***Exchanges at Goldman Sachs*: The Short and Long of Recent Volatility**

Host: Allison Nathan

This is Exchanges at Goldman Sachs where we discuss developments currently shaping markets, industries, and the global economy. I'm Allison Nathan from Goldman Sachs Research, creator and editor of the firm's Top of Mind Report, which focuses on macro economic issues on the minds of our clients. In this episode, we focus on the volatile start to markets in 2021 with a number of heavily shorted stocks unexpectedly skyrocketing in late January amidst a boom in retail trading. This volatility seems to have subsided somewhat. But many questions remain. What factors led to this volatility? Is it likely to repeat, especially given the increased activity of retail investors? What could and/or should be done to prevent similar episodes in the future? And what, if anything, does this episode signal about the broader market or mean for it? Exploring these questions is Top of Mind.

We first turn to Kevin Kelly, Goldman Sachs co-head of Global Prime Services to break down the factors that led to the equity market volatility in late January.

What factors led to the recent period of volatility that we saw in select equities in January?

Kevin Kelly: So, we have to rewind the clock a bit to back in October where we started to see our prime brokerage clients heading to their long exposure at a much faster rate than to shorts driven by a multitude of factors, but definitely the positive outlook on earnings and fiscal stimulus. This was more pronounced within the long/short community where we observed the long/short ratio, which we measure as clients' long market value divided by the short market value, hitting an all time high at the end of 2020.

In early January, we also observed our clients covering nearly 5 percent of our US short book. Now, this was interesting to us as when we see that type of short covering in our portfolio, it's usually accompanied by long selling or long derisking, which didn't happen in January. By clients covering their shorts and not selling their longs, this led to an increased long exposure after being stretched into year end.

With this backdrop, over the first several weeks of January, we did observe when we looked at the prime brokerage performance that longs were underperforming as well as shorts. To put that in context, as of Friday, January 22nd, our internal estimate that we calculate within prime brokerage on client performance equated to 250 basis points of negative alpha performance, offset by 300 basis points of positive data, which is your client's net exposure to the market. That equated to a positive 50 basis points for the month. But then throughout the week of January 25th we observed an acceleration of poor performance on the long and short side of our long/short client portfolios. When you look at our performance for January on an asset weighted basis, we estimate that our long/short funds were done 5.9 percent. The performance loss though was primarily driven by the losses on the short side, which we estimate was 5.5 percent for the month. And a much more modest loss on the long side of .4 percent. And the most short float names in our most short basket was up 42 percent for the month.

This all reached a crescendo on January 27th with performance down 7 percent for the month. We then observed our clients derisking by selling longs as well as covering shorts. That day we observed the largest notional selling we have seen since 2008. This derisking was a majority of a US story. But we also did see derisking in Europe and Asia.

Allison Nathan: How do you think about leverage related to this episode?

Kevin Kelly: I don't believe that leverage played a material role in this bout of volatility. And I'll explain why. The community that experienced the most challenging performance was US long/short funds. Generally, these funds have gross exposure, which is defined as long market value plus short market value over equity, or their NAV of their fund, of less than 200 percent. So, they were levered four or five, six times. This is a modest leverage strategy.

Where the pain point really came from was on the short side, and specifically concentrated shorts. So, it wasn't much of an unwind given leverage. It was the performance degradation of shorts that led to people derisking and underperforming.

Allison Nathan: Given the importance of short selling to these market moves, we then speak to Wellington Management's Owen Lamont who published extensively on the topic during his prior academic career. He drills down into short selling dynamic and the role they likely played during the recent volatility.

How do short squeezes work? And when do we typically see them?

Owen Lamont: A short squeeze is usually defined as an increased in an asset's price that causes existing short sellers to buy the asset and to close their short position. They might do that because they're trying to limit their losses or because they've run out of collateral, or something has disrupted their ability to borrow the asset. So, you've got this additional buying by short sellers that pushes up the price even more. And that's a process that may just happen naturally. Or perhaps it's the result of deliberate market manipulation.

An extreme version of a short squeeze would be a corner. And a corner is where somebody gets control of the entire supply of the asset such that the short sellers are forced to buy from that person who is controlling the supply.

Allison Nathan: In Lamont's view, the recent volatility was the product of a short squeeze. But it differed from historical short squeezes in important ways.

