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The Wisdom of the Short-Sellers

By MARK HULBERT

SHORT sellers profit by finding stocks or other securities that will underperform the market. But how do the short-sellers accomplish this? A new study provides some answers.

Short-selling — borrowing shares and selling them, intending to buy them back later after the price declines — is a divisive issue. Traders who bet on the decline of a company, a currency or even an entire market aren't always popular. The billionaire investor George Soros was initially pilloried when he bet correctly in 1992 that the British pound would fall sharply.

James S. Chanos, a hedge fund manager, was a lone voice when he began betting against Enron in November 2000, long before the company collapsed; he now says he is betting against the entire Chinese market, a position that is unlikely to win him friends among investors if Chinese shares plunge.

Short-selling became particularly controversial during the recent bear market, when many of its practitioners turned a profit while almost all other investors were suffering. This fueled long-held concerns that short-sellers might be inducing the very price declines from which they profit. A series of regulations have been imposed in the last few years to restrict short-sellers' behavior.

These concerns are largely unfounded, however, according to the new study, titled "How Are Shorts Informed? Short Sellers, News and Information Processing." Its authors are Joseph E. Engelberg and Adam V. Reed, both finance professors at the University of North Carolina at Chapel Hill, and Matthew C. Ringgenberg, a Ph.D. student there. The study has been circulating since January as an academic working paper.

Their work suggests that the average short-seller has done well through astute research and analysis, not market manipulation.

The researchers analyzed a database containing all short sales involving stocks listed on the New York Stock Exchange from January 2005 to July 2007. The database showed the exact time and price at which each short sale was executed. That enabled the researchers to compare the timing of short sales with the publication of news articles about the companies whose stocks had been sold short.

They found that, in a vast majority of cases, short-sellers reacted to news articles when the rest of the market did. As a result, the ratio of short-sale volume in a given stock to overall trading volume remained virtually constant over a period beginning three weeks before the typical news article about that stock and lasting until three weeks after.

The researchers reached the same results when they focused only on articles that reported negative information about the stock's underlying company.

These results suggest that, for the most part, at least, "short-sellers do not uncover and trade on information before it becomes publicly available," the researchers wrote.

Furthermore, they found that in those cases when the timing of short-sellers' trades did deviate from the timing of other types of trades, more often than not the short-sellers reacted later rather than earlier. In an interview, Professor Reed said that these results show that "short-sellers are primarily reactive rather than proactive," and so it is "unfair to blame the average short-seller for engaging in so-called 'distort and short' schemes."

What, then, is the source of short-sellers' historical success? The researchers concluded that the most likely explanation was that short-sellers, compared with other kinds of traders, have a superior ability "to analyze publicly available information."

The researchers didn't try to determine the source of that ability, and could only speculate. One possible explanation, Professor Reed said, involves the many roadblocks that the marketplace places in the path of the short-seller — such as the cost and risk of borrowing shares, which is intrinsic to short-selling and in some respects makes it harder than simply buying shares for long-term investment.

"Since those barriers are formidable, traders are more likely to initiate a short sale only when a stock is totally overvalued," he said. "They therefore will appear to have more ability than other types of traders who, because they operate with fewer barriers, are less likely to 'look before they leap.' "

IN any case, Professor Reed added, more research is definitely needed.

One question, he said, is whether there was any major shift during the recent bear market in the timing of short-sellers' trades. (He added that he and his co-authors had no reason to believe that there was.) But until regulators release additional data on short sales, the best that researchers can do is extrapolate from what happened from January 2005 to mid-2007.

And Professor Reed said it remains to be seen how short sellers' behavior will be changed by regulations like the modified version of the so-called uptick rule, adopted in February by the Securities and Exchange Commission. Under that rule once a stock has fallen by 10 percent in a trading session, it can be sold short only if its most recent price is higher than its previous one.

But for now the study shows that extra effort spent in analyzing a company can pay handsome rewards. And you needn't be a short-seller to do that.

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