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INSIGHT

The ethics of short selling and the risk of ‘infinite’ losses

by Mark McClatchey

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Short selling is a trading approach that enables investors to profit from a *fall* in the price of an asset. To create a short position in equity markets, an investor typically borrows a listed company’s shares with the assistance of a broker or investment bank, and then sells them into the market. If the share price subsequently falls, an investor may realise a profit by buying back the shares at the current price and returning them to the lender. This process is illustrated in Diagram 1 on page 2.

Whilst the market for short selling is a well-developed, relatively large and liquid one in Australia, the practice of ‘shorting’ remains controversial and raises several issues that investors need to consider. These include questions on the ethics of short selling[1] and the risk of ‘infinite’ losses if the company’s share price rises rather than falls.

To maximise our returns from active share portfolios IFM Investors employs short selling judiciously and with a number of strict controls.

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Ethics of short selling

Ethical considerations can arise with short selling because the profits are made when a company’s share price *falls*. A falling share price reduces the value of the company and its shareholders’ wealth, and may put other stresses on the company such as a higher cost of capital in raising equity and potential breaches of debt to equity covenants. Companies with weak share prices can also become takeover targets, put margin loan pressure on shareholders and breach regulatory requirements. Taken to the extreme, a significant share price fall

[1] It is important to note that this paper discusses the ethics of legal short selling in financial markets. It is not an analysis of illegal market behaviour, such as ‘rumourtrage’ that involves the creation of false information about stocks in an attempt to affect share prices. Such practices undermine the integrity and confidence of markets, impacting the efficient allocation of resources and hindering the growth of the economy, and are rightly banned.

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may even jeopardise the very existence of the company, impacting all stakeholders including employees, management, creditors and the broader community.

Given this prospect, it's not surprising that short-sellers are often seen as the cause of market corrections or significant falls in share prices. Companies tend to be sceptical towards engaging with short-sellers in the same way as they do with long investors, fearing that their share price might be undermined.

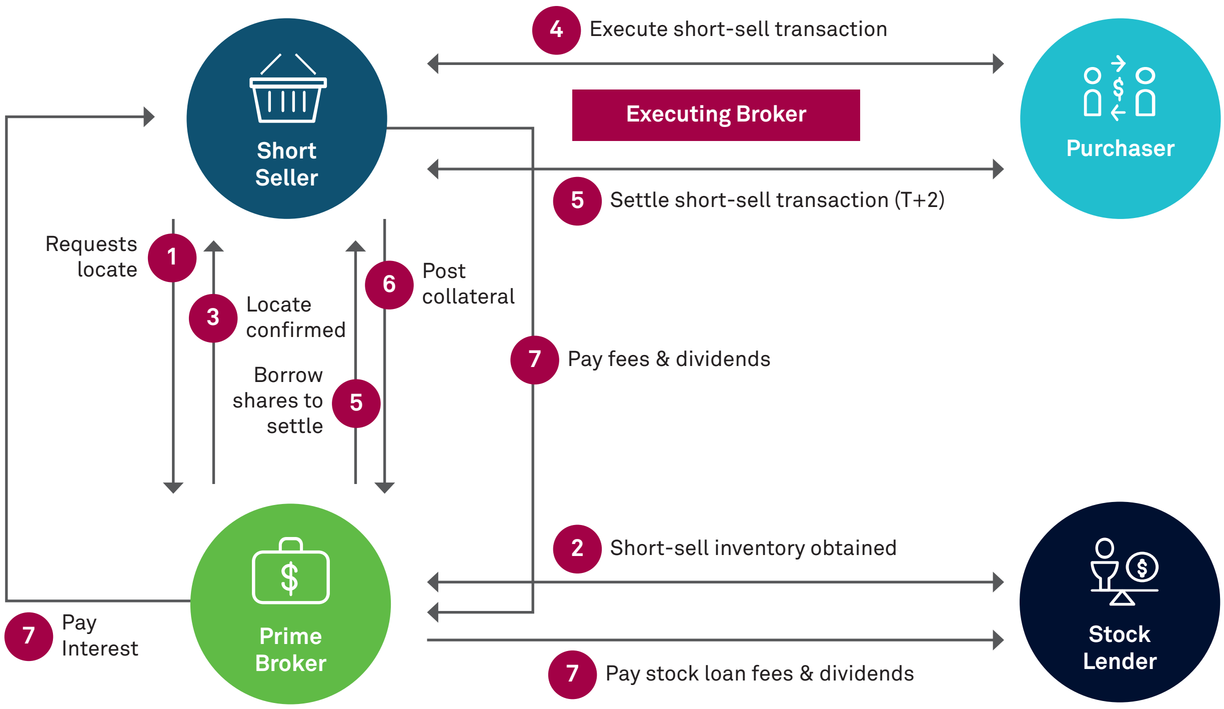
But is this attitude legitimate? Like all 'ethical' questions, there is a wide spectrum of views on the ethics of shorting that are neither right nor wrong, but it is helpful to get a better understanding of the underlying issues.

