GameStop madness and the resurrection of short-selling myths

In general, short-sellers typically get singled out during crises as the public hunts for scapegoats.

While the GameStop madness has created numerous controversies, the incident underscores the need to debunk short-selling myths, says the writer.

In order to solve the controversy, subsequent research delved into the empirical data and uncovered strong evidence of informative trading by short-sellers.

For instance, an early research study found that short-sellers had trading advantage stemming from their ability to analyse publicly available information. More specifically, short-sellers process public news better than other market participants which enables them to make profitable trades.

Another study found that short-sellers use both public news and private information to anticipate earnings-related developments.

Taken together, this evidence shows that, on average, short-sellers are not speculative traders as they have the ability to process information better than other market participants.

The study found that market liquidity deteriorated after the introduction of the short-selling ban. Another study also found that “during the crisis, banned stocks had higher information asymmetry, lower liquidity, and lower abnormal returns compared with non-banned stocks”.

Taken together, this evidence shows that stock markets benefit from short-selling as prices better reflect the fundamental values. In contrast to the myths, short-selling actually contributes to well-functioning of stock markets.

DESTROYS TARGETED COMPANIES

A recent research paper analysed managers who were deciding whether to abandon value reducing decisions. The researchers found that managers of firms whose stocks are less subject to short-selling constraints were more sensitive to stock price changes than managers of other firms.

This is consistent with the notion that short-selling reduces earnings management, helped detect fraud, and improved price efficiency.

Similarly, another study found that banks whose securities were subject to short-selling bans had an increased probability of insolvency.

Finally, short-selling constraints act as a limit to arbitrage and impede well-functioning of stock markets. A research study found that more short-selling risk leads to less short-selling and (more importantly for this article) less price efficiency and lower future returns.

While the public typically turns against short-sellers during crises, academic finance literature is almost unanimous that short-selling constraints or outright bans cannot stabilise financial markets during crises.

On the contrary, short-selling constraints are more likely to undermine the market efficiency, reduce liquidity, and lower future returns.

While short-selling may have costs, the myths about speculation, impediment to markets as well as destruction of companies should be decisively debunked.