Recent Market Events

January 2021

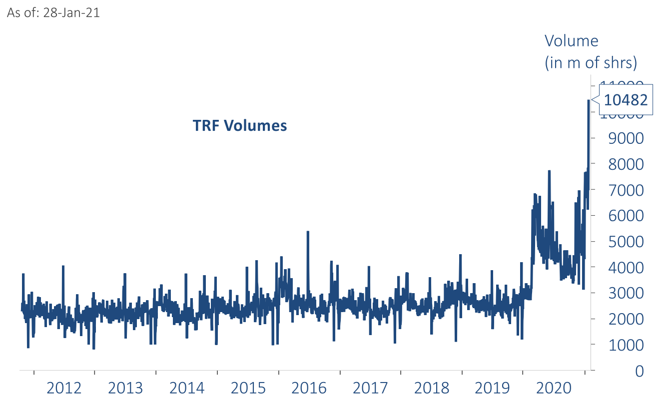
Retail investors are back…

Since the onset of the pandemic last March, a segment of the US retail investor base has grown much more active in trading single-name equities. Zero-cost trading on major retail brokerage platforms, the closure of traditional betting venues due to the pandemic, work-from-home and greater savings are driving an explosion in the volume traded by this investor group.

Retail trading activity can be approximated by tracking volume at Trade Reporting Facility (TRF) venues since these are used by brokers to report trades executed via alternative facilities, primarily used by firms catering to small investors. The first chart shows a new high in activity on Wednesday January 27th and more generally a significant pick-up in trading since the first quarter of 2020.

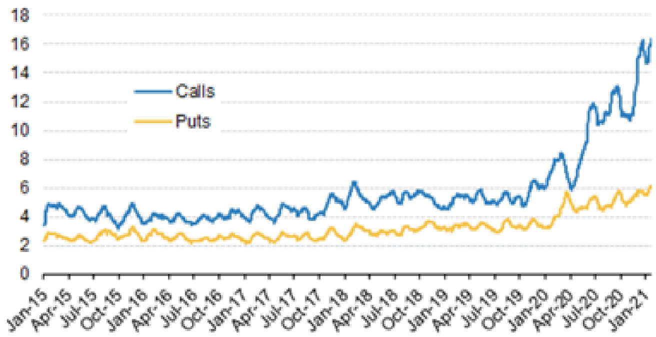
The activity is being driven by new day traders that often look to social media for trading tips. This exuberant behaviour, reminiscent of the dot-com bubble heydays, has extended to option markets, where volume in odd-lots (small orders) has exploded as part of the retail community seeks short-dated options to gain increased leverage on their capital. The following two charts highlight the significant growth in options volumes over recent months and how this has been primarily driven by small investors, aka retail.

Volume on TRF Exchange Facilities, a proxy for retail trading activity



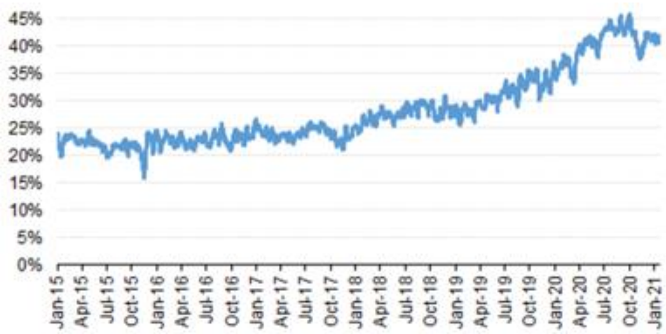
Source: Investcorp-Tages, Macrobond

Average Daily Single-name Option Volumes Customer traders, million contracts, 1m rolling



Source: Morgan Stanley, OCC

Small Lot Call Orders (<=10 lots) as Percentage of Total Call Volume



Source: Morgan Stanley, OCC

Recent Market Events

January 2021

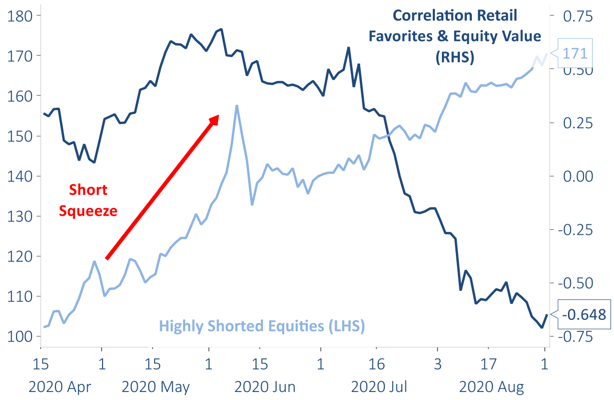
Burned once already...

