Meme Stocks: Implications on Institutional Benchmarking

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DelMarche

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Abstract

The behavior of retail investors has significant implications on certain segments of the stock market, which affects institutional investors' returns, volatility, and methodologies for benchmarking investment performance. This paper explores the areas of the market that are affected most, which are usually Small Cap equities.

Today's retail investor is setting records in terms of trading volume - affecting market volatility and creating anomalous trading patterns such as "short-squeeze" trades resulting from retail investors piling into meme stocks. Generally speaking, meme stocks are those that are popular on various online platforms, such as Reddit (think GameStop), Quora, Digg, and Mashable, despite an often challenged fundamental outlook. Retail investors' behavior has significant implications on certain segments of the stock market, which affects institutional investor returns, volatility, and methodologies for benchmarking investment performance.

Free Trades, COVID-19, the Retail Investor, and Robinhood

Historically speaking, retail investors have been classified as "dumb money" due to their behavioral shortcomings when it comes to investing and inefficient approach relative to industry best practices. Their impact also would typically seem to be minimal given the sheer size of the institutional marketplace. That stereotype, however, does not pair well with the fact that a person only known in online forums as "Roaring Kitty" testified before Congress on his impact and contributions to the retail investing space during 2021. So, how in the world did we get here? There is no certain answer, but the timing of brokerages cutting commissions in 2019 and 2020, the rise of trading apps and digital platforms, and the COVID-19 pandemic seem to have brought on a wave of new retail equity investors.

By 6/30/2021, new brokerage accounts opened by individual investors had already roughly matched the total created throughout 2020, hitting more than 10 million, according to estimates from JMP Securities. Individual investors have poured a net $140.6 billion into the U.S. stock market this year, according to data through 06/16/2021 from Vanda Research's VandaTrack. That is up roughly 33% from the same period a year ago, and more than six times the amount during the same stretch in 2019.[1]

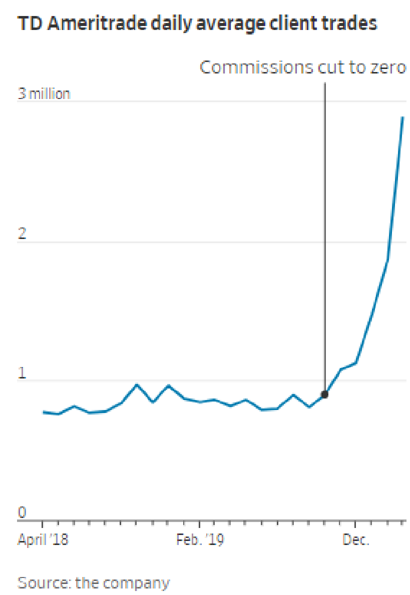
[1] McCabe, C. (2021, June 18). *It isn't Just AMC. Retail traders Increase pull on the stock market*. The Wall Street Journal. https://www.wsj.com/articles/it-isnt-just-amc-retail-traders-increase-pull-on-the-stock-market-11624008602.

According to Deutsche Bank, who surveyed 430 users of online broker platforms between Feb. 5 and 9 this year, half of the respondents between 25 and 34 years old plan to spend 50% of their COVID-19 relief payments on stocks. Trading stocks has become a common use for the stimulus checks and has also sparked interest in so-called meme stocks following the Reddit-fueled surge in GameStop earlier this year.

A survey from Charles Schwab attempts to estimate the size of this new generation of traders. Based on an analysis of about 500 investors, the brokerage found that 15% of current retail investors began participating in the market in 2020. Schwab — which now hosts 31.5 million retail clients and $6.9 trillion in assets because of the retail investing boom — is calling the new wave of investors "Generation Investor."[2] Retail trading had a record year in 2020, as unprecedented market volatility and COVID lockdowns created a unique opportunity for regular investors to play the stock market's surprising comeback. JMP Securities estimates the brokerage industry added roughly 10 million new clients in 2020, according to app download data from SimilarWeb. More than 6 million of those clients flocked to Robinhood, one of several fractional-share, commission-free web-based platforms for investing. Some of its popularity stems from the fact that all one needs is to be 18 years or older, have a valid Social Security number, and a U.S. address. "Robinhood (RH) investors collectively increased their holdings in the March 2020 COVID bear market, indicating an absence of panic and margin calls. Their steadfastness was rewarded in the subsequent bull market," is noted in NBER's Working Paper on "The Wisdom of the Robinhood Crowd."

