis on her own as a side endeavor; this is a positive trend. But the intentional takedown of institutional investors is dangerous and ends badly for all involved.

Melvin Capital/the ‘Hedge Fund’ guys: Having managed institutional assets where I could take a short position, I understand the challenges. However, all professional investors need discipline. Capital preservation is key. One of the most difficult parts of investing is knowing when to take a loss. I think hubris played a part in Melvin’s failure. One thing is certain: if I acted similarly with our clients’ funds, Napatree Capital would not be bailed out. And we wouldn’t deserve to be.

Robinhood: My gut says this episode may topple the company. Brokerages need to be able to fill orders for investors/traders and that is very difficult in such wild trading. It creates a liability for the broker. So, while Robinhood was founded on the premise of access for the small investor, the great irony is that very access is now being restricted and hurting their clientele. Another story is concurrently developing. Robinhood is owned by venture capital firms. Those firms are raising additional capital to bail out the company. A lot more to come on this part of the story. Much damage has been inflicted to the Robinhood brand as the platform’s users see the decisions over the last week or so to be hypocritical. Already law suits have been filed challenging the company’s actions.

Gamestop: It is a real company. Last year they generated more than $5 billion in sales. Context is totally lost because of the wild swings, but as of this writing it is up 60%, trading at $316 per share. That equates to a market capitalization about 23 billion, which is 4.6x revenue. Here are some examples of well-known stocks and their valuations using similar metrics:

Company	Ticker	Market Capitalzation	Estimated Revenue	Multiple of Revenue
Tesla	TSLA	780 bil	28 bil	28x
Zoom Video	ZM	109 bil	2 bil	55x
Snowflake	SNOW	76 bil	300 mil	253x
Uber	UBER	94 bil	13 bil	7x
Gamestop	GME	23 bil	5 bil	5x

Certainly, there is a lot more nuance when valuing public companies. But I think you see the point. When asked by a client if he should short it, my response was "It could go to $50 but it could also go to $500".

Wild Trading: This is not a new phenomenon. Nor is the idea of individual traders in a virtual chat room talking about a stock. Go to any Yahoo! Finance stock page and there is a chat feature. While the magnitude of these swings is abnormal, it isn't unique. Last year, shares of Tilray, symbol TLRY, a cannabis company, rallied 700% in four weeks on a short squeeze.

Media: The frenzy surrounding these types of events adds fuel to the fire. Last I checked there are about 1500 quality, public companies available for folks to invest. Gamestop and the like are tiny fractions of the investment landscape. It exacerbates problematic behavior (mostly greed), which is good for Napatree Capital because the…

'Do It Yourself 'trend: Just because someone hands you keys to a Formula One car doesn't mean you should enter the Grand Prix. If this whole situation doesn't make it obvious that hiring a professional to manage your funds is crucial to success, nothing will.

Bottom line: Investing carries risk. Why is no one talking about this? The stock market isn't a game. It isn't rigged against the little guy. It is a proven tool for wealth creation. Success requires patience, discipline, experience, and more than a little humility.

One final note…we had been invested in Gamestop since the inception of Napatree Capital (personally I had been invested for longer). Many of you probably saw it in your accounts. Our thesis was that the market had unfairly discounted a company at the forefront of a major trend, gaming. Wall Street research largely compared it to Blockbuster Video. We took a contrarian stance. The stock was so undervalued, the company had enough cash flow to repurchase all of the existing shares without moving the price much, effectively the company could've taken itself private. But Gamestop was a poorly managed company (they recently hired a new CEO which started the rally in the share price). After several quarters of declining earnings and lower sales figures, we decided to sell our stake at a loss, at a price between $5-$6 per share. Do I regret it? Of course. But certainly the current situation could not have been predicted and we have made plenty of profitable investments since that time. It was a single holding in a portfolio of stocks. We followed our discipline, and we don't regret that decision.

Hope this helps to frame the current situation that I'm sure you've heard about in the news.

Jeff