Has Reddit Revealed Major Cracks in the Market?

Presented by McCarthy & Cox

With concerns growing over a potential stock market bubble and a recent market pullback, it seems another crisis has hit the headlines: a group of retail traders has come after the market itself. Specifically, these retail investors tried to beat Wall Street by trading up several stocks well beyond what the professionals think they are worth. In doing so, the headlines claim, they have broken the market. Could that possibly be true? Let's take a look at the details.

Redditors Hack the System

What happened here has two parts. First, a group of people on an online message board got together and all decided to buy a stock at the same time. More demand means a higher price. But that also means the market is working, not broken. Pumping a stock is something we have seen before, many times, usually in the context of a "pump and dump," when a group of buyers attempts to drive the price higher in order to sell out at that higher price. That practice is criminal. Although that doesn't necessarily seem to be the case this time, the technique itself is well known and has a long history.

Second, because of the way they bought the stock (i.e., using options), they were able to generate far more buying demand than their actual investment would warrant. The details are technical. Briefly, when someone buys an option, the option seller buys some of the stock to limit their exposure. The more options, the more stock buying. The Redditors found a way to hack the system by generating more buying demand than their actual investments, but the underlying processes that drive this result are standard. A group of small investors, using typical option markets, does not necessarily indicate that the system itself is broken.

Panic Ensues

Some of the headlines have talked about the damage to other market participants, notably hedge funds and some Wall Street banks. The damage, while real, is also part of the game. Hedge funds (and banks) routinely make mistakes and suffer for it. Traders losing money is not a sign that the system is broken. Another source of worry is that somehow markets have become less reliable because of the price surges. Perhaps so, but the dot-com boom didn't destroy the capital markets, and the distortions were much greater then than now.

Everything that is going on now has been seen before. The market is not broken.

There is something different going on here though that is worth paying attention to. If you go to the Reddit forum that is driving all of this, you do see the pump behavior from a pump and dump. What you don't see, however, is the explicit profit motive—the dump. There's more, "Let's stick it to Wall Street!" than "We're all going to be rich!" Not that being rich is despised, quite the contrary, but this is more of a protest mob than a bank robbery. The bank may get smashed either way, but the motivation is different.

What Happens Now?

That's one reason this likely won't break the system: the "protesters" are acting within the system—and in many cases benefiting from it. The second reason is that, simply, this is an easily solved problem.

The first thing that will happen is that regulators and brokerage houses will be taking a much harder look at the internet as a source of market disruption. Fool me once, shame on you; fool me twice, shame on me. The regulators and the brokers won't get fooled again. Expect a crackdown in some form.

The other thing that will likely change is option pricing. Much of the impact here comes from the ability of small investors to trade call options, bets that stock prices will rise, cheaply. The reason they have been cheap is because, to the option makers, they have been relatively low risk. After 1987, the risks of a meltdown were much clearer, and put options—bets on stock prices going down—rose to reflect those risks. Until now, the risk of a melt-up seemed entirely theoretical, so market makers did not include them in their pricing. That practice will very likely change, making it much costlier for investors to use options to hack prices.

Cracks in the Market

What we are seeing here is a new version of an old pattern of events. We haven’t seen it much in recent decades, because the regulators and brokers decided it wasn’t going to be allowed. Yes, it is a problem, but it is a fixable one. The market is not broken, but recent events have revealed some cracks. That is good news, as the repair team is already planning the fix.

Options trading involves risk and is not appropriate for all investors. Please consult a financial advisor and read the options disclosure document titled Characteristics & Risks of Standardized Options before making any investment decisions.

###

McCarthy & Cox Retirement & Estate Specialists LLC is located at 127 W. 5th Street, Marysville, OH 43040, and can be reached at 937.644.0351.

Authored by Brad McMillan, CFA®, CAIA, MAI, managing principal, chief investment officer, at Commonwealth Financial Network®.