WARRINGTON
ASSET MANAGEMENT

January 2021 Market Commentary

Political ructions in early January caused brief selloffs during the first few weeks of the month, but these proved temporary and stock markets quickly resumed their march higher. The situation changed in earnest later in the month when GameStop, a small-cap video game retailer that was a favorite short-selling position of a number of high-profile institutional investors (firms seeking to profit from what they perceive as an overvalued stock), became the target of a monumental short-squeeze. Atypically, the squeeze was not initiated by sophisticated professionals, but instead was the work of many smaller investors participating in an internet chat forum (Reddit, in this case), who acted in coordination to buy the stock and call options to drive the stock higher. GameStop shares then went parabolic, advancing from a low price of about $17 in early January to a peak of almost $500 near the end of the month. While a relatively small stock, the reverberations of this conflict required large portfolio managers to radically de-risk their portfolios by selling indexes and large-cap stocks, causing the S&P to selloff by about -4.6% in just a few days as investors struggled to determine the fallout from this situation.

The Strategic Program was able to achieve small profits from put spreads early in the month, taking advantage of the limited declines in the S&P. However, once the market began to falter late in the month and volatility began to rise significantly (from a low of 21 to a high of almost 40 a few days later), our risk management mandate led us to aggressively reduce position sizes and close out our ratio put spread positions, taking small losses from the hedges. The program finished the month of January was a net loss of -0.61%.

The Tactical Program accumulated profits throughout the month until the broader market selloff caused by the GameStop short squeeze. Hedging portfolio exposure rapidly when markets become unstable is a hallmark of our risk management philosophy, and a dramatic change in market risk parameters is a trigger for us to protect our portfolio even if our positions' risk levels are far removed from the current market price. We were able to minimize those hedging costs in January and achieve a profit of +0.35%.

Discussions in the media following the GameStop event suggested a battle between "ordinary" investors and larger institutions and highlighted the new-found power of the non-professionals to push back against the "establishment" of Wall Street. While the populist interpretation of this event is a win for "David vs. Goliath", we believe the takeaway is somewhat different. Our concern is more focused on the idea that if a collective of investors is able to control a small company's stock due to a high level of short exposure, what happens if similar groups target more serious areas of prospective dislocation, such as the CBOE Market Volatility Index ("VIX") or other unstable derivative instruments? The ramifications could be much greater and present a new risk to equities that does not appear to have been contemplated prior to this month's clash. We will continue looking for these and other factors that may impact our portfolios, and for ways to protect and profit from them.

As always, we thank you for you continued support of Warrington Asset Management.