Long-Term, Short Squeeze

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Last week was one of those remarkable weeks in financial market history that will be remembered for a long time. It was not a market crash. In fact, I was surprised how little ripple effect there was into wider markets. I'd place something like this in a more esoteric "I thought that couldn't happen" camp…until it does happen. There have not been many of these events; excluding mainstream incidents like stock market crashes, only a handful of similar occasions over the past two decades come to mind (for example the Quant Crash of August 2007, Flash Crash in 2010 and oil prices turning negative in 2020).

Harbor's investment analysts looked at what impact the short squeeze in GameStop (and other companies) had on active managers, and what an event like this may mean for markets in the future.

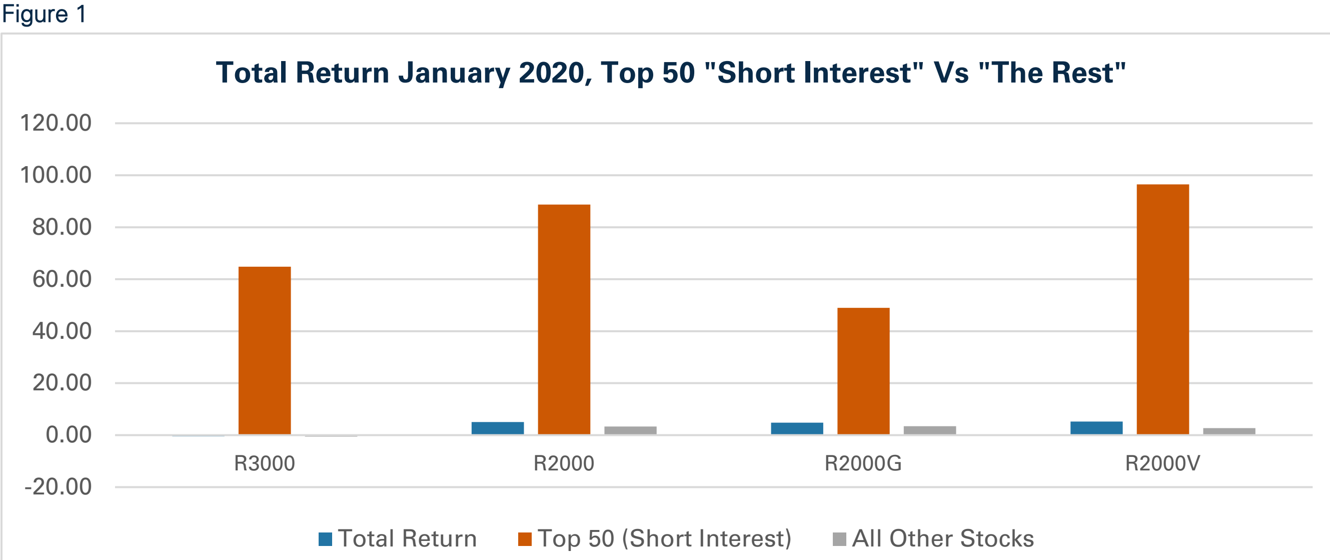
What is happening?

A short squeeze. The headlines may be all around GameStop, but this is only part of the story. What is unusual about this event is that it appears to be driven by masses of retail investors organizing themselves online.

How has this impacted active managers?

In a word, I would say "negatively." Figure 1 looks at the 50 stocks with the highest short interest across several Russell indexes vs. all other stocks in each index. It is striking to see how much better, on a total return basis, the top 50 most shorted stocks did versus EVERYTHING else. Remember, these are the most shorted stocks as they are the least liked by "professionals" (whatever that means anymore):

Figure 1

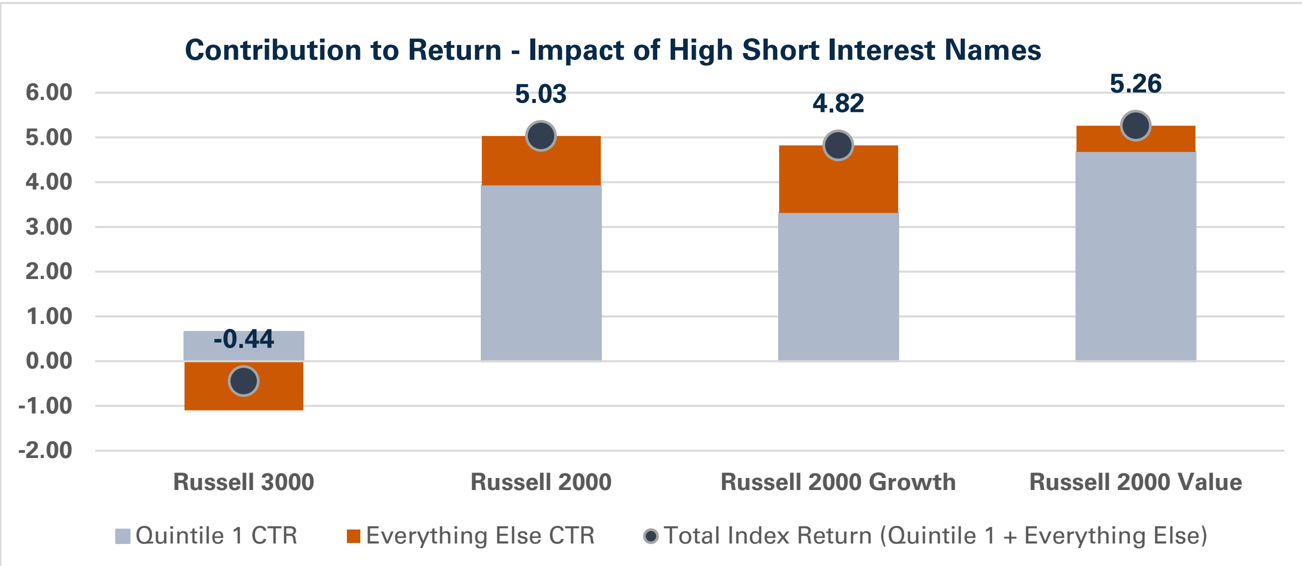


Source: FactSet, February 2021

All charts and data herein are shown for illustrative purposes only.