In June of 2020, the rapid migration of retail day traders from "ultra-growth" stocks to value names, including bankrupt equities like Hertz, had already triggered a painful short covering episode for hedge funds. This investor group generally follows price momentum but has periodically shifted focus to "distressed" plays.

In recent days, a loosely organized community of retail traders' part of the Reddit Wallstreet bets community sought to replicate the phenomenon by targeting highly shorted US equities and buying "en masse", partly through short-dated call options. The strategy was initially focused on GameStop but quickly expanded to a larger universe of names throughout the week. This time around, the move is not driven by hopes of an economic rebound but has been expressly targeted towards a couple of hedge funds that had disclosed large short positions in these equities.

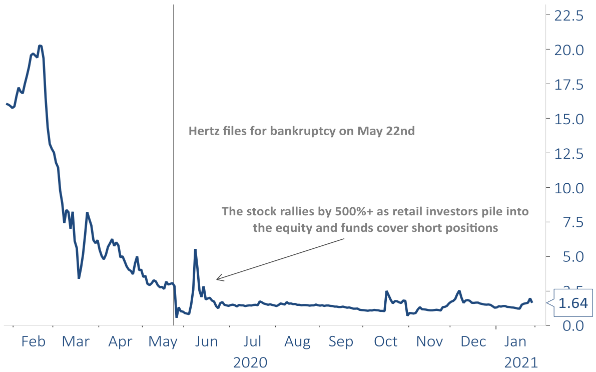
Needless to say, the move has not been driven by a change in the macro-economic environment or idiosyncratic positive developments for the single-name equities in question. It could nonetheless have positive impact for the targeted companies as they are able to issue equity capital at much higher valuations. For instance, AMC has issued equity at the new prevailing price levels, thus shoring up its balance sheet and leading to substantial gains to the price of its outstanding debt. These technical moves have had the impact of providing near bankrupt companies the luxury of time and liquidity options.

Retail quickly pivots to value stocks in May/June, triggering a painful short covering episode for hedge funds



Source: Investcorp-Tages, Macrobond

This has happened before...
Hertz unexplainably rallied a few weeks after announcing bankruptcy in May



Source: Investcorp-Tages, Macrobond

And again, this week: highly shorted equities skyrocket on retail demand and short covering

Source: Investcorp-Tages, Macrobond

Recent Market Events

January 2021

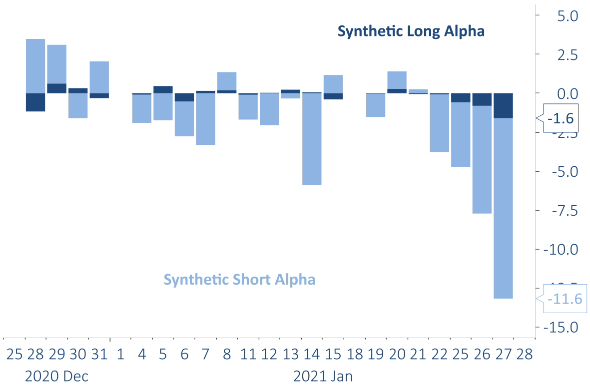
Painful week

The short squeeze has painfully affected several hedge funds, with reports of Melvin Capital requiring emergency capital influx from Citadel and Point72, for instance. The squeeze acted as a trigger to a larger unwind of positions within the industry on Tuesday and Wednesday.

The first two charts highlight the extent of the alpha destruction witnessed in recent days. Synthetic long alpha is computed as the performance differential between popular hedge fund long positions, as measured through the September-end 13F portfolio reports and the S&P500 index. Synthetic short alpha is computed as the performance differential between the S&P500 index and an equity basket composed of the most highly shorted equities – as measured by short interest ratios. Wednesday was the most dramatic drawdown for synthetic alpha, with the measure losing more than 12% on a single day.

Granted the actual damage across hedge fund investments is likely to be much lower, on average, as funds hold more diversified portfolios and respond quickly to changing market conditions. Goldman Sachs estimates that hedge funds on its prime brokerage platform saw an alpha destruction of only 3.1% on Wednesday January 27th. Funds have reduced gross exposure dramatically as the third chart shows, with Goldman Sachs reporting an 11-standard deviation reduction in gross exposure compared to averages since the global financial crisis.

