3-4-2021

Governors State Expert Explains Robinhood's Game Stop

Office of Marketing and Communications

University Park, IL,
March
04,
2021

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The financial world fascinates Governors State University Finance Professor Mucahit Kochan, who has a master's degree in accounting and information management, and a doctorate in finance.

Rather than become an accountant, he opted to research investments, risk management, and empirical corporate finance. A member of the American Finance Association (AFA) and Financial Management Association (FMA), Dr. Kochan has presented his work at several national academic conferences.

At Governors State, Kochan teaches a variety of courses at both graduate and undergraduate levels in the College of Business. He recently sat down with the GSU Newsroom to discuss the GameStop phenomenon that saw the gaming merchandise retailer's stock skyrocket and then plummet, leaving members of Congress and investors scratching their heads.

To Governors State students and other new investors, Kochan offers this savvy advice, "Know the difference between gambling and investing. If you want to double your money in two days, four days, we're talking about gambling,'' he said.

GSU Newsroom: What is Robinhood, and how did it figure in the story?

Kochan: Robinhood is an app-based broker that allows investors to buy or sell stocks without paying commissions. You go to a broker and say, "I want to buy (or sell) this stock at this price." Robinhood takes your order and sends it to a clearinghouse that require deposits to protect against possible price fluctuations like what we saw with GameStop. The stock went from $70 to $480 almost overnight following social media traffic. The spike left Robinhood short on cash to cover the deposits.

GSU Newsroom: Is that why Robinhood halted purchases of the stock?

Kochan: Yes. Small investors were buying stock expecting an increase while hedge funds were expecting the value to drop. When the stock spiked, the hedge funds had to buy at even higher prices (short squeeze). This created a massive liability for Robinhood. Because there were so many buyers and no sellers, Robinhood had two options: putting trade restrictions and increasing margin requirements. Robinhood did both: increased the margin requirements and told investors that they could not buy anymore, they could only sell.

GSU Newsroom: How did the sudden spike affect hedge funds?

Kochan: You can make money two ways. One is by buying low and selling high. Let's say that the stock price is $10. You think that the stock price will go up, so you buy the stock. If the price goes up to $100, you make 90 dollars. If it goes down to zero, you lose ten bucks.

You can also make money by selling high and buying low. The stock price is $10, but this time you think that the price will go down instead of up. You *borrow* the share from the broker and sell it. Later, you buy the stock back and give it back to the broker. This is called short selling.

If the price goes up to $100, you lose 90 dollars since you sold it at $10 and bought it back at $100. But if you were right and the price goes down to zero, you make $10. The hedge funds were betting that the price would drop from $70 to $40 or maybe down to zero. Instead, hedge funds had to buy the stock at the higher price and this pushed the prices even higher. The hedge funds lost billions of dollars.

GSU Newsroom: By stopping sales, was Robinhood was protecting the profits of bigger clients at the expense of the little investors?

Kochan: The government agencies are investigating Robinhood. Those who understand the trading and settlement mechanism, may see Robinhood's actions as standard risk management practices in a highly volatile market.

It's so easy to find someone to blame when there is a problem. I think the problem is the system, letting hedge funds borrow so much stock expecting a price drop. A possible solution could come from SEC increasing margin requirement percentages from hedge funds.

Also, the free commission phenomenon needs to be discussed more. Robinhood makes money from order flow instead of charging investors for each trade. Maybe we should go back to old times when we used to pay for each transaction.

GSU Newsroom: So small investors could be facing permanent losses?

Kochan: Exactly. You saw stories about the 21-year-old who put in all his savings, $30,000, and lost 90 percent. This frenzy may seem like little guy vs. hedge funds, but looking at the valuations, it may well be hedge fund vs. hedge fund.

GSU Newsroom: What can GSU students who want to invest learn from this?

Kochan: Be very careful of fast money. When you hear your neighbor, your grandma, your uncle, 'Hey, we heard about GameStop. Let's get into this thing.' that's a sign that it's going to crash.

When you start making money, you want to make more and more. That's the time you should be scared. If you don't know when to stop, you can lose everything that you have. If you happened to be right and made money, don't be greedy. Know when to get out.

GSU Newsroom: What else?

Kochan: Be diversified. Don't just invest in one hot stock. Investments should be like watching a tree grow instead of betting on slot machines.