It can be argued that short sellers actually play several very important roles in financial markets:

- **Unwinding overvaluation** – Short-sellers are generally selling stocks that they believe are intrinsically overvalued. In essence, this is no different to long investors who buy stocks they believe are intrinsically undervalued – same coin, just analysed from different sides.
- **Price discovery** – A key determinant of an efficient market is a fair price, hence short-sellers may be seen as assisting the process of price discovery and what the market should pay for a company's shares. If listed share prices are perceived to be too high, a market that enables shorting should move more quickly and efficiently towards fair value.
- **Forensic accounting** – Short-sellers could also be perceived as performing an important forensic accounting function on companies in which they trade and this helps the broader market to identify vulnerable stocks and those engaging in fraudulent and/or unscrupulous activities.

Given these potential functions, it is difficult to argue that short-selling is, by definition, wrong or unethical. In fact, part of the ethical conundrum associated with short selling can be explained by the fact that short-selling creates a different set of beneficiaries to those who benefit from holding long positions in shares.

DIAGRAM 01 SHORT SELLING A STOCK



Source: IFM Investors

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A different set of beneficiaries

With long investing, just about everyone benefits when the share price rises – new investors, existing investors, the company, its management and employees (particularly if there are staff share schemes). With shorting, it's a little different and more complex.

Short sellers obviously benefit from their trade if the share price falls and so do investors in funds that incorporate shorting in their investment strategies (e.g. long-short equity funds). But there are also other potential winners and losers to consider:

- **Share lenders** – Existing shareholders (e.g. large institutional investors) can earn extra income by lending some of their stock into the market. This additional income can enhance returns for share lenders and their member bases.
- **Listed companies** – Falling share prices put pressure on companies and can be a significant factor motivating positive change. But short sellers can also push share prices well below intrinsic value, causing damage that may not be rectified. This is particularly true amongst less liquid and smaller capitalised stocks.
- **New investors** – The impact of short sellers in pushing down the prices of overvalued stocks is positive for new investors as the subscription price to buy into a fund should be lower and fairer if the underlying stocks are trading at their intrinsic value. This is also a win for funds that have an increasing member base.
- **Existing long investors** – Short-sellers may depress share prices, hence existing long investors in those stocks tend to lose. Whilst share prices may be more efficient and representative of intrinsic value, it's a clear negative for current investors who feel the impact of a lower valuation.

There are also overlaps between these categories that complicate the final outcome. For example, an institution can simultaneously be a share lender and an existing long investor, so the degree to which it benefits from shorting may not be clear. Shorting might produce the wrong outcome for certain institutions that lend out their stock (possibly due to different member profiles, exposure to smaller capitalised or illiquid stocks etc.), but in other cases it might be the right outcome.

It is likely that short selling will remain contentious and emotive given the inherent suspicion surrounding this type of trading, but hopefully the above discussion has provided a better understanding of the underlying issues.

