Twitter Thread by Emily Suvada

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Seeing lots of explainers about the reddit/hedge fund drama right now, and as someone who worked as a quant for a big fund for 7 years, figured I'd chime in. This whole situation is pretty much why I quit. Big thread.

First, what's happening? At the simplest level, hedge funds "short" stocks. That is, they borrow stock, sell it, and have to buy it again later to return it to the borrower. If the price falls during that time, they make a profit.

It's an effective way to make money from falling prices. But it also has enormous risk. Normally, if you put $100 in a stock, all you can lose is that $100. But if you short a stock and it goes to the moon, your losses are unlimited.

Consider $GME, Gamestop. Let's say a fund shorted it when it was $40. When the price spiked to $470 today, they'd be facing a LOSS of $430 on that $40 investment. If they shorted it for, say, $10M, they'd be facing a loss of >$100M.

But it gets worse. Let's say an institution BORROWED money and then used that loan to short the stock. That's called leverage. Before the GFC, banks were running at ~33x leverage ratios. For every $1 they owned, they'd invested $33.

It's not accurate to apply that ratio here, but you need to know that a lot of the money in the market is borrowed. Margin (leverage) debt right now is at a record high. Higher than the GFC. It's hard to overstate how dangerous this is.

So what if you were able to borrow money and short GME? Your loss would be multiplied by your leverage ratio. At a high leverage ratio, it wouldn't take a very large short position against Gamestop's $40>>$430 run to bankrupt you.

If you don't want to be bankrupted, then if you're short and the price rises, you're forced (sometimes literally) to rush in and buy stock. That pushes the price up even more, making the problem worse. It's called a short squeeze.

These squeezes have been happening forever. It's nothing new. Usually, it's the institutions and big investors squeezing each other in semi-secrecy. This one is spectacular because it's open to small investors who are coordinating online.

You might ask: why are funds allowed to take these risks? After all, a lot of money in these funds is people's 401ks. Well, there are three big risk model styles that forecast stockmarket risk and NONE of them would cover this situation.

One reason banks fell in the GFC was their risk models failed. They knew the risks for stocks, bonds, real estate etc falling, but they didn't consider them all falling at the same time. It was a new kind of risk. And this is, too.

No risk model could predict small investors piling into $GME at $200 because of internet memes. I don't know how many standard deviations this move is, but it's literally off the charts. And now these funds are taking it in the teeth.

But there's more! We must mention OPTIONS! If you think a stock will fall, you can sell someone a contract that'll let them buy the stock later at a high price. If it never hits that price, you keep what they paid you for the contract.

Theoretically, you'd OWN that stock before you write contracts to sell it. YOU WOULD THINK SO. But no! Enter "naked calls"! You write a contract to sell stock, WITHOUT OWNING IT. If it rises, you scramble to buy and cover the contract.

And what have these small investors been buying huge amounts of? CALL OPTIONS. They're squeezing in MULTIPLE UNFORESEEN dimensions. It's epic, it's mind-boggling and it's so damn entertaining to watch. But it's not all fun and games.

The story we all want to see is a bunch of little fish banding together to take down big sharks. We're seeing that, sure, but behind these fish are almost certainly giant sharks who are urging this buying mania and profiting from it.

BlackRock is estimated to have made billions in this trade. Michael Burry's fund is profiting by 100s of millions. They're just some we know. Can they cash out and lock in those profits? Unknown. But I bet they're not holding to the moon.

On the other side, the sharks have tools at their disposal to crush the fish. They're already forcing brokers to stop trades in these stocks. They have real, coordinated power. They have lobbyists and donate huge amounts to politicians.

Besides which, they're big enough to literally call up Gamestop and ask them to issue stock at an agreed-upon price. Free money for GME, and boom - the funds have covered their shorts. It would be a win-win for everyone but the fish.

And then you have to look at the bigger picture. The stock market is bubbling, and a crash is imminent. It's beyond debate. And what's happening right now? Millions of new investors are racing in a FOMO panic and throwing their money in.

You have a bunch of banks holding stocks they know are going to tank, staring down the barrel of a crash, and now there's a flood of folks opening brokerage accounts to take those toxic stocks right off their hands.

Because the music will stop eventually, and the people who will lose will be whoever's left holding the bag. I look at this small investor buying frenzy and I see small investors signing up to be those bag-holders. Same as it ever was.

But here's the thing - these investors don't want my pity and they don't need it. Plenty are young, and look at what they're saying. They want to make $$, but what they're yelling about is burning down the machine that's keeping them small.

The only obvious thing about this is that there's a massive swath of folks who have no belief in the American dream, and who know their only chance at a big paycheck is to risk EVERYTHING in a YOLO trade, firing bullets at the big machine.

That machine is built to suck money up and funnel it to the top. What's worse, it's so easy. What's worse is that it's allowed. It's why I couldn't work in finance any more, and why I'm glued to the markets in moments like this.

So while I'm loving seeing this, it feels to me less like a Robin Hood wealth transfer and more like a guerrilla infantry yelling battle cries as they take on a line of tanks. Because that's what's happening.

It's scrappy, manic, and tragic, and the guerrillas have corrupt generals in their ranks, and the big guys will walk away and plenty of fish will be crushed when the dust settles. But I can't help it that it also makes my heart lift.

We're facing a recession with high unemployment, staggering debt, and a sloshing money supply. Anyone who says stagflation isn't a possible outcome is kidding themselves. The fish know this and it's why they're fighting so hard.

Is the market going to crash? Sure. Are most of these folks gonna lose their asses? Yup. Are we going into years of economic pain? You betcha. But somehow, this episode still feels like a glowing light.

The only path out for America (well, the only one that doesn't involve war) is for American ingenuity to somehow invent a solution and launch us on to a better path. It's for us to FIGHT for a better path for the economy and for all of us.

And this whole drama is wild, but it's genius. It's surprising and brilliant and scandalous and it's a new, bold tech-centric FIGHT against the machine. It's a rejection of the broken, fake American dream in the most American way possible.

Why does it feel so hopeful, in the face of a crash? Because even after everything we've been through, America is still America. I love this country, and I'm so happy to see that it's still kicking, it's still hungry, it's still clever, and the kids are alright.