The Rise of Retail Investors and the Birth of Meme Stocks

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Ella Thompson
ethompson@acuitasinvestments.com

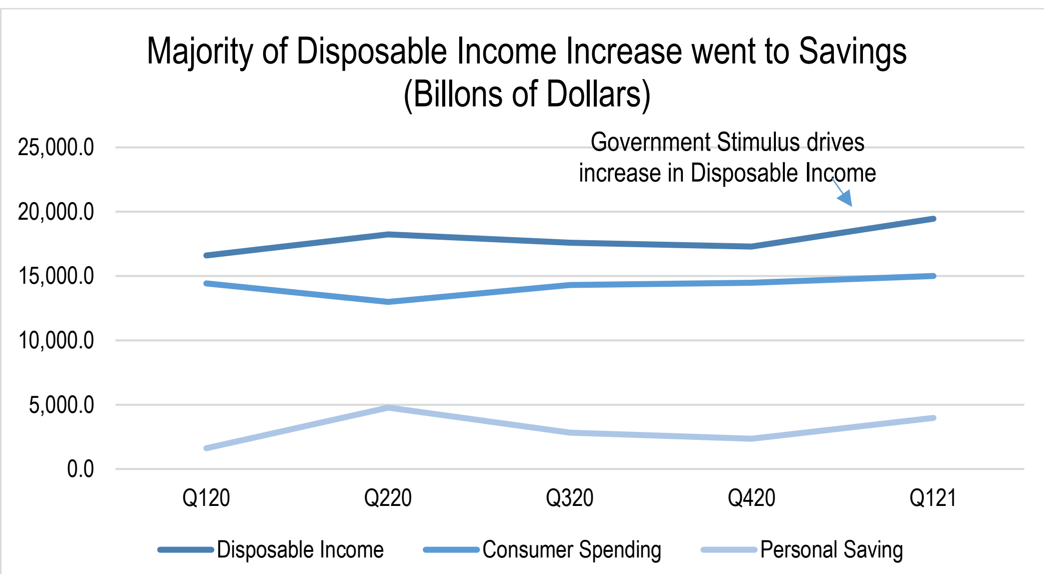
Dylan Tessin
intern@acuitasinvestments.com

At the same time that retail trading activity has surged over the last 18 months, a confluence of social media, extended government stimulus and changing demographics have led to profound changes in market trends and stock behavior. One of the results of these changes has been the phenomena of "meme stocks". Retail investor activity has created an environment where certain stocks have experienced stratospheric gains in short periods of time. As many of these stocks saw their meme story origins within the Russell Microcap Index, this paper is intended to help contextualize the impact of retail investors and the evolution of financial markets given the modern-day investing landscape.

- Retail investors with the power of the internet and social media have driven market distortions from their collective actions.
- Low-cost and increasingly self-directed trading facilitated this coordinated investment activity.
- Changing demographics have helped drive the surge in retail trading, with one result being the interest in meme-stocks and other speculative investments.
- Institutional investors generally didn't have exposure to meme stocks and most of these stocks have graduated from microcap at June's Index reconstitution.
- Important legacies include the increase in liquidity of small stocks, greater ability for investors to coordinate, and a decreased reliance on advisers.
- While retail investors remain a force, we believe the most dramatic market distortions from meme stocks are behind us and the evolving market and economic environment are likely to further place them in the rear-view mirror.

How we got here. The beginning of 2021 was full of hope for a global economic and market recovery. As the world looked forward to the roll-out of multiple vaccines, we witnessed signs of economic strength after a massive, coordinated effort by governments and central banks to stimulate the recovery. Investment markets responded to these efforts and recovered aggressively. The market recovery seemed contradictory as people across the country had witnessed local retailers and restaurants close their doors and lay off their employees during the pandemic. However, the effect of pandemic relief bills throughout 2020 and 2021 resulted in both direct payments and unemployment benefits that in the short-term have outweighed the disruptions from COVID-19. The net effect was a $2.17 trillion increase in personal disposable income in the first quarter of 2021, and the largest year-over-year increase ever recorded. The impact of this was visible in both economic activity from consumer spending and the rise in financial market participation. Disposable personal income increased by over 17% during the first quarter of 2021 compared to the first quarter of 2020. During this time consumer spending also increased, but by a modest 3.9% while personal saving amounts more than doubled, rising 147% over this period. As we will discuss in this paper, this influx of cash allowed many new investors to deploy their disposable income into the market in ways that created temporary market distortions, including the emergence of meme stocks.

