



Ruminations on Short Selling

Short selling is selling a security (typically a stock) one doesn't own in hopes of buying it back later at a lower price. It is just the reverse of the normal practice of buying first then selling (which is called being "long" the security). Because short sellers are predicting a price decline, and will profit if they are correct, they are much maligned. In times of market turmoil they are invariably blamed and frequently there are calls to ban or restrict short selling. This is unfortunate because short sellers serve a very important function.

First, it might be helpful to further describe exactly what short selling is. If a trader gets paid on the opening transaction he or she is short. If the trader pays on the opening transaction, he or she is long. There is a stigma with short selling, but it is done all the time. If a contractor wins a bid to build an office building, the contractor is then "short" bricks, drywall, labor, etc. He has sold all of those for a fixed price without actually owning them at the time she sells them.

Incorporating all known information into prices (including negative opinions) aids price discovery (this is the technical term for finding what the "real" price is). We shouldn't want prices high, we should want them right, and short sellers help reduce bubbles and volatility. In the long run prices will always approach their correct level; temporary imbalances because all opinions can't be expressed don't raise the long-term return on the investment.

It is understandable that when prices go down folks want someone to blame, and people with negative opinions who are selling are a convenient target, the theory being that the short sellers can drive the price down and then buy to cover their positions without those buys driving the price back up and removing the profits. Not only is that probably not possible to do, but notice that people don't get worked up about the reverse – buying to drive the prices "too high" and then selling at a profit, even though it is exactly the same thing. Knowingly disseminating false rumors (positive or negative) to move a stock is securities fraud regardless of whether the investor is long or short. Short sellers have a very tough time in the first place because stocks have an upward trend. This is one of the reasons we are biased against it as a strategy – there is a headwind. Further discouraging short sellers is the existence of uptick rules, the difficulty of locating shares to borrow, etc.

In my view structural difficulties should be eliminated if at all possible. For example, I don't see why you should have to locate shares to borrow to sell short. You should be able to create "synthetic" stock. If someone wants to be short and someone else desires to be long, there is no reason not to have a derivative transaction where they settle up later based on the value of the underlying without forcing them to actually locate it and borrow it as is required now. This does lead to two slight issues for the long side since the stock wouldn't actually be owned: dividends would not receive the qualified treatment for taxes, and there would be no voting rights. I envision these "synthetic" shares trading alongside the regular ones with small discounts because of those two detriments. Assuming adequate collateral requirements to protect the long side of the transaction, I imagine the spread would be very small.

Notes:

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