> *"When Robinhood traders are more active in purchasing firms' shares around the earnings announcement event, it tends to drive returns up, and it tends to result in more positive returns, even if the earnings news was relatively negative."*
>
> *- Jeremy Michels, The Wharton School*

The commission-free aspect that Robinhood, and subsequently more established brokerage firms, has brought to mainstream investing[3] has led to dramatic increases in trading volume. An example is shown to the right. There is a valid argument, however, that nothing is free: The payments for order flow used by brokerages to make money from commission-free trades may result in lower quality order execution, leading to slightly higher buy prices and lower sell prices.



[2] Fitzgerald, M. (2021, April 8). *A large chunk of the retail investing crowd started during the pandemic, Schwab survey shows*. CNBC. https://www.cnbc.com/2021/04/08/a-large-chunk-of-the-retail-investing-crowd-got-their-start-during-the-pandemic-schwab-survey-shows.html.

[3] Robinhood pioneered commission-free trading, and they made money from interest, margin lending, fees for upgraded services, rehypothecation, and payment for order flow. Most other brokerages now offer commission-free trading, and their revenues from payments for order flow rose rapidly during 2020. The payments for order flow used by brokerages to make money from commission-free trades may result in lower quality order execution, leading to slightly higher buy prices and marginally lower sell prices.

So, what is the Retail Investor investing in?

While there's no actual indicator that denotes retail trading and allows broker/dealers to track it in real time, there are a few metrics that Cowen looked at that point to record levels in recent months.[4] The first is the sheer amount of volume so far in 2021. If we look at average daily volumes in U.S. equity markets over the prior 20+ years, 2021 volumes have outpaced the past dramatically. Through mid-March 2021, volume was averaging 15.2 B shares daily, which is almost 50% higher than last year's levels, which also set records. Retail online investors are investing in a wide variety of sectors and a wide range of market cap stocks.

While Tesla and Apple were the number one and two top Robinhood stocks in June 2021, the much smaller AMC Entertainment Holdings was number three.[5] Note that a given dollar trade in a large cap company will have less of an impact on that stock versus a much smaller company. For instance, a $1 billion aggregate purchase of Apple on a given day by retail investors would not even make the needle move (roughly 5/100 of a percent of the company, given a $2 trillion market cap). The same investment in Tesla might buy 1.5 percent of the company, depending on the day of purchase in the first half of 2021. Compare that to the small cap stocks that retail investors have been chasing. Using AMC as an example, $1 billion is over twice what AMC was worth at the beginning of the year. By June 30, the stock had experienced a total return of nearly 2,500%! Their second quarter return of 455%, which brought their market cap to about $29B, caused the market cap of their sector in the Russell 2000 Value Index, Communication Services, to have an average capitalization of $10.4 billion, dwarfing all other sectors, which ranged from $2.3 to $3.3 billion.[6] This rally is in the face of the company having to restructure its debt last year as well as having to issue new debt and equity ($1.2 billion in Q2 alone[7]) to stay afloat. The company has $5.5 billion worth of debt expiring by 2027 and to put that into context, the company's market cap was roughly $500 *million* at the end of 2020. Despite all of the volatility this year, we noted in last quarter's DeMarche paper that so far in 2021, evidence was starting to indicate that the **median active managers in various U.S. equity categories have performed *better* versus their benchmarks year-to-date. Not true for the small cap value space!** In small cap value, managers have struggled significantly to match the Russell 2000 Value, which was driven by a handful of stocks with outsized returns (see the table above).