Would you consider what occurred in the equity market in the US in January to be the product of a short squeeze?

Owen Lamont: Yes, I think there is no doubt that there were a handful of companies that were targeted that had high short interest. And we saw a series of short squeezes in a small number of stocks in the US starting in January and arguably continuing to today. It's similar to previous history like the Piggly Wiggly case, the Stutz Motor case, and Volkswagen in 2008, one of the largest short squeezes in history. For a couple days, Volkswagen was the largest market cap in the world. And then the price was moving, but not because of new information about the fundamental value.

What was different about January was, historically, a short squeeze is something that is done by a few large players. And here you had many small traders. I would describe what happened as a flash mob short squeeze where you had a large number of small players who were coordinating on social media. Also, in the case of Volkswagen, some people had to deliver Volkswagen shares. And they weren't able to deliver the shares because of disruptions in their ability to borrow the shares. I don't think the disruption of the securities loan market was the issue in January.

Allison Nathan: How common is it to see these types of dynamics in markets beyond equities?

Owen Lamont: Most of the historical examples of corners and manipulation come, not from the equity market, but from the commodities market and other markets. The Hunt brothers' corner of the silver market in 1980. Another famous example is the Solomon squeeze, which involved treasury notes. Different markets have different institutions, but the basic mechanism is the same.

Allison Nathan: I think asked Lamont about the role that retail traders played in the recent volatility and whether it's been overhyped. Here's his take.

Owen Lamont: I don't think that the impact of retail training has been overhyped. There is significant evidence that retail trading has grown. There's evidence that retail trading as a percent of total equity market share volume has probably doubled in the past couple years. And in the options market, retail trading has exploded.

With respect to their ability to access leverage through the options market, there's no doubt that that's part of the story. And part of the buying power of individual investors has been through equity options on individual stocks. One way to describe the events of January was a crowdsourced gamma squeeze. Gamma squeezed means that retail investors are buying options and trading in the options market. And the options dealers are hedging their exposure by buying shares. So, it's a way for the retail investors to magnify their impact on the underlying stock price.

Allison Nathan: Having put the latest market dynamics into context, the big question now is whether heightened retail trading activity, as well as the other factors that contributed to the late January events, are likely to repeat and what that means for markets.

In Kelly's view, it's difficult to say that the markets have moved completely beyond these dynamics. But he believes that shifts in positioning and awareness of this growing risk factor will leave hedge funds nimbler and better prepared to anticipate and manage them.

Are the underlying dynamics that drove this episode still intact? Or is it unlikely that we're going to see this confluence of events again?

Kevin Kelly: I think it's hard to say we've fully moved away from that dynamic. But at the time when we were speaking to clients in late January, our sense was that the performance challenges in derisking was mostly experienced and being driven from our US equity long/short client base. Which was later confirmed by performance data from client letters.

As we look at other hedge fund strategies, macro, CTA, credit systematic, many posted positive average returns in the month of January. And even within the long/short community in the US, the performance dispersion was very high with several managers actually posting positive returns for the month. And now, overall, risk is lower as positions in the most shorted names in the US has reduced dramatically. For example, the constituents of the GS most short basket collectively saw covering as much of 65 percent year to date on a unit basis. So today, equity long and short managers on average have much less exposure to these names. And they're much less exposed to a sharp rally. Our clients have repositioned their portfolios to remain nimble to this new market dynamic.

Allison Nathan: Kelly also emphasizes that even with record-breaking trading volumes during this period, the market functioned well from an execution, financing, and clearing standpoint.

Was there anything about this episode or any point during this episode where it seemed like the market wasn't functioning properly?

Kevin Kelly: No, the market functioned incredibly well as we've discussed. In one of those days, we had a record day of volume, everything went through very well from an execution standpoint, from a financing standpoint. Clearing. Everything was working well. So, I think the stability and fortitude of the market proved itself again during the last of January.

Allison Nathan: But Lamont stresses that short squeezes rarely happen in well-functioning markets. And he's concerned that market prices look less and less like the outcome of an orderly process. So, he believes that more volatile episodes are likely ahead. Here's Lamont.

