Wagner Road Capital Management

Why We Didn't Trade GameStop (And Other Things We Don't Do)

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"The GameStop trade" is old news by now, but it was unique enough to represent a timeless explanation of what we try to avoid. If you haven't heard the story yet, here's the simplified version:

1. GameStop (GME) stock had a low price on the expectation that its core business will eventually die.
2. The stock was excessively shorted. A high percentage of the shares had been borrowed and sold by short sellers—these shares would eventually have to be bought and returned (short sellers hope to buy the shares back at a lower price, making money on the way down).
3. Traders realized that the stock was excessively shorted and began to buy it, raising the price.
4. The short sellers were forced to start buying shares to close their short position, raising the price even more. This is called a short squeeze.
5. In just one week, GME stock had a return of 400%.
6. Other traders jumped into the trade hoping to ride the momentum.
7. The stock fell by more than 90% soon after the squeeze was over.

There is more to the story, but that's enough to get a general idea of what happened. It was a short term trade that relied on the actions of other traders to be successful, and it had a wide range of high risk outcomes—depending on which side you took, which trading tools you used, and when you bought in. None of those things fit what we're trying to do (our focus is on the fundamentals), but it helps describe the type of trading tools that we choose not to use. It's also a good contrast with the type of investing that we do.

We do not short sell.

Short selling can be unpopular because short sellers are betting against a company's success, but I think it's good to have incentives for investors to see the cynical side of things. In general, we see two main reasons why an investor would sell short. There are specific strategies for short selling, but almost all of them will fit within these two big ideas.

1. The short seller believes that the company is committing fraud.

2. The short seller believes that the company's price is too high when compared to its value.

It sounds pretty simple, but it's very hard to do, and it comes with some massive risks. This biggest one is that you can simply be wrong about the company.

The mania over GameStop is a great example of this risk. The short sellers piled in to GME stock on the belief that the stock price was too high to be justified. The long-term prospects of the company are not good, but the stock price already reflected these poor expectations. Too many short sellers crowded into the trade, and the price of GME stock spiked when they tried to exit the trade, leading to huge losses for the short sellers.

Being wrong is just a normal part of investing, but being wrong *on a short sale trade* is much more dangerous, because the downside is unlimited. And you could just try to not be wrong, but that's not always enough—*you can be right and still lose money*.

One of my favorite examples of a short seller being right is the short sale of a German company called Wirecard. The short version of the story is that some short sellers discovered that Wirecard was committing fraud, but they were harassed by the company (and German regulators!) for several years before this fraud was revealed.[1] For at least one of these investors, their short selling trade actually lost money—it took too long for the fraud to be exposed to the market. They were right, and they made the right trade, but they didn't make any profit.

And it's not just hidden fraud that can ruin a short seller's year. The speculation that comes with an excited market can be just as bad. One of the most consistent targets of short sellers is Tesla. The company has been overpriced for most of its history, but Tesla short sellers have regularly been punished for shorting Tesla. They were likely correct that the company's share price was too high, but it has continued to climb higher and higher. Many of these short sellers have lost a lot of money, and I know of at least one who had to shut down his investment fund after massive losses that came partially from shorting Tesla. The fact that the stock has fallen from its top doesn't mean anything to a short seller who couldn't hold on while it was rising.

That's the best summary of why we don't do any short selling. We certainly don't want to be wrong, but we also don't want to lose money when we're right.

[1] I believe this is the most compelling argument for allowing short sales. Frauds like Wirecard would go on for much longer without short sellers closely examining their business.

We do not use leverage or any type of derivatives.

The fastest way to achieve bigger returns is by using borrowed money or using derivatives such as options. An investor can reach 10x their money using these trading strategies when they might "only" double their money without it. These tools can also be useful for other investment strategies, such as managing short-term risk and protecting against volatility.

The challenge with using leverage to boost returns is that it can amplify returns to the upside *and* the downside—leverage that can double your winnings can also double your losses, or worse. And to do it correctly, you also have to get the timing right. These risks can be managed, but our aim is to avoid a reliance on timing and avoid any situation that could generate unnecessary losses. When the market turns, it turns hardest against those who borrowed the most.

The GME situation saw both sides of this. Early traders who bought options and borrowed money to invest in GME took home a huge windfall. The ones who came later, using the same tools and the same strategies, were too late—many of them lost everything, and some of them lost more than everything because of their leverage.

On the other hand, options strategies can be used to manage returns in the same way that they can amplify returns. They can protect against the downside and cap the upside. These strategies are useful in certain contexts, but we are not trying to be clever. They simply don't fit our current model.

We do not invest in "distressed" or speculative equities.

Every investment that we select has a strong balance sheet and strong profitability. But not every high quality company needs to have a high quality balance sheet, and not every high quality company needs to be profitable. Relaxing that standard would reveal a lot of high-growth investment opportunities.

But relaxing that standard too far implies a change in strategy. The line between high quality and "not high quality" is open to debate and depends on research preferences, but the closer you get to that line, the more temptation to abandon quality completely. We try to stay away from that line.

The line between high quality and low quality is easier to see. The complication for investors of low quality companies is that they are generally looking for one of three different outcomes (GameStop fit each one of these for different buyers of the stock):

1. The low quality company will become a high quality company in the future.
2. The low quality company has a price that is much lower than its true value.

3. The low quality company will go up in price because other people are buying it.

In extremely rare cases, we may consider the first one, but only if there is enough evidence that a transition is in progress. By the time that we decide to buy, it is likely that this type of company will already be high quality in some significant way. But the other two expectations simply don't match what we're trying to do.

