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

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. BY EMIR HRNJIC

A BATTLE of retail versus institutional investors reached its climax when Melvin Capital Management covered its short positions in GameStop at a signficant loss and had to be rescued.

As the price of GameStop soared from US$20 to almost US$500, Melvin Capital Management and other hedge funds with short positions on its shares suffered almost US$20 billion of losses.

While Wall Street investors cried foul, retail investors pointed to the nefarious nature of short-selling. As many celebrated hedge funds' losses, old myths about the trading strategy resurfaced.

Among the most resilient myths were that short-selling is inherently speculative, that it impedes well-functioning of stock markets, and that it destroys targeted companies.

Activists called for short-selling constraints or outright bans, arguing that short-selling depresses stock prices and thus the constraints would increase them.

In general, short-sellers typically get singled out during crises as the public looks for scapegoats. Indeed, a number of European regulators imposed various short-selling bans during the Covid-19 pandemic.

But is short-selling really nefarious activity? And how accurate is the typical narrative about short-selling? More specifically, can the three main myths about short-selling be debunked?

INHERENTLY SPECULATIVE

Early theoretical finance literature developed opposing predictions with respect to short-selling. While some researchers developed models whereby informed short-sellers contribute to converging of market prices to firms' fundamentals, others argued that prices can become less accurate due to manipulative short-selling.

In order to solve the controversy, subsequent research dived 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.

IMPEDES WELL-FUNCTIONING OF STOCK MARKETS

Based on data from 26 countries, a seminal study found that stocks with more short sale constraints have lower price efficiency. Moreover, relaxing short sale constraints does not lead to price instability or extreme negative returns.

A more recent research provided evidence that the relaxation of short sale constraints in China and the United States improves price efficiency by providing incentives for short-sellers to produce information.

Utilising a natural experiment in the aftermath of Covid-19 pandemic, researchers exploited differences between different short-selling regulations in various European financial markets.

More specifically, a number of European countries which introduced temporary bans on short-selling activity in the March-May 2020 period were compared to other European countries which did not introduce short-selling constraints.

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 myth, 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 managers learn more from stock price movements when there are less short-selling constraints.

Another research study tapped a natural experiment whereby one-third of the Russell 3000 index were exempted from short sale constraints. The results were consistent with the notion that short-selling reduced 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 speculations, impediment to markets as well as destruction of companies should be decisively debunked.

The writer is head of fintech training at Asian Institute of Digital Finance (AIDF), National University of Singapore (NUS). The opinions here are the writer's and do not represent the views and opinions of AIDF or NUS.