Owen Lamont: Short squeezes are rare in well-functioning, liquid markets. And we shouldn't have a market where prices are moving so much in response to sentiment. We should have markets that are more robustly reacting to information. In academic finance we have a concept called noise trader risk. Noise trader risk is where you have traders who are doing weird stuff and they're making market prices move all around. And the rational traders don't want to bear that risk. They just exit. In that story, volatility begets volatility. And the crazy prices in volatility are a self-reinforcing cycle. So, I'm not sure whether it's the illiquidity that's causing the volatility today. Or the volatility that's causing the illiquidity. But somehow, we're in a situation where market prices, at least in a handful of names, seem out of whack.

The events of January just made it seem like our system is more fragile.

Allison Nathan: How likely are we to see similar episodes in the future?

Owen Lamont: I could imagine more squeezes, especially in illiquid names or in weird little corners of the market. I could imagine flash crashes. We had a flash crash in 2010 and other little incidents since then. So, it seems to me that we're in a market where prices are moving a lot. It's probably not that horrible if a couple stocks every now and then go crazy. But I'm more concerned about the whole system being fragile.

Allison Nathan: Finally, for perspective on the regulatory implications of the recent volatility we turned to Arthur Levitt, who was Chair of the SEC from 1993 through 2001 amid the internet bubble. Levitt sees parallels between then and now.

You were chairman of the SEC during the internet bubble. What similarities or differences do you see between the recent equity market volatility in that period or other periods in your career?

Arthur Levitt: There are considerable similarities between both periods. In both instances people were seeking high returns based on the upward momentum of the market rather than fundamental analysis. And the use of the internet to hype stocks in chat rooms or social media was present in both instances. And stock trading was viewed as kind of an entertainment. And there was a total divorce of pricing from fundamental research.

Allison Nathan: When you think about that episode of volatility and the recent one we experienced in January, do you consider it to be problematic?

Arthur Levitt: I think that volatility around individual stocks driven by casino-like trading is a byproduct of a culture of extreme risk taking, seeking higher returns than you can typically get. If record low interest rates are a byproduct of liquidity, then I'd say liquidity is a problem. When savers can't get any return on bank deposits, they're going to chase yield elsewhere. And chasing yield is always risky. But people need to be conditioned to the responsibilities and risks of long-term investment. We haven't had a sustained period of market weakness since '08 and '09. And most of today's day traders weren't in college yet at that time. They've never bought high and been forced to hold through a trough.

Allison Nathan: But while Levitt finds some aspects of the recent volatility problematic, he thinks some areas of focus in terms of what's been driving this volatility deserve more scrutiny like online trading platforms than others like short sellers.

In light of the testimonies, a lot of focus was on retail trading platforms. Do you have any thoughts about this?

Arthur Levitt: There is a role for these trading platforms. They're part of the fabric of our markets today. But investors using brokers have been told that they're getting their trades for free. But that's misleading. The reality is that investors get nothing for free. Brokers give away a percentage of the difference in the big NAS spreads or trading platforms, affecting the returns that investors get. As the old saying goes, if something's free, you are the product. And unfortunately, the trading platforms brokers route your stock trade to may not always be getting you the best deal. They're not necessarily acting in your best interest. That's why we need to consider how to make the plumbing in the markets more transparent and requiring those operating in the markets to really act in the best interests of their customers, the investing public.

I also think we need greater focus on whether trading platforms are using the same tools that make social networking platforms addictive.

Allison Nathan: There was also a lot of focus during this episode on short sellers. How do you view the role of short selling in the equity markets?

Arthur Levitt: There's an argument that short selling is actually a way to supply shares to a market where more investors want to hold long than there are shares available. I don't believe that argument is true. It's a way of allowing those who believe the stock is priced too high to invest on the short side by borrowing shares from most funds in a long position. I believe that short selling has an important role in insuring proper pricing of stocks in the market. There are those who have argued for the last 100 years that short selling should be banned. But often those arguments come from executives of companies whose stock is overpriced and being shorted. Enron is an example of that. In the fall of 2000, two hedge funds shorted the stock of Enron publicly, alerting investors that they believe the stock was significantly overpriced. A little over a year later, the seventh largest company in America was in bankruptcy and has ceased doing business.

Allison Nathan: Lamont agrees with Levitt, emphasizing that despite a common perception that short selling generates market volatility, it's actually a stabilizing force in the market that helps push asset prices towards their fundamental value. Here's more with Lamont.