Exhibit 1. U.S. Increase in Disposable Income 3/31/20 to 3/31/21



Source: Bureau of Economic Analysis; Acuitas Investments, LLC

Demographics played a role. Over the last year investors have witnessed a period of civil and social unrest in the United States. In addition to COVID-19, the country has dealt with a robust social justice movement and a dramatically partisan political environment. Millennials have been in the center of these societal upheavals with a resistance to historical norms. Millennials are defined as the generation born between 1981 and 1996. As a generation, they are more organized through social media and possess greater digital savvy than any previous generation. This has changed the dynamics of investing for this group of more than 85 million people. Millennials are also a generation with more debt than any previous generation, in particular student loans, which has led to a delay in wealth accumulation and home ownership. This indebted status leads us to take a page from the study of investor psychology where there is a robust debate about how investors perceive and react to gains and losses. In behavioral finance, some proponents of "prospect theory" believe investors may increase their level of risk-taking when they perceive that they are substantially behind a benchmark, have incurred significant losses, or in this case are saddled with significant debt. The availability of disposable income, paired with a willingness to challenge societal norms and combined with a backdrop of significant levels of personal debt has resulted in a shift in investor behavior and substantial risk-taking. This was further facilitated by low-cost, self-directed trading. The confluence of events resulted in a surge of activity by retail investors, which in turn resulted in what would typically be considered bizarre market activity. Perhaps the most visible and unpredictable event was the emergence of meme stocks.

Meme stocks emerge from the chaos: One result of the surge in retail trading is that in late 2020 and into the early months of 2021, investors collectively targeted a handful of stocks and conspired to drive their prices higher. The stocks gained the moniker "meme stocks" after the tools used to help them gain traction on social media. A "meme" is nothing more than a humorously captioned photo or video that gains some traction on social media. The most popular memes go viral and collect millions of views, but not until recently were memes used to drive interest in stocks. The most notable case was the stratospheric rise of GameStop. Mountains of fundamental research has been conducted on GameStop, but the combination of factors discussed worked to increase the price of this stock higher than any fundamental investor would have thought possible. The rise of meme stocks had its origins in the global pandemic in addition to the gamification of investing through apps that have made trading stocks fun, easy, and addicting. The rise of commission-free trading on platforms such as Robinhood and the growth of online communities like Reddit are also among the key factors contributing to the rise of meme stocks. And for individuals that want more broad exposure to these social media driven stocks, ET's have emerged offering diversified exposure to the most prominent meme stocks.

Why these stocks? To understand the way financial markets are evolving, it's important to look at the underlying causes of trends like meme stocks. In 2020, job loss and the collapse of small businesses, coupled with the success of larger corporations, furthered the divide between the upper and middle class. There was an underlying resentment towards corporate America, driven by the notion that they were benefiting from the misfortune of others. When beloved companies like GameStop faltered, hedge funds naturally capitalized by shorting them. Companies with high short interest that were potentially on their way to failure and were targeted as retail investors rallied others to support their cause. Retail investors coordinated via social media to "fight back" against the hedge funds by pumping up heavily shorted stocks like GameStop or AMC. Investors effectively conspired to force short covering, with many of the social media comments invoking war metaphors that pitted individuals versus the large hedge funds that were short the stocks. Further amplifying these trends was the massive increase in trading activity among young retail investors. While trading volumes were elevated across the board, from February 2020 to January 2021 investment flows from the 18–25-year-old age group increased 400% while flows from individuals with net incomes from $0-$35,000 increased nearly 450% (source: JP Morgan). These demographics were among the least likely to invest in the stock market previously and help illustrate some of the underlying causes for the meme stock phenomena.