Company	First Half 2021 Return (%)
AMC Entertainment Holdings Inc Class A	2,573
Cassava Sciences Inc	1,049
GameStop Corp Class A	1,012
Express, Inc.	680
Prothena Corp PLC	328
Chico's FAS Inc	313
Pandion Therapeutics Inc Ordinary Shares	304
SM Energy Co	302
Evolus Inc	297
3D Systems Corp	281
Tellurian Inc	233
Houghton Mifflin Harcourt Co	231
Peabody Energy Corp	229
Rubius Therapeutics Inc	225
Safe Bulkers Inc	208
Matador Resources Co	207
TimkenSteel Corp	203
IDT Corp Class B	199
Signet Jewelers Ltd	196
Veritiv Corp	195
Russell 2000 Value	**26.69**
Russell 2000	**17.54**

[4] Hadiaris, J. (2021, March 25). *Cowen market Structure: Retail trading - What's going on, what may change, and what can you do about it?* Cowen. https://www.cowen.com/insights/retail-trading-whats-going-on-what-may-change-and-what-can-institutional-traders-do-about-it/.
[5] Williams, S. (2021, June 1). *The top 50 ROBINHOOD stocks in June*. The Motley Fool. https://www.fool.com/investing/2021/06/01/the-top-50-robinhood-stocks-in-june/.
[6] Columbia Threadneedle Investments
[7] Li, Y. (2021, June 4). *AMC says it has already completed share offering, raises $587 million*. CNBC. https://www.cnbc.com/2021/06/03/amc-says-it-has-already-completed-share-offering-raises-587-million.html.

What does this mean for Institutional Investors?

Part of the headlines in early 2021 were the struggles of hedge funds, which were often betting against meme stocks, but the impact goes beyond hedge funds and into more traditional portfolios, particularly in small cap. AMC, GameStop, and others are all a part of the investment universe for these managers but more importantly, the benchmarks they are measured against. Both held meaningful weights in the Russell 2000 core and value benchmarks, with AMC occupying the highest weight as of 6/30/2021. Based on the struggling fundamentals of these companies, it is understandable for most institutional investors to avoid taking positions. For managers benchmarked against the Russell 2000, not owning GameStop in Q1 and AMC in Q2 would have detracted 0.37% and 0.62%, respectively, relative to the benchmark. The impact was even more severe for Russell 2000 Value managers where the numbers were 0.73% and 1.13%. Not owning these companies, as generally expected, can also add value relative to the benchmark. AMC, the largest constituent of the Russell 2000 and 2000 Value indices, fell 41% in the first nine trading days of the third quarter. Depending upon a money manager's investment style, it is not surprising many small cap core and value managers struggled during the first half of the year, though AMC certainly gave them an assist in July. Investing is hard enough, but now institutional managers are having to cite meme stocks in their quarterly commentaries — a relatively new phenomenon.

Institutional investors who have a preference for managers that focus on quality and are indifferent to high-tracking error in order to achieve alpha, may be in for an environment where high tracking error and patience is the norm in order to produce excess returns over the benchmark over the next several years. Passive investors, as well, need to understand what they hold in their portfolios, as the recent increase in absolute volatility may continue with the new generation of online Gen-Z investors. We do not know what the next AMC or GameStop will be, but if the current investor behavior continues, the impact of retail investors will continue to be felt by institutional investors.

Call to Action

The new wave of young, retail investors has changed the landscape of investing. Equity returns are a function of change in earnings and change in earnings multiples over the long term. While over the short term, investor sentiment may play an ever-increasing role as a result of zero-commission retail investing, fractional share investing, and a reemergence of short-term trading last witnessed during the dot com era. DeMarche feels now is as important a time as ever to understand what you hold in your portfolio and what risk characteristics are associated with your holdings. As portfolios change over time, it is critical to understand the processes and philosophies used by the managers that share your fiduciary duty overseeing your stakeholders' assets. As mentioned above, reconstitution of passive benchmarks have a great impact on your understanding of how your portfolio will react to moves in the capital markets. Please reach out to your DeMarche consultant to discuss this important topic in further detail.

Sources Utilized:

- *Wall Street Journal*
- *Investopedia*
- *CNBC*
- *NBER*
- *TD Ameritrade*
- *Deutsche Bank*
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- *Cowen*
- *JMP Securities*

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