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The Day-Trading Barbarians at the Gate Won't Sack Wall Street -- Heard on the Street -- Update

BY Dow Jones & Company, Inc.
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Once upon a time, short sellers were the hotshot outsiders, energetically assaulting fusty old Wall Street. Now they're on the ramparts looking down as armies of day traders use options to send the value of heavily-shorted stocks like GameStop Corp. (GME) surging.

Professional investors are worried: How can financial markets function when stock movements are so obviously disconnected from fundamentals, played by both sides like a videogame? After a sharp correction midday Monday, GameStop (GME) on Tuesday rose a further 93%, bringing its total gain since Jan. 11 to more than 600%.

Those worries are understandable but overblown. Here, a little international comparison is helpful: Unlike some other major global equity markets, frenetic individual investors are far from the point where they are really disrupting the real purpose of equity markets -- to help companies to raise capital.

Retail traders are associated with market inefficiency, because they're considered more likely to trade on noise, accelerating surges and dips. Volatility isn't good for companies that want a placid, reliable environment to raise capital in. That's part of the reason special-purpose acquisition vehicles, or SPACs, boomed in popularity last year, with both investors and issuers looking to avoid a choppy stock market.

But there is a difference of degree internationally. Retail order flows have reached 20% of the U.S. stock market's total, according to UBS research, twice what they were in 2010. Off-exchange trading, which includes but isn't limited to retail, is up to a record 48% of the total, compared with 2019 levels of more like 35%. That is nothing though, relative to the over 80% that Chinese retail traders account for, according to recent research by U.S. and China-based academics.

That's why even on the most frenetic days in the U.S., individual options traders may move single stocks, or even a bundle of heavily-shorted stocks, but they don't have anything like the same impact on the overall market. Compared with the retail-led run-up and collapse of Chinese stocks in 2015, what's happening in U.S. markets is marginal. Nor is there anything yet to indicate that day traders, even in coordination, can beat the long-running, money-losing historical record of day traders in aggregate.

And even in China, public equity markets with far more frequent surges and swoons have improved over the years. Research by Thomas Gatley of Gavekal Dragonomics notes that public equity fundraising for strategic high-tech industries was at record levels last year, and filtered down into a boom in capital investment by those companies. Unlike in 2015, a market crash didn't follow.

For the hedge funds shorting specific stocks, the prospect that day traders could disrupt that positioning for their own gain is a live-by-the-sword, die-by-the-sword sort of issue. If a surging stock has such a large effect on a short position that it threatens your business, you are playing at the high-stakes table and the risks are yours to bear.

Massive intraday movements driven by individual traders are dramatic, and can be extremely damaging for those also taking large risks betting against them. But for everyone else, they're still a sideshow, and aren't really undermining the working of American capital markets.

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