The risk of infinite losses

The other key issue to consider when shorting stocks is the inherent risk. Shorting introduces specific risks into an equity portfolio, in particular the potential for an 'infinite' loss. With a long position, the share price can only fall from its current level to zero, hence the maximum potential loss is theoretically limited to 100%. With a short position, the share price can continue to rise in a (seemingly) infinite path, creating losses significantly greater than 100% for short investors.

Whilst this unbounded and asymmetric risk of shorting is very real in markets, we believe it is overstated for several reasons:

- In practice, short investors do close-out positions or, if they are unable to buy back the stock, they may negotiate alternative arrangements to satisfy lenders.
- Long investors are typically subject to capital raisings as the share price falls, hence a long position can end up costing the investor more than 100% of their initial investment.
- In Australia, long investments tend to be larger positions in a given portfolio than short investments due to the structure of the benchmark index which is dominated by a relatively small number of large cap companies[2]. This means long investments can detract more from a portfolio's performance than short investments even if the share price move is smaller. For example, if the share price of a long position with a 5% portfolio weight fell to zero, it would subtract 5% from portfolio returns. The share price of a short stock with a 0.5% portfolio weight would need to rise by 10 times to have an equivalent performance impact.

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[2] The top 20 stocks in the S&P/ASX 200 Index represent 58.5% of the index capitalisation as at 31 January 2020.

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Controlling for short selling risk in portfolios

IFM Investors' large cap share portfolios that engage in shorting have a number of risk controls in place to help reduce and mitigate the unbounded risk associated with short selling. These include:

(i) **Diversification of short positions and the avoidance of concentrated positions** – Our portfolios tend to hold a large, diversified list of short positions. There are no concentrated positions as these are more vulnerable to extreme returns, particularly on the short side.

(ii) **Limiting or avoiding short positions in highly volatile sectors and stocks** – Sectors such as oil explorers, miners, bio-techs, technology and industry disruptors share a common 'discovery or eureka' characteristic that can swiftly and materially change their share price. In such cases, share prices can gap-up aggressively, with little opportunity to cover short positions.

(iii) **Limiting or avoiding short positions in micro-cap stocks** – Stocks with a market cap less than $200 million are unlikely to qualify as an investable stock in our investment process as they have little or no broker coverage and are often loss makers with high growth expectations. These stocks typically have no stock borrow availability, which is a natural barrier to shorting.

(iv) **Avoiding takeover targets based on price to book ratios** - These stocks are vulnerable to takeovers given the share price can be well below the realisation value of the company's underlying assets. Shorting these asset rich stocks can be risky as a takeover bid usually results in a significant jump in the share price.

(v) **Pair-trading** – This involves reinvesting the proceeds from short positions into long positions in the same industry/sector. This approach helps hedge some of the sector and macro risk associated with short positions. If a group of stocks does rise significantly, the portfolio will lose performance on the short position, but there is a natural hedge provided by the long position.

(vi) **Stop-loss and short covering management** - Our team closes out short positions relatively quickly if the share price rises too fast, even if there has been no change in the stock's underlying fundamentals. This is facilitated by our trading system that flags short positions that are detracting more than 0.1-0.2% from excess performance and automatically loads the trades required to close out the positions into the daily trade list. These trades have to be actively removed by the portfolio manager to avoid them being executed.

(vii) **Monitoring borrow risk and recall risk** - The team tracks the 'short interest' in each stock and the 'days to cover' these shorts. Both these measures are good indicators of a stock's potential to 'short squeeze' higher on the back of positive news. The higher the level of short interest, the higher the potential for a spike in the share price as short sellers try to rapidly close out their positions in response to new information.

The above risk controls help us manage the inherent risks involved in shorting stocks and can help insulate IFM's portfolios from the potential of an 'infinite' shorting loss. We believe they have also contributed to the much more symmetric and better behaved stock contribution from shorting that has flowed into the performance of IFM's portfolios in recent years. ❚❚

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