Owen Lamont: Do you find shorting to be a good thing or a bad thing for well-functioning markets?

Owen Lamont: I think shorting is a good thing. It has several roles. One role is for short selling to get negative information into the market. So, you have optimists. You have pessimists. You want them to come together in a market to find the right price. And an important part of that process is to allow them to trade on their views. The second function or benefit of short selling is liquidity. Short sellers have to buy the asset eventually. And so, if you don't have short selling, you're going to decrease market liquidity.

Allison Nathan: Does it help to stabilize markets?

Owen Lamont: Milton Friedman said more than 50 years ago that speculation is inherently stabilizing because speculators buy low and sell high. So, if you think speculators are making money, you think they're stabilizing prices. Now, short sellers sell high and they buy low. So, they do it in a slightly different order, but they're doing the same thing. They're pushing prices towards fundamental value.

Is all speculation necessarily stabilizing? Profit-making speculation is going to be stabilizing. But if you have people who are trading for reasons other than profit motive, they're trading for fun or they're gambling or they've got some sort of antiestablishment feeling that they're trying to protest somehow with their trades, that's not profit seeking. And you could imagine that kind of speculation would be destabilizing. But I would argue that short selling is a good stabilizing force. And short sellers are an important part of a well functioning, liquid market. In places where you don't have short selling or where short selling is temporarily banned or restricted, those places typically have deterioration of market quality and prices are farther from fundamental value.

Allison Nathan: But the question remains whether the recent volatility suggests a need for new rules or regulation. Levitt says that volatile episodes have happened in the past and will happen again. But he struggles to define new regulation that could help protect investors from them.

Obviously, the million-dollar question that Congress and regulators are grappling with is whether any type of regulation should be increased or implemented to help avoid some of these bouts of volatility.

Arthur Levitt: I don't think I could define any new regulations that could be called upon to protect investors at this time of market volatility. We've seen periods such as this before and we'll see them again. So, it doesn't surprise me or worry me particularly.

Allison Nathan: But Levitt does believe that the new administration and incoming SEC Chair Gary Gensler will be focused on making sure that existing rules and regulations are still appropriate today. And he advocates that the SEC play a leading role in educating the public about the risks of investing.

Arthur Levitt: Generally speaking, with Democratic administrations, the Commission tends to be more aggressive from an enforcement point of view. Whether that continues remains to be seen. But I think that Gary Gensler is going to be a strong advocate for investors in Washington. And I don't expect him to ease up on regulations.

But markets are so sensitive. And we've been down most of these roads many times during market cycles. Gensler understands that as well as anybody in America. And rather than seeking out new corners for regulation, I think the Chairman of the SEC is going to be constantly examining existing rules and regulations to see if they are appropriate for today's markets. So, you never can sit back and rest on existing regulations and say, "The job has been done," because markets are constantly changing. And I think part of the responsibility of the head of the SEC is to see to it that regulations which were totally appropriate for periods in the past are adequate for the present time. And I can think of no one better than Gensler to make those judgments because he's lived through those markets in the past and lived through them with great expertise.

Allison Nathan: Beyond regulation, what else could and should the SEC do in response to all this?

Arthur Levitt: The Commission has to stand with the investing public in public markets. It's important that investors know that there is a cop on the beat, a regulator looking out for their best interests. The growth in retail trading may level off after people are able to return to full time work and school. But I think that it will outlast the next direction. That's the historical pattern.

And in one sense, retail trading is good. The more people involved in markets, the more they'll be sensitive to issues such as good corporate governance, efficient investment, et cetera. But people need to be conditioned to the responsibilities and risks of long-term investment. Retail trading doesn't encourage that education. Regulators should.

When I was at the Commission, I focused on engaging the public and educating the investing public through town halls, the internet, public speeches, and media. I don't think regulators realize they can and should use the bully pulpit to engage and educate. A vocal SEC chair can do more with public events than in a handful of rule changes or enforcement actions.

Allison Nathan: As we continue to grapple with questions following the recent volatility, we'll be sure to keep tabs on the implications for investors and for markets more broadly. I'll leave it there for now.

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I'm Allison Nathan. Thanks for listening to Exchanges at Goldman

Sachs. And I'll see you next time.