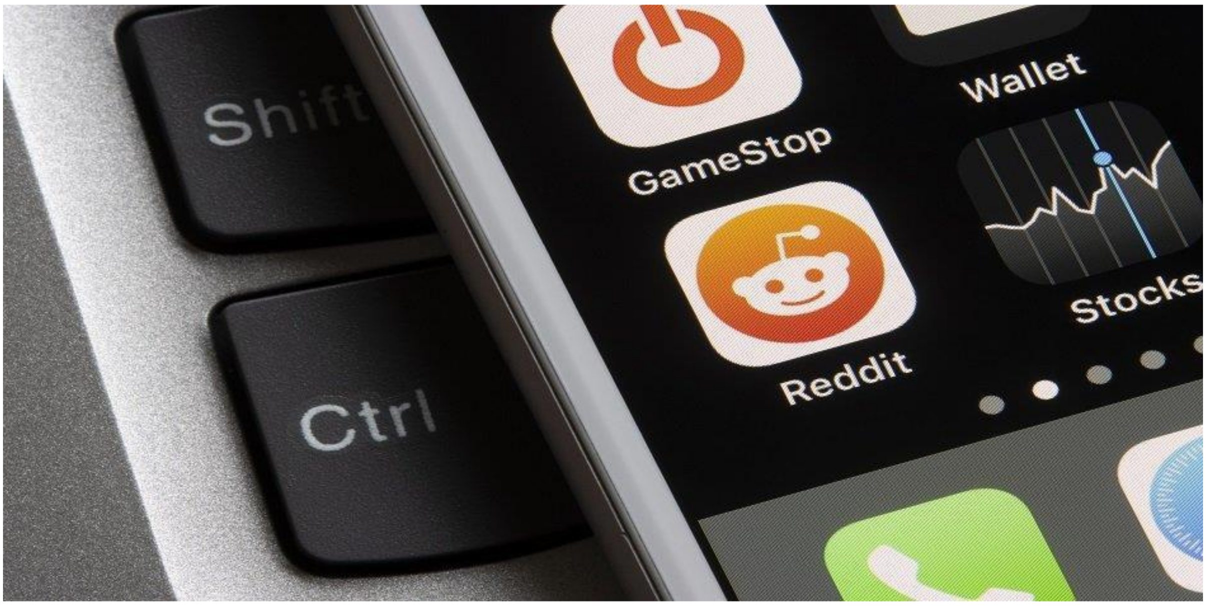
KEYSTONE



GameStop: The ethics of short sellers

THE WAR THAT HAS WAGED BETWEEN HEDGE FUNDS AND RETAIL INVESTORS OVER GAMESTOP HAS SHONE A LIGHT ON THE ETHICS OF SHORT SELLERS. BUT WHAT'S THE ISSUE AND IS IT FAIR?

The global media has recently been entranced by a battle between retail traders and hedge funds over the US computer game store, GameStop. It has also shone a light on a practice that makes many people feel uneasy: “short selling”. So much so that lots of members of the Reddit community which spearheaded the attack openly say they want to drive “short sellers” out of business. So, what is short selling, why does it attract such strong negative reactions, and is it a fair assessment?

SHORT SELLING EXPLAINED

In practical terms, short selling involves borrowing a stock from an investor then immediately selling it, in the hope that its price will fall and it can be bought back later at a cheaper price. A profit is realised based on the price decline (or a loss if the price rises). At that stage it is returned to the original shareholder, who receives a fee for their troubles.

The borrowing involved in this strategy introduces some additional risks (and costs) compared with traditional stock market investing. One implication is that positions tend to only be put in place for relatively short time horizons.

Another way to profit from declines is through derivatives known as futures, although these are more commonly used at the overall stock market level than for individual stocks. A so-called “short futures” position will deliver a return if a stock market falls and a loss if it rises.

On the face of it, an investment strategy specifically designed to gain in value when companies fall in value might not seem particularly responsible. Short selling is often associated with lurid headlines predicting corporate failure, market abuse and policymakers’ concerns that the practice undermines financial markets. However, a look past the headlines reveals a more complex reality.

While it undeniably has its more unsavoury side, short selling can also help manage risk more effectively and contribute to market efficiency. Its reputation is unfairly tarnished by the actions of a few cowboys.

There are no blanket answers to questions of the ethics of short selling. In our view, the pertinent question is less whether short selling is ethical and more how investors behave, whether in expectation of price rises or falls.