Meme stock characteristics are unattractive to most institutional investors. Aside from GameStop, the majority of high-profile meme stocks find themselves outside the Russell Microcap Index. However, a handful of stocks within the Index were privy to the meme stock trend and found themselves bolstered by a massive increase in positive market sentiment. The table below shows a snapshot of characteristics for the top ten meme stocks in the Russell Microcap Index at the end of the second quarter of 2021 compared to a representative Acuitas microcap account (as a representation of a typical institutional active manager). The meme stocks we have highlighted were selected based on having high short interest as a percentage of shares outstanding, a recent spike in stock price, elevated retail trading activity and characteristics of being overvalued. The majority were also recently actively discussed on the infamous Redditt subforum r/wallstreetbets. It's worth noting that eight of the ten were removed from the Microcap Index post reconstitution in June, but while in the Index they acted as a headwind for active managers in the first half of the year. The comparison chart below helps show how their characteristics vary from the Acuitas representative microcap account. Unsurprisingly, the profitability and risk measures are more attractive in nearly every way in the representative account. In aggregate the meme stocks look extremely expensive, with low historical growth and negative earnings.

Exhibit 2. Meme Stock Characteristics vs. Acuitas Rep Portfolio (As of 6/30/21)

	Acuitas	Meme Stocks
Wtd Avg Market Cap	912	4240
Price/Book	2.3	6.6
Price to Earnings	15	122
Hist 3Yr EPS Growth	14.6	-14.2
EPS	0.4	-0.6
ROE - Wtd Avg.	-1.6	-9.5
Operating Margin	5	-21
Short Interest (% of Total)	3.5	13.0
Volatility (Annualized)	44	104

Source: Acuitas Investments, FactSet, FTSE Russell.

As one might expect from stocks with lower quality characteristics, an inordinate amount of activity from retail investors, and that are featured frequently in the headlines, the volatility of the meme stocks has been extreme.

Exhibit 3. Meme Stock and Index Performance by Month During 2021

Month	Meme Stocks	Russell Microcap Index
January 2021	110.2%	14.2%
February 2021	9.0%	6.0%
March 2021	0.5%	2.3%
April 2021	-11.1%	0.3%
May 2021	-14.1%	1.6%
June 2021	24.7%	2.2%
July 2021	-17.6%	-5.5%

Source: Acuitas Investments, FactSet, FTSE Russell.

Indexes, institutional investors, and meme stocks. Although several of the most prominent meme stocks were in the Russell Microcap Index during the first half of the year, not all meme stocks are microcap stocks, and meme stocks only made up a small percentage of the Microcap Index, even at their peak. However, given their rapid ascent and the extreme volatility of the meme stocks, they did have a disproportionate impact on the Index's returns in the first six months of 2021. That said, there were many larger meme stocks as well, and although we noted that most meme stocks do not have characteristics that appeal to institutional investors, there were a handful with a reasonable institutional investor base and only modest short interest that became meme stocks. Additionally, the recent impact retail investors have had on microcap stocks through their trading of meme stocks is an anomaly relative to where retail investors are normally active. Historically retail investors have tended to be much more active in large stocks and not microcap stocks.

We've seen this movie before. While several of the factors that have led to the increased retail investor activity and the emergence of meme stocks are unprecedented, the broad theme is not new. Investors conspiring to drive individual stocks higher, especially widely shorted stocks, has happened many times in history. As an example, perhaps the most famous was Northern Pacific Railway in May 1901. Edward Harriman, who controlled the Union Pacific Railway, initiated a raid on the stock and purchased all but 40,000 shares. The stock had unusually high short interest and short covering drove the stock from $95 to $1,000/share before settling down significantly. However, what was unique this time in 2021 was the coordinated mob mentality and self-directed nature of the investments, facilitated by social media amplifying the messaging. In comparison, in the late 90s we also saw significant activity by "day traders". A powerful bull market, especially in tech stocks, led retail investors to use venues like Schwab and E*TRADE. Yahoo! chat rooms were the forum of choice as opposed to modern-day Reddit. The impact of day traders was significant and led to an exaggerated impact on the short-term volatility of certain, most notably tech stocks. At the time, estimates were that 15% of the Nasdaq's trading volume was day traders. Notably, the prevalence of day trading in the 90s ended almost as quickly as it began with a touch of bear market and the bursting of the Internet bubble in March 2000. Jumping ahead, in January of 2020 Virtu Financial, one of the world's largest retail market makers, estimated that retail trading was 17% of the market. That number rose to 25% by the summer of 2020 and Jeffries more recently estimated that retail investors may account for as much as 32% of the total U.S. equity volume traded.