Alpha destruction was driven by hedge funds short positions

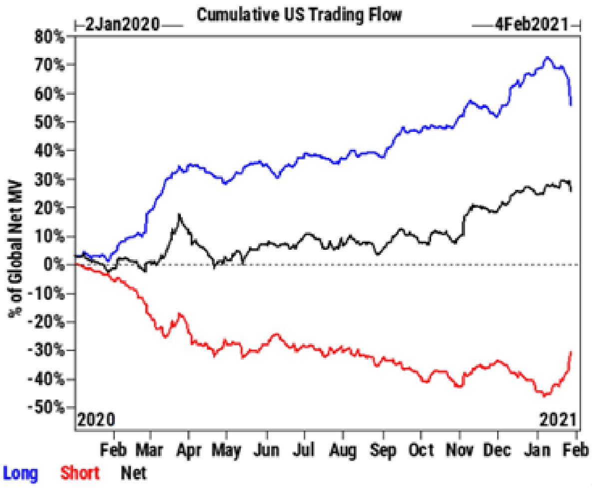


Source: GS, Investcorp-Tages, Macrobond

A long/short strategy of popular hedge fund longs against highly-shorted equities is experiencing its largest drawdown ever

Source: Goldman Sachs, Investcorp-Tages, Macrobond

Hedge funds are quickly covering short positions and reducing gross exposure



Source: Goldman Sachs

Recent Market Events

January 2021

<u>Limited impact across our portfolios</u>

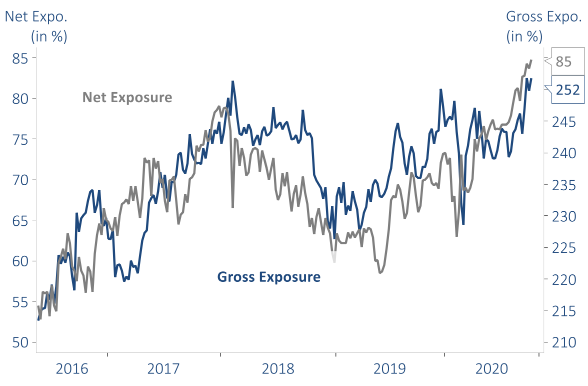
As regular readers of research will remember, we have warned about a toxic confluence of factors for equity L/S funds that left the strategy vulnerable, in our view.

The US equity long/short universe, on aggregate, had been running elevated risk levels with both net and gross exposure sitting close to their historical highs, as the next chart shows. The overlap across hedge fund portfolios, or crowding, had also reached high levels relative to history, while the industry ran concentrated factor bets with significant long growth and short value exposure.

The current liquidation episode is likely to improve the outlook notably for the strategy. It will lead funds to run lower risk, consistent with a still fluid macro-economic environment and elevated equity volatility.

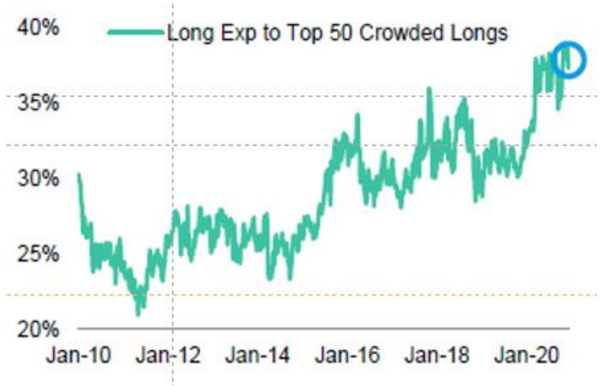
Outside of cryptocurrencies, we do not expect this ongoing retail frenzy to materially affect other markets, beyond US single-name stocks. Liquidity in interest rates, foreign exchange and commodities is deeper than in smaller cap single-name equities and barriers to entry too high for retail day traders to gain a meaningful foothold.

Hedge funds gross and net exposures were at multi-year highs



Source: GS, Investcorp-Tages, Macrobond

Long Exposure as a Percentage of Total Gross Exposure



Source: Morgan Stanley

Short Exposure as a Percentage of Total Gross Exposure

Source: Morgan Stanley

Recent Market Events

January 2021

Important Information