Short selling does not directly undermine the health of a company any more than buying its shares improves its fundamentals. Companies are not deprived of funds when investors sell shares nor do they become financially stronger when investors buy shares in public markets. Ethical questions arise when investors take additional steps to influence companies' financial health and value after they have bought or sold shares. To assess the ethics of short-selling, we therefore need to consider the actions of different short sellers rather than short selling as a principle. In general, those actions reflect their motivations, which can be broadly split into four categories:

STOCK PICKING ON STEROIDS

Traditional so-called long-only investors in the stock market try to identify undervalued stocks, in the expectation that their value will converge on some estimate of fair value. If they don't like a company they can hold less of it than the benchmark allocation (an underweight position) or not hold any at all.

The stock picker on steroids is no different but they search for overvalued stocks or stocks which are facing structural headwinds that are not yet fully reflected in the price. "Shorting" these companies is a more direct way to position for their anticipated fall in value towards more reasonable levels than would be possible in a long-only portfolio. This can either be done on a stand-alone basis or by taking a long position in (buying) those companies that are expected to do well and a short position in those that are expected to struggle. It's like the value style of investing but with extra bells on top.

Stock pickers on steroids also help to bring market prices into balance, so contribute to overall market efficiency. This beneficial impact is one reason why the index provider MSCI requires short selling be possible before it will consider a market for inclusion in its developed market benchmarks.

An area of emerging interest is funds with a sustainability focus which short stocks. Some investors prefer to exclude certain sectors from their portfolios such as tobacco stocks, oil and gas companies, and weapons manufacturers. However, a more extreme approach would be to take an outright short position in these sectors, or in companies with poor (or deteriorating) sustainability credentials more generally.

To manage risk, shares in companies or sectors with more favourable (or improving) characteristics could be bought. That would send a very strong signal to the management of the companies being shorted and would earn a profit if their share prices fell relative to those with better (or improving) credentials.

THE ACTIVIST SHORTER

The activist shorter takes a more extreme approach than the stock picker on steroids. Rather than assuming that the market will eventually price companies fairly, they seek to force the issue. They often try to maximise publicity on their reasons for believing a company is overvalued. By generating negative coverage they can force a company's share price down, which can affect the terms that a business can get from its creditors, which can push the company into further difficulty. On one level, this can be applauded. The forensic analysis conducted by some short sellers can unearth previously underappreciated issues (accounting irregularities are a common target, as was the case with the recent Wirecard scandal) and in making these public, they can force management to deal with them.

However, the more extreme activist shorters are the ones that give the practice a bad name. Some have been guilty of spreading unfounded and malicious rumours in the press, a consequence of which is that they can earn a profit on their trade but push otherwise healthy companies into financial difficulties. Even if these companies manage to prove the accusations false, the short seller may be long gone by that stage, having booked a profit on their trade and left a trail of devastation in their wake.

The concerns are parallel to investors buying long positions in shares before attempting to boost the value of their holdings by spreading dubious suggestions of coming positive news. This point is often underappreciated – there is nothing philosophically different between talking up a stock you have a stake in and talking down a stock you have a short position in. They are two sides of the same coin and neither is better or worse than the other, from an ethical standpoint.

Before investing in strategies which take a more activist approach to shorting, investors should ensure they understand the process and tactics that are likely to be employed and, to the extent it is possible, the integrity and ethics of the fund manager.

THE RISK MANAGER

These people use shorting to control risk in their portfolios and express their views on particular stocks in as pure a way as possible. Let's say an investor wants to express a positive view on a particular stock relative to the market. One way to do this would be to buy the stock. However, then, if the market falls, that stock could fall too. If it falls by less than the market the original thesis would be proven correct but that would have been somewhat irrelevant as it would have been swamped by the decline in the broader market.

One way to avoid this is to buy the stock while also taking out a short futures position on the market. Then the return would be the difference in return for the individual stock and the market. In our example above, the trade could yield a profit, even in a declining equity market. Shorting allows a cleaner expression of a view on a particular stock or sector while also reducing volatility and risk of loss. The approach does not affect the health of individual companies, is typically low profile and doesn't raise ethical concerns in our view.

THE EMOTIONALLY-DETACHED TREND FOLLOWER

The trend follower seeks to profit from trends in markets, buying when markets are rising and shorting when they are falling. CTAs (Commodity Trading Advisors, although the name is a misnomer as although they were once focused on commodities, they now cover a much wider range of asset classes and currencies) or managed futures are other names for these types of investment strategy.

These strategies are normally highly quantitative and systematic in nature, powered by powerful computer algorithms. Their emotionally detached nature means they cannot be accused of attempting to drive down prices. It is all about maths.

AN UNFAIR REPUTATION

In summary, short selling has an unfairly bad reputation. Rather than avoiding the practice, investors, especially those who are more ethically minded, should ensure they understand its potential uses in a strategy and how its practitioners intend to behave. It can bring about significant benefits, both to investment performance and standards of corporate governance. Some short sellers are unethical but short selling itself is not.

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