ROUND UP THE USUAL SUSPECTS

Why shorting is not only good for markets, it should be in all investors' portfolios.
INTRODUCTION

On recent trips to the local supermarket you begin to notice that the cost of the shopping appears to be getting a little more expensive. Friends have been talking about a new store that has opened a few suburbs away and so you decide to visit it the next time. To your surprise, not only is it substantially cheaper but the quality is also pretty good. This story has been slowly playing out across Australia over the last decade to the point that the company eventually announced to investors that it could no longer be as profitable as everyone expected. This is the story of Woolworth’s fall from grace.

This is the tale of a cozy duopoly that for a long time was great for investors but was slowly changing, one person at a time. We all have heard of the idea that if you like the product you should buy shares in that company, but what about another approach? That is, if the product is letting you down, how do you profit from that? This is where short selling comes in. It is a way for investors to “invest” in the poorly run or expensive companies they see around them.

HISTORY

Short selling is, and always has been, an emotional topic. It was partially banned during the crisis of 2007/08 and Franz Müntefering, head of the Social Democrat Party (SPD) in Germany famously referred to “International Capital” as being “locusts”.

Shorting, despite being relatively complex, has been around since the first stock that was ever traded - The Dutch East India Company in the Netherlands. A person by the name of Isaac Le Maire shorted the stock in 1609, though profiting in a way that we (and authorities then) would deem unethical: via spreading rumors to drive down the price. He had his stock confiscated and died penniless and exiled!

The term “short” has been in use from at least the mid-nineteenth century. Jacob Little was known as The Great Bear of Wall Street and began shorting stocks in the United States in 1822. Short selling was blamed for the crash of 1929 (which saw the implementation of the uptick rule which we will come to later). It was again blamed for some of the collapse of 2008 and partially banned in many countries, only to be subsequently allowed again.

So, there is no doubt that shorting has a colorful history. Yet, short selling is allowed in most parts of the world despite populist calls after each crash to find a scapegoat, of which short sellers often provide a suitable looking candidate. Why?

WHAT IS IT?

Firstly, what is it? Technically, it is the borrowing of another person’s stock, for which you pay them a fee, to then sell on the market; receiving the cash; and owing them the stock that you have borrowed from them. If the stock falls, you buy the stock on the market using less cash than you received and return the stock to the owner with you keeping the difference as profit (see Figure 1).

Figure 1 - How does short selling work?

Reference: “Short (finance)” by Grochim - Own work. Licensed under CC BY-SA 3.0 via Commons

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1 Casablanca the movie.
If this sounds a little complex, think of it this way. You've got some wine in your cellar you have collected but aren't planning on drinking it any time soon. Your friend asks if he can borrow it from you for a few months and pay you for it. Your friend then sells the wine as he has heard that the grape glut will see prices fall a lot when the new vintage comes out.

In six months, he then goes and buys that wine in a bottle shop at a lower price and returns it to you. You're happy as you got paid for doing nothing and he's happy as he made money.

I would also note that “naked short selling”, which is where you put a sell order in the market with no stock to deliver (i.e. not doing the first part of step 1 above), just hoping that you can drive the price down, is banned/illegal in most of the world. Nearly all places require the short seller to prove that they have “borrowed stock” that they can actually deliver to the exchange, prior to placing an order on the market.

Rules such as this stop short selling from “driving down the price” as these rules make it such that if the price is to fall rapidly, it has to be selling from people who are already long the stock that causes it. Whilst this idea of long holders being the cause of stock price collapses goes against what some media commentators may want people to believe, academic studies support this view of long holders being part of the reason for heavy falls in stocks.²

"Shorting a stock is one way an investor can communicate his or her views on that business, just as going long a stock communicates the opposite."

One topical area in equity markets is renewable energy stocks versus coal companies. The higher the share price of renewables, the more money they can raise to fund expansion and drive down the costs of solar panels to a point where the economics can justify going solar, even if there is no “ethical” motivation – witness the large expansion in Queensland. On the other side the higher the cost of capital, the harder it is for a coal business to expand, without resorting to cutting their dividends, making expansion harder.

To look at another market dear to our hearts in Australia, and Sydney in particular – housing - here is a market that you can't short. If people are concerned about overvaluation, there is no mechanism for this market to balance itself out, which increases the probability of a bubble if only a positive view can be held.

