Case Studies:

Pairs Trading in the Era of Meme Stocks*

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"Case Studies" presents a case pertinent to contemporary issues and events in investment management. Insightful and provocative questions are posed at the end of each case to challenge the reader. Each case is an invitation to the critical thinking and pragmatic problem solving that are so fundamental to the practice of investment management.

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At Zero Beta Capital Management (ZBCM), John has long established his fund's brand in pairs trading and long/short strategies. Throughout his decades in this sphere of investment management, John has also been keenly aware of and amused by the ongoing popularity and reincarnations of meme assets, such as Beanie Babies[1] and Dogecoin,[2] whose inherent "value" is derived only by a culturally symbolic or humorous statement with no explicit financial claim or practical use case attached. At cocktail parties and idea dinners, he often declared that -- even if market mechanisms were in place to facilitate meaningful institutional positions in memes -- he would never enter a pairs trade or other long/short strategy in this asset class. After all, given the fickle and exuberantly emotional nature of meme assets, how could he possibly hazard a guess as to when (or even whether) two seemingly identical memes would converge?

But in his thought experiments, John never imagined that a publicly traded equity security would ever enter the meme asset class. However, in the past several days, John has woefully discovered that the stocks in the short leg of several large pairs trades have become popular meme stocks, and he is faced with the very time-sensitive decision of whether to post additional collateral or to close out his positions at a steep loss. His co-founding principal at ZBCM argues that the fund has sufficient capital to meet additional margin calls until the hype surrounding these meme stocks subsides. To exacerbate matters, though, the short interest in these stocks is much higher than their respective floats, and the open interest on short-dated in-the-money call options on these underlying stocks is also uncomfortably high.

Fearing the joint weight of a short squeeze and a gamma squeeze, John decides to close out the short legs of the problematic pairs trades while also liquidating the respective long legs to

[1] For a brief historical overview of the Beanie Baby bubble, see https://www.history.com/news/beanie-babies-value-criminal-activity
[2] As of January 31, 2021, Dogecoin (DOGE) had a total market capitalization in excess of $5 billion USD (see https://coinmarketcap.com/currencies/dogecoin/).

partially finance the purchase of the meme stocks. He also begins to wonder which other securities in ZBCM's various positions might also prove similarly problematic, and tasks his quants with developing predictions as to the likelihood that an equity security may become a meme stock. With this final decision in execution, John begins to prepare a statement informing investors as to the recent events leading to ZBCM's greatest loss to date, along with reassurances as to how the fund will avoid such calamity going forward.

Questions

- Was John extreme in closing out his long/short positions?
- What are key considerations in identifying when an equity security has (or is about to) become a meme stock?
- What are key considerations in how meme stocks can be incorporated into a pairs trade or other long/short strategy?