What next? While the impact of the increased retail participation in markets has been disruptive to stock behavior, there is the potential for companies to benefit from the surge in retail attention, giving them increased opportunity to pivot their business model. After all, access to capital, however brief, can change the fortunes of a business. As an example, GameStop was able to raise over $1.6 billion in cash at an elevated price in secondary offerings in April and June of 2021. Conversely, the entire market cap of the company was below $300 million during most of the first half of 2020 before it caught the attention of the Reddit investors. GameStop has been using the capital infusion to attempt to pivot into the online world and has been hiring eCommerce executives to facilitate the shift.

Index reconstitution shuffles the meme stocks. The end of June saw the annual reconstitution of the Russell Microcap Index. As a result, eight out of ten meme stocks mentioned earlier are no longer part of the Russell Microcap Index. Notably GameStop, which at its height surpassed a market cap of $24 billion and was at $12 billion at reconstitution, now sits in the Russell 1000 Index. This contributed to the weighted average market cap of the Russell Microcap Index dropping back into the $700mm range from a peak of $1.5 billion. For active managers, it is a double-edged sword. While most are happy to see the Index characteristics normalize, others viewed the meme stock valuations as unsustainably high and had hoped they would decline while they were still in the Index. The largest sector shift occurred in consumer discretionary, which moved from 18.8% of the index to 13.7%. This was a direct result of meme stocks becoming too large for the Index.

Exhibit 4. Russell Microcap Index Pre and Post June 2021 Reconstitution

Russell Microcap Index Pre and Post June 2021 Reconstitution

	Pre-Recon	Post-Recon
# of Holdings	1309	1804
Wtd Avg Market Cap	1564	733
Beta	1.2	1.4

Quality	Pre-Recon	Post-Recon
LT Debt/Capital	30.3	29.9
EPS Variability (wtd median)	5.3	5.7
ROE	-5.3	-9.8
Valuation		
P/Book	2.3	2.0
P/FY1 Earnings	15.8	14.1
Growth		
Historical Sales Growth	18.8	16.6
Est. Long-Term EPS Growth	17.9	14.9

Sectors	Pre-Recon	Post-Recon
Health Care	25.8	29.2
Financials	19.0	18.2
Consumer Discretionary	18.8	13.7
Industrials	12.2	13.0
Technology	10.3	8.9
Energy	3.4	4.7
Real Estate	3.0	3.9
Consumer Staples	2.4	1.9
Basic Materials	2.3	3.2
Telecommunications	2.0	2.4
Utilities	0.8	0.8

Source: Acuitas Investments, FactSet, FTSE Russell.

Retail investors still going - looking forward. It is important to understand the evolution of retail investors and their impact on stock behavior, particularly given the unprecedented surge in retail trading since the beginning of the pandemic. We believe some aspects of the increase in retail trading are cyclical in nature, but some are a result of permanent shifts in information sharing and social trends that are more likely to have a lasting impact. We wanted to provide investors context specific to microcap where the Index has experienced the most disruption over the last 18 months. The resulting stock volatility has led to more awareness of short-interest and greater appreciation for the power of retail investors. We continue to see investor participation in the stock market increase and demographics have changed investing. Fueled by new disposable income and easy access to trading, investors have found new ways to participate and collaborate which will likely have lasting effects on markets. In September the SEC published a report on the rally in GameStop and other meme stocks finding that their meteoric rise was fueled not simply by short covering, but rather by the hundreds of thousands of retail investors purchasing the stocks. New investors did enter the market and many, for at least a brief time, chased popular trading ideas from social media. The report notes that Robinhood recklessly gamifies trading, but few solutions have been offered. Retail investors continue to be empowered, but retail trading activity tends to peak during periods of rapidly rising markets and will likely cool significantly with any notable market pullback. Meanwhile, traditional long-only institutional investors are unlikely to hold stocks that qualify as meme stocks or that have been bid up aggressively by retail investors. There is always a bubble somewhere and we think the meme stock bubble is largely in the rear-view mirror. That said, investors with an appetite for growth companies with strong fundamentals can find more opportunities than ever within the expanding microcap universe.