Now, that is not to say that equities don't have bubbles - just look at the “Dot Com boom and bust” for example. But even here, some short sellers were trying to bet against those stocks to “prick the bubble” earlier. Unfortunately for them, they fell foul of J.M Keynes maxim "the market can stay irrational longer than you can stay solvent” and in one (infamous) case were forced to shut their doors just before the peak.

Could there be instances when shorting is ‘wrong' and can do damage? Yes, there are some businesses, like banks, who derive their value from their share price and confidence in the business. A complete collapse in the share price could theoretically cause a bank run, thus destroying the bank.

In a context such as the 2007/08 crisis, it can be argued shorting should be banned, though I do note that Lehman had got itself into a lot of questionable investments - it wasn't short sellers who forced them into sub-prime mortgages!

**VARIATIONS OF SHORTING**

If we look at the implementation of short ideas, then shorting a stock on a standalone basis is just one variation of shorting. We at Morphic use three methods:

1) **Long the stock, short the market (say the ASX200):** this just helps you make more money out of a good long idea without taking on as much day to day market risk. For example, in the USA, there are some bank stocks which we think have excellent management and we are happy to own a lot of. So, if we short sell the stock market against those stocks we can own more without taking as much risk on.

2) **Short one stock, long another:** this is what is called a “pairs trade” and used to reflect a view of one management team being better than another, again, without taking on market/sector/country risk.

In some cases, you aren't even saying a company is ‘bad', rather the spread between two isn't priced correctly in your view. An example is that up until recently, Morphic was long a Japanese homebuilder, **Open House**, but short another one called Iida Group. It wasn't that we loved the homebuilding sector, rather we thought that the Open House management was better than Iida's which also had poor corporate governance.

3) The third and last type is the one we discussed above - **short a stock on its own.** We actually do very little of this last one as it is incredibly difficult to do as over long periods of time, markets tend to go up not down. An example of how we use it is to be short Woolworths as discussed in the opening of the article.

**WHY SHOULD I ADD THEM TO MY PORTFOLIO?**

Having walked through the types and varieties of shorting, the question an investor could rightly ask then is: what difference does this make to my portfolio? The first thing to note is that it is very difficult for retail investors to short stocks. The arrival of “Contracts for Difference” or CFD's has opened up the market to retail investors, yet it seems from positioning data most investors don't take advantage of the shorting ability offered through them as most positioning data suggests clients take long positions.
The most important addition is that empirically, (Figure 2), adding short positions to a portfolio reduces the overall volatility of the portfolio. Investors have now positions that make them money on days when the market goes down which doesn't come at the cost of lowering returns. In fact, long run returns are slightly higher.

The main problem individual investors face is that as long-term investors, buying and holding is a good strategy as the winning positions get naturally larger, whilst the losing ones get smaller (assuming one doesn't add to them).

This is good portfolio management and the investor didn't have to lift a finger to do it.

On the other hand, shorting is the opposite. A stock that you short at $100 goes to $50, which is great, but you now have only $50 in it.

On the other hand, one you short at $100 goes to $200. Your equal weighted portfolio now has 4x as much money in its “bad pick” ($200) than it does in its “good pick” ($50)!

Compare this to a long example – the bad pick would be $50 and the winning one would be $200. The losing call is hurting the portfolio a lot less.

So actively adjusting the portfolio becomes a lot more important now. For people who invest through their SMSFs, this is going to be time consuming.

For investors who want to use managers who can short, unfortunately the choices are more limited than the usual fund managers list. Fortunately, if you are reading this, you know at least one.

Figure 2 - Historical return and volatility of L/S strategies vs long only indices (1 April 2005 - 22 March 2019)

Source: Morphic Asset Management

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3 Behavioural economics says bad investors do the opposite.
CONCLUSION

In conclusion then, why should an investor consider using short selling as part of investing?

Firstly, as we discussed, it helps the market be more efficient. To ban short sellers is to silence a point of view – people can listen to me offer my opinion on, say, Whitehaven Coal and dismiss it if they want. But there is plenty of evidence that says for companies (or anyone), the wider the range of opinions they listen to, the better their decision making. Maybe coal companies should listen to climate concerns more? We certainly think they should.

Secondly, it also has the effect of lowering the risks in their portfolio when stocks are paired out with a long and short together.

Lastly, it enables investors to profit from more opportunities in the market via taking advantage of not only those things they see going right in the world around them, but also those things going wrong. If you’re concerned about global warming, shorting fossil fuel producers is a way to profit from the decline of that industry.

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