For the second scenario, buying cheap stocks is not a bad strategy. The challenge is that buying low quality companies just because they are cheap means that you have to be right many times over—and the process will include owning a lot of losers. Warren Buffett made a lot more money after he switched to high quality companies.

The last one is where we find GameStop after the squeeze. As the share price went up, it created a situation where everyone knew that the price was too high. Almost everyone expected the price to go back down *eventually*, and the goal of their trades was to get out before that happened. Some of them did, but many of them did not. Trying to sell a stock when the price is obviously too high means that you have to find someone willing to pay that high price—in other words, you have to expect that someone else will be fooled into buying your overpriced shares. The higher the prices gets, the harder it is to find someone willing to pay it. We don't play that game, and we never will.

We Invest in High Quality Companies

Our perspective relies on business fundamentals. I've already described what this means in general terms in my first blog post, but I think it's useful to expand these ideas with a few more details.

The type of investment that we prefer is one that we never have to worry about (and ideally, never have to think about selling). To achieve that quality, there are a few features we look for. These core values will always be the starting point.

- Strong financial position
- Strong competitive position
- Good management team

My first blog post focused more on competitive position and management than financial position, so this is primarily about the numbers and some bigger ideas.[2]

When it comes to the numbers, we just try to make sure that they're "good enough" in terms of debt and profitability. To narrow down the options, my favorite *starting point* uses two simple metrics: Debt to Equity (D/E) and Return on Equity (ROE). Financial-minded people will intuitively understand the meaning of these metrics, but a basic summary is appropriate.

D/E measures how much debt a company is carrying compared to its equity, crudely showing how much of its returns are generated by borrowing money. It also gives a sense of how well the business can survive a crisis. A D/E ratio of one means that the company is using roughly equal amounts of debt and equity. Less than one means more equity than debt, and more than one means more debt than equity, while a ratio of zero means no debt at all. My search begins with a D/E of less than one. Depending on the industry, I may consider a slightly higher number, but generally set a strict limit at two (twice as much debt than equity). Accounting rules can significantly change a company's equity, unfairly showing a high D/E ratio, but this is a helpful way of quickly screening out the companies that have really high debt.

ROE shows how much money the company is earning on its equity. Higher earnings can raise this number, but so can higher debt—one of the reasons for paying attention to debt. I like to start my search by setting the limit at a minimum of 15% ROE, and get most excited when I see numbers above 20%. I don't use this metric as strictly as D/E because earnings can change dramatically with just one good year or one bad year, and what is considered a good number depends on the industry, but it's a starting point.

[2] If you don't remember the specifics, we basically like to see "a management team that thinks like owners" and a business "that operates inside an industry that is difficult for new companies to enter."

Using these two metrics this way will certainly remove companies with a unique situation, such as negative equity or intentionally low profitability, but the point is to start with companies that I can be *pretty sure* are high quality, and then do more research.[3] This is where I move on to the type of business and the management team, both features that I already covered in my first blog post.

Beyond financial position, competitive position, and management, that's the end of the company-specific focus. The bigger picture is that we're not just looking for high quality companies, we're also interested in high quality companies with *special opportunities*.

One way to evaluate these opportunities is by looking at a deep history of the industry, like I did with video games and the tech sector. This provides a good understanding of the origins of an industry's current opportunities, including every time that these "new" ideas have been tried before (and why they failed). We want to know why this time is different.

Even without a deep historical review, it is helpful to pay attention to the investment themes of today and look at where they are in the industry cycle. For example, some investment themes that are currently very popular:

- Telecommuting and telemedicine.
- Online shopping, takeout, and in-store pickup.
- Green energy and electric vehicle adoption.
- Plant-based meats.
- "Plant-based" smoking.
- Computer and genetics technologies for drug development.
- Cryptocurrencies…

The full list is much longer, but I think you get the idea. The point is that we can't ignore potentially transformative themes—as either threats or opportunities. And if we choose to invest in any of them, we will only do so through the investment in a high quality company.[4] Doing it this way will usually mean that we're not the first investors, and we might miss the fastest growing companies, but it also protects us from getting caught up in overhyped ideas that haven't yet been proven, and it resists the urge to overpay for an exciting theme.[5]

[3] For example, Home Depot and Domino's Pizza are both high quality companies that don't follow these numbers. There is more room for flexibility when accounting rules can hide a company's true value, but my preference is to start with an easier search. There is more than one way to find these companies.
[4] There are also investment prospects that we will never consider no matter how financially attractive they appear. Not every investment theme fits our goals.
[5] Investment themes can also be more short-term, but we generally won't invest specifically for a short-term theme. For example, the "lockdown" theme was popular at the height of the pandemic, and the "reopening" trade became more popular after vaccines were introduced.

The other part of this evaluation is an interest in optionality. For a high quality company, the concept of optionality is a side business that might work out, but it won't destroy the company if it doesn't work out. A great example of this is Alphabet's "other bets" segment. The company's core advertising business is not threatened by its investments in emerging industries such as self-driving cars. A company that is only focused on one area of new research might represent a higher potential return, but it won't be attached to the safety of Alphabet's core businesses and financial security. There are tradeoffs with every investment decision.

The really short version of all this research is a phrase that I've become fond of repeating: *Stability first, and then growth.*

Andrew Wagner
Chief Investment Officer
Wagner Road Capital Management