When the stocks that professionals like least crush everything else, I assume this will be a headwind overall for active management. But how much of a headwind? If you break the benchmark into "short interest" quintiles, you can see the above effect at play in terms of how they contributed to each benchmark's returns (Figure 2):

Figure 2

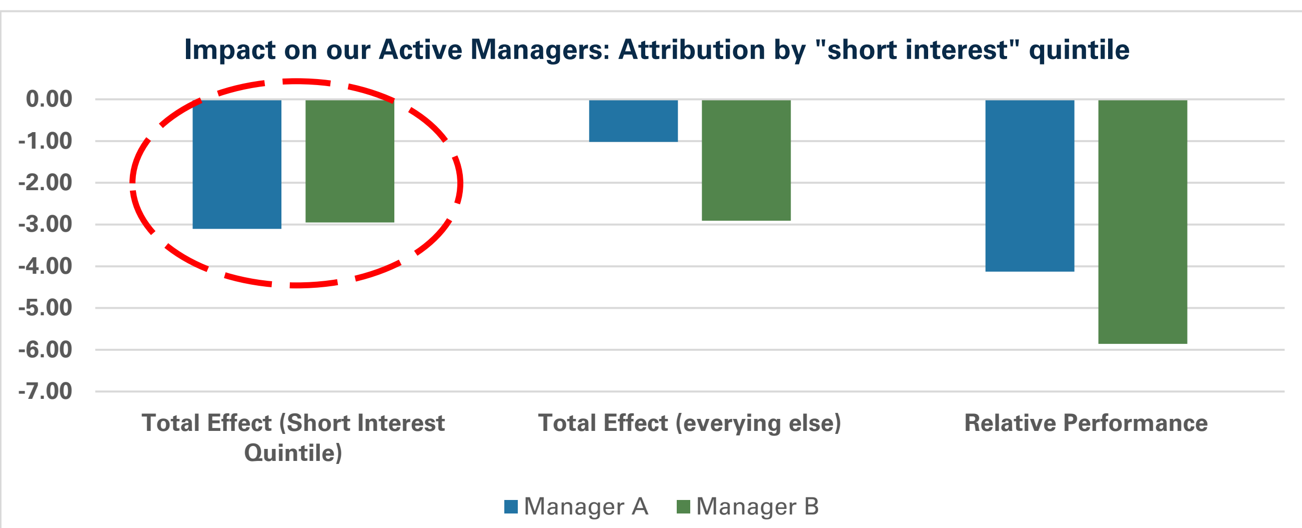


Source: FactSet, February 2021

Here, we see that the 20% of stocks with the highest short interest basically drove returns in January.

Let's take a look at a sample set of our managers. In Figure 3, I have picked two managers that I thought likely to be impacted by this event due to their investment universe and quality bias, meaning they are less likely to be overweight those shorted stocks.

Figure 3



Source: FactSet, February 2021

You can see that most of our managers' underperformance in January was due to this extraordinary event. I expect this underperformance to be a temporary phenomenon, but like I mentioned earlier, calling this from a timing perspective is impossible. I would not be surprised to see this continue in the very short run at least but it will probably unwind quite quickly. It looks like that has started to happen in early February and quite spectacularly too.

What should investors do?

The battle between the swell of retail investors and institutional short sellers has resulted in an "Us versus Them" mentality, with many on the retail side advocating to continue to buy and hold until the Wall Street shorts feel as much pain as possible. On the short side, according to Morgan Stanley's Prime Brokerage, last week was one of the more dramatic in de-grossing (short covering) in recent history. When all of this unwinds, I believe we will see some permanent changes to long-short investing, certainly from a liquidity, portfolio construction and tail-risk management perspective. Unfortunately, and rather tragically, I also expect many people to lose significant sums of money. It's impossible to predict when this event will end, but important to remember the following:

- **Commit to Due Diligence.** Exceptional research is a key component of both stock and manager selection. This is reflected at the stock level with GameStop's massive volatility, and at the manager level with some hedge funds losing more than 50% amid the mania. Harbor has witnessed a significant uptick in dispersion between managers through 2020 and into 2021. Simply put, active management matters again, making it all the more important to know what you're investing in and whom you're investing with. If you're looking into manager performance in January, *enhance your perspective & understanding* with the latest analytical data, tools and insights available.
- **Recognize Disruption**. We generally speak about disruption in terms of a company introducing a new product, service, or technology that shakes up an industry. Through this event, we have seen how the confluence of technology, zero fee brokerage, social media organization, and a shared mentality have disrupted and further democratized markets. I cannot see how hedge funds will return to conventional shorting. Unless there are creative ways to hide outright short positions using derivatives, I believe these managers will be much more cautious taking short positions in names that can be overrun by retail traders.
- **Be *Long-Term* Greedy.** Don't fall for the allure of short-term riches, it can be a dangerous trap. Focus on managers who sift through the noise and buy quality businesses for the long-term. Let compounding do the hard work for you.
- **Stay Diversified.** Proper diversification is a time-tested lynchpin of investing and risk management.

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