This note explores the nature of short selling.

In preview, the merits are meagre, and the pitfalls are plentiful.

My sense is that short selling appeals to (at least) five categories of investor:

(i) Crusaders/Intellectuals;
(ii) Fee Seekers;
(iii) Risk Managers;
(iv) Benchmark Investors; and
(v) Opportunity Maximisers.

Crusaders/Intellectuals: Some people like to ferret out fraud and hold executives accountable. The best short sellers do society a great service in policing fraud, a service that often requires dogged determination and extreme patience.

Grossly overvalued, fraudulent, pointless and/or over leveraged companies that seem destined for failure are intellectually fascinating. Failures are easier to articulate than successes. There is something seductive about spotting a share that is heading to zero, a mental high from being able to foresee the inevitable car crash. By contrast, identifying winners is elusive and less conducive to satisfactory articulation. Deceased short seller Robert Wilson is reported to have said:

"There is something intellectually much more intriguing about failure, which is knowable, rather than success, which is sort of unknowable."

Wilson was highlighting a variation of the theme that it's easier to critique than to create. You may have noticed work colleagues who appear clever in pointing out problems.

Fee Seekers: Having a short capacity in an investment strategy can make it easier to charge performance fees than with a long-only strategy.

Risk Managers: Shorts can be a useful hedge in specific cases (e.g. pair trades) and can provide investors with a form of insurance on long allocations.

Benchmark Investors: There is a category of investors that race in the relative performance derby; benchmark investors.

For benchmark investors, short selling is a possible tool to express views relative to a benchmark. Active managers that are managing against a benchmark are always underweight certain constituents and may outright short some constituents to express a high conviction relative view.

Opportunity Maximisers: The battle cry of the opportunity maximisers is that the capacity to short improves their investment armoury. In practice I think it merely adds a faulty weapon. Adding short selling to your investment talents (at least in the pursuit of alpha as distinct from risk management) is primarily an opportunity to shoot yourself in the foot.

Why is short selling so hard?

(i) Unlimited downside. Russian roulette anyone? In practice the downside is probably not unlimited in the same way that the upside on a long holding can't quite be unlimited either. But the downside can absolutely be more than 100% and that's not a great place to be.

(ii) Capped upside. If you are perfectly right the most you can earn is 100% less funding costs (though you can earn some interest in higher rate environments). There are no 'compounders' in the world of shorting.

(iii) Time is your enemy. With a maximum return of 100% the longer it takes for your thesis to play out the worse your returns. Even obvious frauds can take many years to crack. In other cases, the reasons for fraud can be complex and well-hidden for longer than you would like. By the time you reach, say, five years your maximum return is 15% per annum (while being continually exposed to the possibility of unlimited loss). Patience doesn't pay, patience pains.

(iv) Treacherous risk management. Because of the unlimited downside risk, it is customary to use stop losses. The problem is these stop losses can force you out of a trade at the wrong time. The path dependency is painful.

(v) Roll refi risk and margin calls.

(vi) Exposure to changing regulatory risk on open positions.

(vii) Limited free-float. In practice, the amount of stock available to borrow is limited reducing the investible universe.

(viii) Possible opportunity cost. Short selling is extremely difficult. Perhaps those who are smart enough and with the stomach to make good returns from short selling can make more on the long side? I'm not sure, but it's an interesting question. Short sellers have a valid argument that their space is less crowded.

(ix) Psychological negativity. Wishing for stock prices to implode is out of sync with a healthy human condition. It's generally better to be a cheerleader than a cynic. Don't get me wrong, all investors need a degree of cynicism, I just wonder whether being exclusively focussed on the short side makes for a good disposition.

(x) The short squeeze. You can get forced out of your trade at an in-opportune time.

(xi) The trend is your enemy. A losing trade becomes a bigger position and a winning trade a smaller one, the exact opposite of a long trade.

(xii) Swimming against the long-term current. Markets go up over time. The median long investor gets a satisfactory result, the median short investor a negative one. Wealthy short sellers are a rare breed.

(xiii) Mental bandwidth. Because of the unlimited downside, short sellers tend to need a much larger number of short positions given the risk of any single stock rising significantly.

(xiv) Tricky relationships. Those who decide to engage with management have a strong likelihood of provoking an unsavoury response.

(xv) Behavioural Biases. All investors face behavioural biases. If one goes public with a crusader agenda, it may be harder to admit a wrong call.

The above characteristics makes short selling a difficult craft, one that is more suited to defence (risk management/portfolio hedging) than offence (alpha/absolute return generation). In this sense, short selling is possibly fine as a shield (risk management), but not as a sword (absolute alpha).

<u>Is there a better shield?</u>

If we accept that shorting may have a role in risk mitigation, we should also enquire about the relative merits of other risk mitigation techniques. And we need to be clear about the nature of the risk we are trying to manage. There is a difference between mark-to-market loss, benchmark risk and loss of intrinsic value.

Buying out of the money index options is arguably a safer shield (better liquidity, diversity and loss capped at the premium paid).

In my view the most practical and effective risk management tool is to keep a cash buffer. This provides optionality to add to positions on a market fall, the opportunity cost of which is the expected return on your long portfolio. When bargains are scarce that opportunity cost is at its lowest and the option value of cash is at its highest.

Short selling advocates argue that being short allows you to be 'more long' (e.g. 130% long /30% short = 100% long, only more so). But there is an irony in the timing. The best time to be short is the worst time to be more long.

<u>Might short selling have any place?</u>

In addition to its role as a possible risk management option, the other area where short sellers <u>may</u> have satisfactory results (in the pursuit of alpha) is in shorting credit (as distinct from equity). A critical and underappreciated difference between shorting credit and shorting equity is that the risk/reward asymmetry is reversed. When shorting credit your maximum loss is the effective interest cost of the instrument shorted while your possible gain can be multiples of the short cost.

Many readers will be familiar with the movie "The Big Short". It chronicled how several investors profited from the US housing collapse. What is less well known is that the biggest gains were made shorting credit, not shorting equity. If for example you were short a AAA tranche of a securitisation that paid 1% per annum, and, say, it took two years for the securitisation to crack. Your cost was 2%, but if the security ended up only being worth 50 cents on the dollar you would have made 25 times your money. If you shorted the equity in Lehman the most you could have made was 100%. If you shorted its debt you could have earned many multiples of your investment.

The better pay-off profile in shorting credit still doesn't make it easy but at least the rewards for being right, and the costs of being wrong, are both better than in shorting equities.

In short

Don't bother. When valuations are stretched hold cash instead. If you must short, consider it as a risk management tool; a shield not a sword. And even then, there are arguably better risk management tools.

If you are an alpha hunter, hunt for shorts in the credit world, not the equity world.

L Endersen – November 2017